

Public Concern about Inflation and Unemployment in the United States: Trends, Correlates and Political Implications*

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I think Dick's going to be elected President but I think he's going to be a one-term president. I think he's really going to fight inflation, and that will kill him politically.
—Dwight D. Eisenhower, 1968

1. The Economy as a Public Issue¹⁾

Although former President Eisenhower's forecast turned out to be wrong, numerous empirical studies show that macroeconomic performance has an important impact on mass political support for elected officials. Moreover, during recent years economic issues (principally inflation, energy and unemployment) have overshadowed other problem areas as sources of public concern. Indeed, not since the Great Depression of the 1930s and the immediate post World War II reconversion scare has the state of the economy occupied such a salient place on the public agenda. As the Gallup Poll time-series data in Figure 1 show, in every year since the American withdrawal from Vietnam was completed more than 70 percent of the public identified an economic issue as "the most important problem facing the country today."

In view of macroeconomic developments during the last decade this comes as no surprise. The tight labor markets accompanying the Vietnam war boom and the Johnson administration's attempt to obscure the war's true cost through a policy of hidden deficit finance

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1) This section updates the introductory part of Hibbs, 1979.

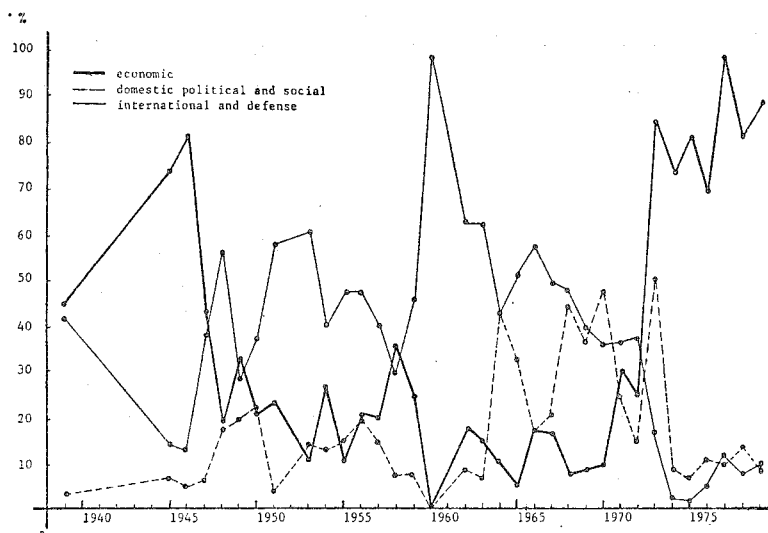


Fig. 1: Aggregate Responses to the Question "What is the Most Important Problem Facing This Country Today?"—United States, 1939-79.

Source: George Gallup, *The Gallup Poll, Public Opinion: 1932-1971*, Vol. I-III, Random House (New York, 1972) and American Institute For Public Opinion, *The Gallup Opinion Index*, various issues.

(abandoned too late with the 1968 tax surcharge) left the incoming Nixon administration facing accelerating prices. The new Republican administration pursued a deflationary macroeconomic policy to check the inflation. The high employment budget surplus grew by about 20 billion (constant 1972) dollars in 1969 and showed an average constant dollar level of more than 5 billion for 1969-70.²⁾ Dr. Arthur Burns—Nixon's appointee as Chairman of the Federal Reserve—accommodated the administration's fiscal policy, and the real money supply (deflated M2) increased by only 0.76 percent in 1969 and decreased by nearly 2 percent in 1970.³⁾ The policy worked helping produce the 1970-71 recession and reducing the consumer prices inflation rate by more than 1.5 percentage points between early 1970 and mid-1971.

By late 1971 wage and price controls were imposed and the policy of fiscal and monetary restraint was jettisoned in a successful attempt to stimulate an election year boom.⁴⁾ In

2) The budget figures are based on the Federal Reserve Bank of St. Louis' high employment surplus/deficit series. The real series are nominal data divided by the GNP deflator with a 1972 base year.

3) "New" M2 deflated by the CPI.

4) For a detailed empirical analysis of the "electoral business cycle" in general and the 1972 experience in particular, see Tufte, 1978.

1972 the real high employment deficit was increased by more than 8 billion dollars and real M2 grew by 8.5 percent. However, new crises soon rocked the economy. This time the shocks were exogenous: dramatic increases in the world prices of food and raw materials in 1972-73 and the OPEC-induced quadrupling of the price of petroleum in late 1973 contributed to unprecedented double digit rates of inflation throughout 1974. The Ford administration responded by launching the "Whip Inflation Now" media campaign and, more tangibly, by cutting back sharply the high employment budget deficit, which in 1974 was reduced by about 9 billion (1972) dollars from the average of the preceding two years. Dr. Burns again accommodated the fiscal authority's policy of restraint proclaiming that the shortage was "of oil not money," and real M2 declined by a crushing 4.5 percent during 1974.

The consequence was the most severe recession in postwar U.S. history. Unemployment stood at nearly 9 percent by the middle of 1975. Consumer price inflation declined from the double digit rates of 1974 to the 5 to 6 percent per annum range in 1976.

The severity of the recession prompted the Ford administration to pursue expansionary policies in late 1975 and 1976, but the President apparently remained committed to his earlier priorities declaring to a cheering Wall Street audience during the campaign that "after all, unemployment affects only 8 percent of the people while inflation affects 100 percent."

These priorities were reversed during the first years of the Carter administration, which emphasized the traditional liberal Democratic goal of moving the economy toward full employment. Real M2 increased at the brisk 5.9 percent rate during 1977 and the high employment budget deficit continued to rise peaking at 29 billion (1972) dollars in 1977:4 after Congress in May 1977 passed the tax cuts proposed by the administration to stimulate the economy. Fueled by these policy actions and no doubt also by the economy's endogenous recuperative capability, the rate of unemployment declined continuously, falling by about 2 percentage points between the end of 1976 and the beginning of 1979.

However, the cost was a steady acceleration of prices. The annualized rate of change of consumer prices increased from less than 5 percent in 1976:4 to more than 8.5 percent in 1978:4. Following the second great OPEC shock of 1979, which more than doubled the price of petroleum, consumer prices continued to accelerate sharply and inflation was running at more than 13 percent per year by the first quarter of 1980.

The escalation of inflation to politically (and economically?) hazardous rates produced

a dramatic policy reversal in late 1978 that continued through 1979 and into the election year. The administration implicitly acknowledged that the voluntary wage-price guidelines plan announced on October 24, 1978 was unlikely alone to decelerate prices significantly and the earlier commitment to achieving a sustained low rate of unemployment was for practical purposes abandoned. The high employment budget deficit was reduced by 9 billion (1972) dollars in 1978 and by more than 11 billion (1972) dollars in 1979 and averaged a comparatively modest 4-5 billion during late 1979 and early 1980—the smallest high employment deficits since 1974. On two occasions, November 1, 1978 and October 6, 1979, the discount rate was increased by a full percentage point and, perhaps more important, real M2 declined in every quarter after 1978:3. The 1979/78 year on year decline was over 2 percent, and during the first half of 1980 the annualized rate of decline was more than 5 percent.

The macroeconomic history of the Carter administration looks like a “political business cycle” run backward: rising inflation, falling unemployment and a favorable real income growth rate during the first twenty-four to thirty-six months of the administration were followed by negative growth rates, sharply increased unemployment, and, during the most recent quarter, decelerating prices as the election approached. Although the OPEC shock of 1979 was obviously beyond the administration’s control, this is nonetheless somewhat ironic because William Nordhaus, an economist who wrote a seminal paper on electorally motivated macroeconomic policy cycles (1975), served on the President’s Council of Economic Advisors during 1977-78. In any case recent events suggest that the assumption of political business cycle models that an expansionary policy is the politically optimal election year strategy is erroneous during periods of high and rising inflation. I return to this point ahead.

2. Public Concern about Inflation and Unemployment

The Gallup data in Figure 1 were organized in a way that show the “economy” has become the dominant public issue in recent years, but inflation, unemployment and to a lesser degree energy (except in 1974 and possibly 1979)⁵⁾ are the variables preoccupying both policymakers and the mass public. Unfortunately, the Gallup data chronically confuse the “high cost of living” with “rising prices,” that is, the price level and standards of

5) See *Public Opinion*, December/January 1980, p. 40.

living with the inflation rate, and therefore the Gallup series cannot be used to assess unambiguously public concern about employment and inflation.⁶⁾

However, at intermittent periods between 1971:3 and 1974:4 and once every quarter thereafter surveys undertaken by the Survey Research Center at the University of Michigan have asked national samples of American households "which of two problems— inflation or unemployment—do you think will cause the more serious economic hardship for people [may have the more serious consequences for the country] during the next year or so?"⁷⁾ These questions encourage people to acknowledge (implicitly) the difficult choice that has been at the heart of recent macroeconomic policy debates and best available time series evidence on the public's relative concern about inflation and unemployment during the critical 1971–80 period.

Figure 2 shows the aggregate responses to the Michigan inflation/unemployment question along with the actual rates of inflation, unemployment and growth of per capita real personal disposable income in the macroeconomy. Nothing in neoclassical economic theory adequately explains the high levels of public concern about inflation revealed by the data in Figure 2A. The principal economic cost of anticipated inflation are the resources devoted to economizing cash balances and fixed-interest rate assets. However, this is likely to be a trivial matter when viewed in relation to the costs of unemployment (but see Feldstein, 1979).

6) Many people apparently do not differentiate between high and rising prices and use the terms interchangeably when responding to open-ended survey questions (see Kiewiet, 1980). The Michigan survey questions described ahead refer explicitly to inflation and therefore are less likely to confuse respondents.

7) The alternative wording in brackets was used in the 1971:3, 1971:4, and 1972:1 surveys.

Notice that the question refers to "people" generally (or to the "country") and not to the respondent *personally*. Question pertaining to *personal* economic concerns invariably yield more mentions of inflation and fewer mentions of unemployment than questions pertaining to respondents' assessment of *national* economic problems.

For example, in February, 1980 the Harris survey asked a national cross section: "If you had to choose, which do you think is a more serious problem

(1) for you and your family today—

(2) for the country today—

rising prices or high unemployment?"

	Rising Prices	High Unemployment	Both
(1) problem for you and your family	82%	10%	7%
(2) problem for the country	46%	44%	17%

The Harris Survey, March 20, 1978.

Research shows that *national* economic concerns have far greater influence on political behavior than *personal* economic concerns (see, for example, Kiewiet, 1980 and Kinder and Kiewiet, 1979) and, therefore, the former are more useful for my purposes.

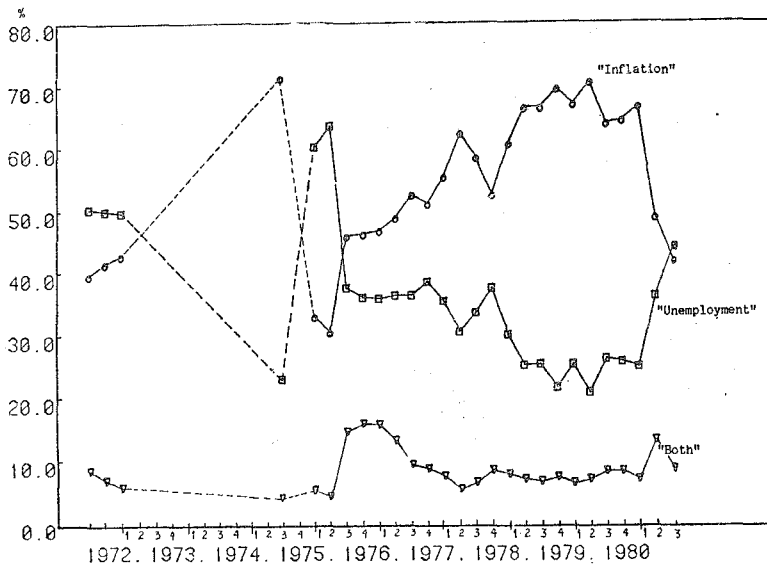


Fig. 2A: Public Concern about Inflation and Unemployment (See text for question wording)

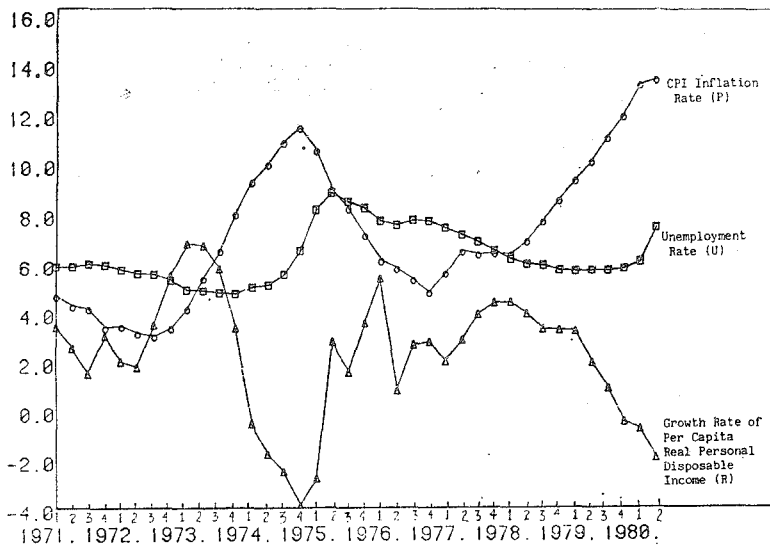


Fig. 2B: Macroeconomic Outcomes

Note: Opinion data through 1980:2. macroeconomic data are through 1980:2.

The menu of costs associated with unanticipated inflation is longer and more interesting, but in my view it does not provide a convincing explanation of the public's aversion to rising prices. The existing empirical evidence suggests that the aggregate wage and salary income share is not eroded by inflation (Bach and Stephenson, 1974) and that rising prices have no dramatic effects on the size distribution of income (Blinder and Esaki, 1978). Unanticipated price increases do, of course, arbitrarily redistribute wealth from

nominal creditors to nominal debtors, and the aggregate amounts involved are probably large. But at the micro-level a great deal of "cancelling" must also take place. People lose on some accounts (fixed price assets) and gain on others (fixed price liabilities). Empirical work suggests that the rich (and perhaps the very poor) are net losers (Minarik, 1979; Palmer and Barth, 1978), which is consistent with public opinion data showing that high income households are more concerned about inflation than low and middle income households (Hibbs, 1975).

One of the major inflation-induced wealth redistributions is intergenerational: from the old and retired, who are likely to be net creditors, to the young and economically active, who are likely to be net debtors (Bach and Stephenson, 1974; Palmer and Barth, 1978). Surprisingly, however, microanalysis of the Michigan public opinion data shows that retirees were less concerned about inflation (more concerned about unemployment) than the young (Hibbs, 1979). Perhaps this is true because retirees in surveys taken in the 1970s were old enough to have experienced the Great Depression and the event was traumatic enough to counteract their current economic self-interest. In theory, the aged poor—retirees whose welfare depends on social security—are perhaps the most exposed to inflation. Since 1974, however, social security has been indexed to inflation, thus limiting the adverse effects of rising prices on the aged poor.

To the extent that state revenue is raised by direct taxation based on progressive nominal schedules, inflation increases the effective rate of income taxation (inflationary fiscal drag) unless the authorities take compensatory action. Although discretionary tax cuts have neutralized much of the potential gross transfer to the state,⁸⁾ it probably is true that inflation has made possible a growth of government revenue higher than politicians could have achieved by making explicit real claims on the electorate. The (unobserved) difference between the historical time path of effective tax rates and what would have occurred in a world of stable prices (or indexed taxes) may explain some of the public's concern about inflation.

However, neither the income, wealth, nor tax effects of inflation appear large enough to explain widespread public aversion to rising prices, and therefore less tangible and partly psychological factors are probably more important than easily identified objective costs. As Okun has argued, sustained high rates of inflation may undermine "the foundations of habit and custom" forcing people "to compile more inflation and to try to predict the

8) See Sunley and Peckman, 1976, on the stability of federal tax rates.

future—costly and risky activities that they are poorly qualified to execute and bound to view with anxiety” (Okun, 1975, p. 383). Empirical evidence does indicate that high rates of inflation are associated with high variability of the inflation rate, and that these quantities are correlated with variations in relative prices and with the variance of inflationary expectations (Cukierman and Wachtel, 1979; Klein, 1976; Parks, 1978; Vining and Elwertowski, 1976). Presumably this heightens uncertainty about the future stream of prices and leads to greater incidence of unanticipated inflation.

It is also possible that people fail to credit inflation-induced windfall gains, for example on fixed interest liabilities such as home mortgages, against the losses incurred on such money-valued assets as pension and life insurance reserves. Perhaps more important, the connection between rising wages and rising prices may not be well understood by the mass public. Although there is no solid empirical evidence supporting this conjecture, it is possible that inflation tends to be viewed as an arbitrary tax that chips away the purchasing power of nominal income increases which people believe they deserve to enjoy fully. For example, between 1975:4 and 1976:4 nominal personal disposable income per person rose by about 7.5 percent, but prices increased by about 4.9 percent leaving a more modest 2.6 percent real gain. Perhaps some people entertained the mistaken idea that their standard of living could have risen by 7.5 percent, or nearly so, if it were not for the “evil” of inflation.

Since 1973 the most important factor contributing to popular concern about inflation has probably been the decline in real income experienced by the consumers of food, raw materials, and especially petroleum as a result of the shift in the terms of trade in favor of the producers of these commodities. It is likely that many people blamed rising prices for the shrinkage of their real income, even though the immediate post-OPEC inflationary burst was to a large extent merely the mechanism of a change in relative prices. In 1974, for example, per capita real personal disposable income declined by almost 4 percent, inflation was running at double digit levels and nearly three-quarters of the public considered inflation a more serious problem than unemployment. Inflation, however, was hardly the root cause of the erosion of real income. Had the real loss absorbed by the oil consuming nations taken place about a stable price level, the pain would not have been any less unpleasant, but inflation could not have been held responsible. However, if people were confused it is understandable: as James Tobin (1976) has pointed out, neither President Ford, nor his economic advisors, nor the Federal Reserve Authorities, and very

few outside economists told the public that anti-inflationary policies could not restore the former terms of trade or the real income loss.

It is no mystery why people are concerned about high and rising unemployment rates—after all, unemployment is a real quantity representing lost real output and underutilized human resources. Remember too that the measured unemployment rate is just that—a rate—and a far larger fraction of the labor force experiences bouts of actual unemployment during any given time interval than the average percentage numbers might suggest. In a 12 month period the fraction is likely to be about three times the average “official” rate. Moreover, in addition to households touched directly by some form of unemployment or underemployment, and even larger number will be aware of unemployment among relatives, friends, neighbors and, of course, workmates.

Viewed in this light it is perhaps puzzling that the public is so concerned about inflation. Indeed in the Michigan data people who were actually unemployed at the time of the interviews often expressed *less* concern about unemployment than some (employed) blue-collar groups (see Hibbs, 1979). This implies that for many individuals fear of future unemployment, the memory of past unemployment or the aggregate social costs of unemployment are more powerful influences than the pain of contemporaneous personal experience. One of the reasons must be that unemployment no longer poses an economic disaster for many of those affected directly.⁹⁾ In the 1930s the unemployed often went hungry. Today public transfers to the unemployed provide a significant cushion against the economic pain and most suffer temporary reductions in income.¹⁰⁾ In other words, as Feldstein (1978) has emphasized, the private costs of unemployment are much lower now than in the past.

Turning again to the aggregate survey and economic data in Figures 2A and 2B, it is obvious that that the public's relative concern about inflation responds to the prevailing macroeconomic situation. In late 1971 and early 1972 as the recession was coming to an end, the conjunction of comparatively low and falling inflation rates and modest real income growth rates produced popular majorities more concerned about unemployment than inflation. However, by the summer of 1974 inflation was raging at more than 10 percent per annum, real income was falling by more than 2.5 percent on an annual basis and

9) For a broader view of the strain and personal dissatisfaction produced by unemployment experience see Schlozman and Verba, 1979.

10) Gramlich, 1974 provides estimates of unemployment-induced earnings losses of various demographic groups.

almost three-quarters of the public viewed inflation as the more serious economic problem.

The situation was reversed six months later. The inflation rate was falling sharply, unemployment increased to its highest level since the Great Depression and only one person out of every three expressed greater concern about inflation than unemployment. As the economy moved from severe recession into stagflation in late 1975 and 1976, popular concern about inflation increased sharply and hovered about the 50 percent mark for the next eighteen months.

During the first year of the Carter administration unemployment fell dramatically, the annualized inflation rate increased to about 6.5 percent, and public concern about inflation drifted upward averaging 58 percent for the year. Over the next eight quarters unemployment stabilized at just under 6 percent, and beginning in 1978:1 consumer prices *accelerated in every* subsequent quarter until the third quarter of 1980. Predictably the public's relative concern about inflation shot upward. During 1978 and 1979 only about one person in four was more concerned about unemployment than inflation, and two-thirds or more of the public typically identified inflation as the more serious economic problem. The situation changed with the onset of the current recession. The unemployment rate rose sharply between 1980:1 and 1980:2, and during the third quarter the inflation rate declined from its mid-year peak. Consequently, by 1980:3 the fractions of the electorate viewing unemployment and inflation as the more serious problem were about the same—about 45 percent.

Regressing the percentages of the public more concerned about inflation than unemployment on the actual rates of inflation, unemployment and real income growth yields more systematic information about the response of public opinion to macroeconomic developments. Such statistical analyses support the following conclusions.¹¹⁾

11) The conclusions are based on the following regression results from available data over the period 1971:3-1980:2:

$$Y_t = 38.6 - 9.03(U_t - U_{t-1}) + 1.32P_t + 11.2(P_t - P_{t-1}) + 2.11R_t - 0.45(P_t \cdot R_t^*)$$

$$(4.7) (4.0) \quad (0.50) \quad (1.62) \quad (0.90) \quad (0.23)$$

$$R^2 = 0.87, \quad DW(2) = 1.52, \quad SER = 4.83$$

where: Y=percentage of the public more concerned about inflation (graphed in Figure 2A);

P=rate of inflation of consumer prices;

U=rate of unemployment;

R=growth rate of per capita real personal disposable income (nominal income deflated by the personal consumption deflator);

$R^* = R$ if $R < 0$

= 0 otherwise;

and all rates of change are formed $\ln(X_t/X_{t-4}) \cdot 100$. The aggregate results above and the discussion in the main text are broadly consistent with the nonlinear, disaggregated analyses reported in Hibbs, 1979.

(1) Relative concern about the problem of inflation is quite insensitive to variations in the prevailing *level* of the unemployment rate. Indeed, if real income per capita is growing at the usual rate (2.5 percent per year; the 1970–80 average), then at any *stable* unemployment rate within the range experienced during the last decade a solid majority of the public is likely to be more concerned about inflation than unemployment *if* the rate of inflation runs higher than 5.0–6.0 percent per annum.

(2) However, changes in the unemployment rate are associated with sizeable movements in the opinion distribution. Each percentage point increase in the rate of unemployment produces a decline of about 9 percentage points in public concern about inflation. Great fluctuations in the public's view of inflation and unemployment are therefore associated with movements of the economy into and out of recessions.

(3) As indicated in (1) above, public opinion does appear to be sensitive to the inflation rate level. Each percentage point of inflation adds about 1.3 points to the percentage of the public believing inflation to be a more serious problem than unemployment. Since this effect was estimated in the presence of the per capita real disposable income growth rate (see below), it implies that people find rising prices distasteful even when money income adjusts fully to cost of living increases.

Public sensitivity to the inflation rate is even greater when rising prices are accompanied by declining per capita real disposable personal income. In these circumstances (prices rising, real income falling) each percentage point of inflation adds about 1.3 plus 0.45 times the rate at which real income is decreasing to the percentage of the public more concerned about inflation than unemployment.¹²⁾

(4) Changes in the inflation rate (accelerations and decelerations of prices) have more dramatic effects on public opinion than the inflation level. A 1 percent increase of the inflation rate typically yields a transitory upward movement of about 11 percentage points to public concern about inflation. Since the best autoregressive predictor of this quarter's inflation rate are the inflation rates one and two quarters ago, this result may partly

12) This estimate is based on limited experience and therefore should be interpreted cautiously.

Surprisingly, in all statistical analyses the consumer prices inflation rate performed better than the inflation rate of the personal consumption deflator, even though the latter probably has measured the actual inflation experience of consumers more accurately in recent periods. This implies either that people use a "fixed basket/fixed weight" standard in developing opinions about the relative importance of the inflation issue or, more likely, that opinions are to some extent affected by the media, since media coverage focuses heavily on movements of the consumer price index.

reflect the public's aversion to *unanticipated* movements in prices.¹³⁾

(5) Aside from the consequences of the (unusual) conjunction of high inflation and falling real income, the growth rate of real income alone typically has a positive association with popular concern about inflation. When real income is rising each percentage point of the growth rate adds approximately two points to the percentage of the public more concerned about inflation than unemployment. When real income is declining the public's relative concern about inflation changes on the margin by 2.0 times the marginal income change minus 0.45 times the inflation rate.

These results suggest that recession rather than inflation typically is viewed as the more important threat to living standards and, therefore, when real income is increasing at a brisk pace the public's attention turns away from the unemployment issue toward the problem of inflation. Conversely, declining real income generally increases public concern about the unemployment issue.

3. Political Implications

If one believes, as I do, that economic policy is responsive to and constrained by public views of economic developments, then the public opinion data discussed earlier help illuminate the political environment facing macroeconomic policy officials. More direct evidence on the political implications of macroeconomic outcomes, however, is available from econometric models of how economic conditions affect mass political support for the President.

Figure 3 shows the elasticities of political support with respect to real and nominal macroeconomic performance for every President since Kennedy.¹⁴⁾ (The political support index is the percentage of the public responding "approve" to the well-known Gallup Poll question, "Do you approve or disapprove of the way (the incumbent) is handling his job as President?") The elasticities give the long-run proportional changes in political support expected from unit proportional changes in the economic performance variables that are sustained indefinitely. (Practically speaking, "indefinitely" means five to six years.)

13) Cf. the earlier discussion. Over the period 1971:1-1980:2 the best autoregressive equation for the CPI inflation rate is

$$P_t = 0.51 + 1.77P_{t-1} - 0.84P_{t-2}$$

(0.23)(0.11) (0.11)

$$R^2 = 0.97, \quad DW = 2.05, \quad SER = 0.51$$

$$\text{where } P_t = \ln(CPI_t / CPI_{t-4}) \cdot 100.$$

14) The results in Figures 3 and 4 are based on Hibbs, 1980.

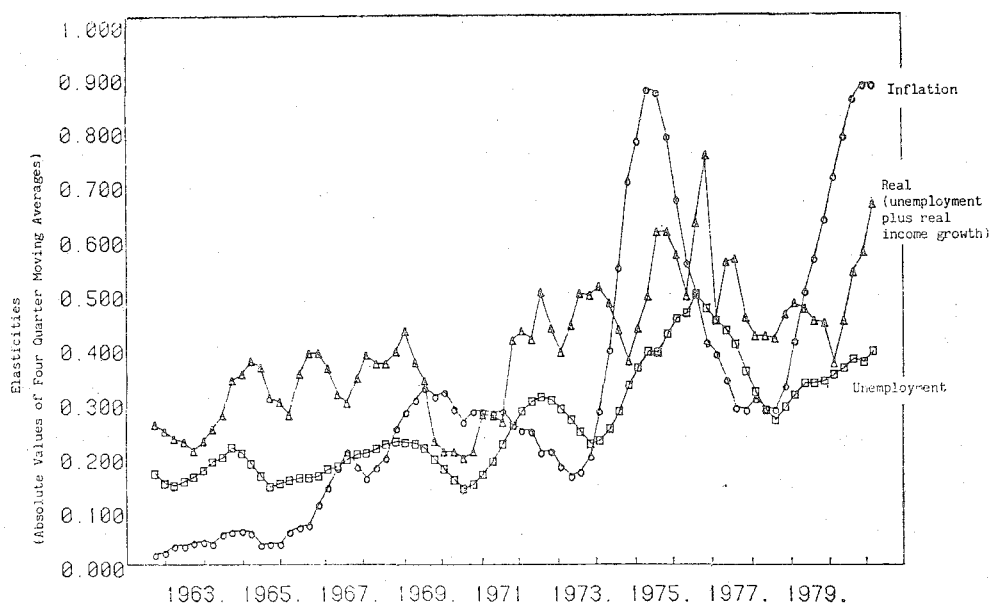


Fig. 3: Implied Long-Run Elasticities of Political Support with Respect to Nominal and Real Macroeconomic Outcomes

The elasticities implicitly reveal the public's marginal, proportional aversion to various economic outcomes. So that persistent developments are not obscured by short-run realizations of the variables, the time plots show four-quarter moving averages of the long-run elasticities implied at each period. For convenience Figure 3 displays absolute values of the moving averages, though, of course, the underlying unemployment and inflation parameters are negative and the real income growth rate parameter is positive. Notice also that the "real" elasticities are the sum of the absolute values of the unemployment real income growth rate elasticities.

Several patterns are apparent from the data in Figure 3. First, the elasticities increase, typically quite dramatically, from the 1960s to the 1970s. For example, if the real variables (unemployment and the per capita real income growth rate) had changed simultaneously in a perverse direction by a factor of 1 percent in the 1960s, on average the expected long-run proportional decline in support for the President would have been on the order of 0.3 of a percentage point (the real elasticity mean for 1960-1969). During the 1970s the expected long-run proportional decline in the President's support from the same sustained movement in the real macroeconomy would have been on the order of 0.55 of a percentage point (the real elasticity mean for 1970-79). As the figure indicates, the upward increase of the nominal inflation elasticities over time is even greater; the mean over

1960-69 is 0.14 as compared to a mean of 0.46 for 1970-79. These results are hardly surprising in view of the favorable economic conditions in the 1960s—virtually a “golden age” of economic performance—and the “stagflation” characteristic of more recent years.

Second, on the margin, popular support for the President has been relatively more sensitive to nominal, inflation economic performance than to real economic performance in the 1970s than it was in the previous decade. In the 1960s the mean of the real elasticities was about twice the mean of the inflation elasticities (0.3 vs. 0.14); in the 1970s the average real and nominal elasticities were both in the vicinity of one-half. By the second quarter of 1980 the relative impact of inflation on political support had increased enormously. For the most recent four quarters of President Carter’s administration (1973:3-1980:2) the mean of the real elasticities is about 0.66—somewhat higher than the average for the previous decade. However, the corresponding mean of the inflation elasticities is 0.88—higher than at any period (including 1974) in the preceding twenty years.¹⁵⁾ From a political as well as an economic point of view, then, the Carter administration’s policy reversal in late 1978 comes as no surprise.

However, the policy change came late—probably too late to reverse the upward trajectory of inflation by a margin great enough to influence decisively the President’s standing with the public by the end of this year. Indeed, President Carter’s electoral fortunes probably hinge more on the course of events in Iran and Afghanistan than on any economic adjustments the administration is capable of engineering during the next few months using policies favored by most professional economists.

As has been typical in the past of sharply focused international crises involving the United States, the seizure of American hostages in Teheran and the Soviet Union’s incursion into Afghanistan aroused considerable “rally-round-the-President” sentiment giving a sizeable boost to the Carter’s approval rating in the polls. Consequently, the President almost surely was saved from suffering further erosion of his domestic political support, which in the face of accelerating price increases and falling real disposable income had declined by the 3rd quarter of 1979 to a level not seen since the Watergate scandal. The results in Figure 4 (which are derived from the model in Hibbs, 1980) yield estimates of

15) Since the elasticities are a nonlinear function of all variables driving political support (see the model in Hibbs, 1980), they do not necessarily track closely their associated economic variables. As it turns out the inflation and real income growth rate elasticities have high shared variation with the rate of inflation and real income growth respectively (the r^2 s through 1980:1 are 0.91 and 0.86), whereas the shared variation between the unemployment elasticity and the unemployment rate is a more modest ($r^2=0.41$).

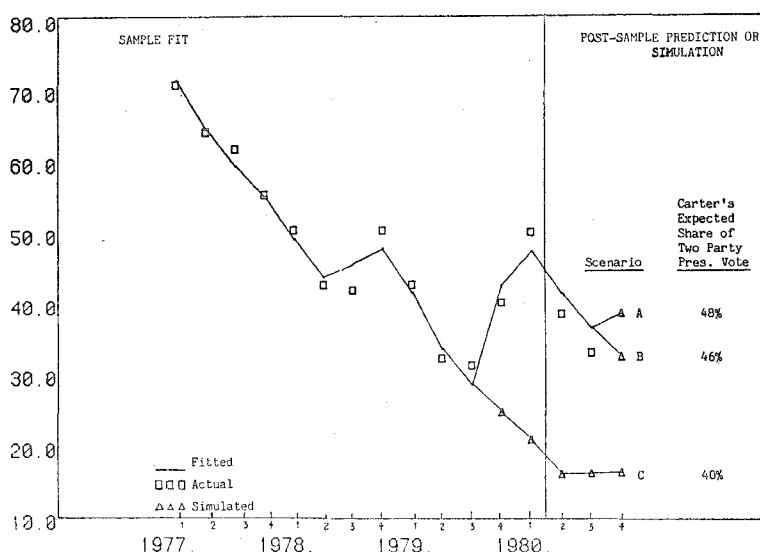


Fig. 4: Public Approval of President Carter's Performance(Gallup Poll)

Scenario A: International crises continue at current level (1 rally event per quarter 1980:3-1980:4).

Scenario B: International crises resolved by 1980:4 (No rally event in 1980:4)

Scenario C: Counterfactual: No Iran or Afghanistan crises.

just how much the events in Iran have contributed to the surge in political support for President Carter.

The figure shows quarterly averages of the President's actual approval ratings in the Gallup poll in relation to the ratings "fitted" by the model during the sample estimation period (1977:1-1978:4) and predicted by the model for post-sample periods (1979:1-1980:3). The time paths of poll ratings traced out by the triangles on the right side of the figure depict simulations of the model made under varying assumptions about the course of international events. In every simulation economic performance for 1980:3-80:4 is assumed to follow the latest forecasts of the Data Resources econometric model.

Scenario C is a counterfactual simulation. Beginning at the end of 1979, it depicts what *would* have been the likely time path of the President's approval ratings if the events in Iran and Afghanistan had never occurred. The difference between the actual and simulated approval ratings in 1979:4 yields an estimate of the initial boost to the President's support caused by the events following the seizure of American hostages in Teheran: the data indicate that the crisis raised President Carter's quarterly average poll rating more than 15 percentage points. Moreover, given projected economic performance this simulation indicates that by the end of 1980 the President's approval rating would

have fallen to less than 17 percent—the lowest level ever recorded by the Gallup Poll.

Scenarios A and B illustrate predictions for 1980:4 starting from the present situation (1980:3). Scenario A assumes that the intensity of the crises over Iran and Afghanistan is sustained at the present level throughout 1980:4. Despite poor economic performance the President's popularity rises slightly reaching 39 percent by the end of the year. Scenario B makes the assumption that the international crises are resolved, that is that there are no new crisis events during 1980:4. As a result the President's approval rating stands no higher than 32-33 percent at the election quarter.

What implications do these simulations have for the presidential election outcome? Based on the past relationship between pre-election Gallup poll approval ratings and the *two-party* vote shares received by incumbents running for a second term, one would predict President Carter getting about 48 percent of the two-party vote in scenario A, 46 percent in scenario B, and only 40 percent in the counterfactual scenario C.¹⁶⁾ In other words, without any boost from Iran and Afghanistan during the last year Carter would almost surely be a loser, but in view of the actual history of international developments much will depend upon the impact of Anderson's candidacy, the quality of Reagan's campaign, and international events in the next few months. If international tensions subside altogether during the election quarter, it is likely that poor economic performance will ensure a Reagan victory, unless Mr. Reagan manages to defeat himself.

4. Politically Feasible Policies

It is not surprising that President Carter is in deep political trouble because of high and rising inflation rates. Since the late 1960s solid pluralities (more recently majorities) of the public have identified "Government" as opposed to "Business" or "Labor" as the institution most responsible for inflation (see Figure 5), and great majorities regularly agree that the federal government "spending more money than it takes in" and "printing money with nothing to back it up" are "extremely important" particular causes of

16) These predictions are based on the equation

$$V = 33.9 + 0.37GP,$$

where: V = the share of the major party vote received

by an incumbent president running for a second term; and

GP = the President's Gallup Poll approval rating prior to the election.

The equation shows that Gallup approval ratings exhibit wider swings than presidential voting outcomes: people find it easier to approve or disapprove of a president's performance than to give or to deny him their vote.

inflation. (For example, the percentages of the public agreeing that government spending and money creation are extremely important causes were 79 and 74 respectively in the April 1980 New York Times/CBS News Poll.) On this score the public is in general agreement with the economics profession's diagnosis of the proximate sources of inflation. Today few economists dissent from Milton Friedman's assertion that the *proximate* cause of inflation "is always and everywhere a monetary phenomenon resulting from and accompanied by a rise in the quantity of money relative to output" (Friedman, 1966). As the public opinion data seems implicitly to acknowledge, the most important indicator of fiscal pressure on the money supply and therefore on the inflation rate is the size of the budget deficit.

The anti-inflation policy favored by the vast majority of economists is straightforward: contract the supply of money and credit thereby raising interest rates and unemployment and reducing the rate of growth, that is, induce a recession to reverse price acceleration. Here the public and the economics profession part company. Sizeable majorities in the opinion surveys repeatedly oppose letting interest rates and unemployment rise to fight inflation,¹⁷⁾ preferring instead, as the data in Figure 6 suggest, a policy of wage and price

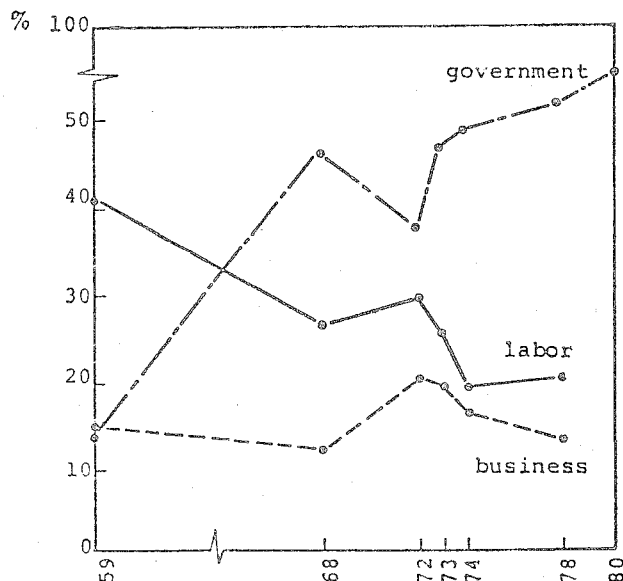


Fig. 5: Responses to the Question: "Which is the most responsible for inflation—government, business or Labor?" Source: Gallup Polls and 1980 NYT/CBS Poll

17) For example, in April 1980 New York Times/CBS News Poll 69 percent of the public opposed "letting unemployment rise to try to fight inflation" (34 percent were in favor) and in the January 1980 poll 56 percent opposed "letting interest rates go up."

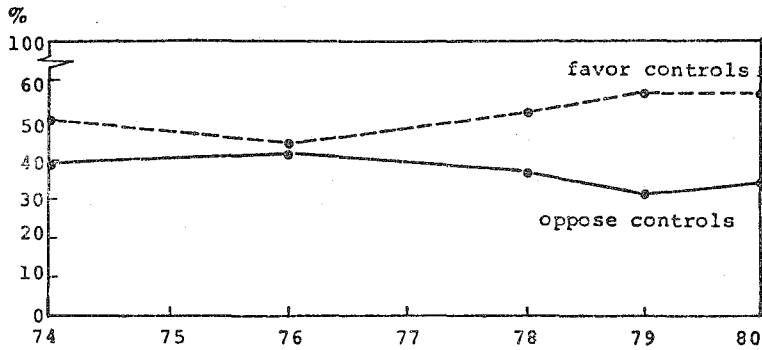


Fig. 6: Responses to the Question: "Would you favor or oppose having the government bring back wage and price controls?"

Source: Gallup Poll

controls. Indeed, there is solid popular support for controls even if the policy means a reduction in real wages.

Fifty-one percent of the respondents in the April 1980 New York Times/CBS News Poll were willing to accept government limitations on their wage increases "to a rate considerably lower than the present rate of inflation" (39 percent were "not willing"), and the 1978 Harris Poll found 68 percent of the respondents willing to accept a "pay rise less than the cost of living" if there were "some assurance" that it would contribute to bringing inflation under control.

With the exception of unorthodox thinkers such as Galbraith, Lekachman and Heilbroner, economists generally oppose wage-price controls on the grounds that they introduce distortions and inefficiencies in labor and product markets and confer no long-run benefits in the form of reduced inflation. (See the econometric evidence on the 1971-73 experience in, for example, Gordon, 1975, 1977.) Yet the pain associated with the economists' policy of deflation via recession will be enormous. By Hall's (1979) reading of the econometric evidence, the year on year underlying (wage) inflation rate falls by one-half percentage point for every percentage point that the actual unemployment rate stands above the "natural" rate. Hall judges the "natural" rate to be a staggering 6.8 percent, which given an underlying inflation rate currently in the vicinity of 10 percent per annum implies that it would take about ten years of 8.8 percent unemployment to restore price stability. By Okun's law this would mean a real GNP loss (gap) of about 5 percent in *each year*.¹⁸⁾

18) Here I have accepted Hall's very high estimate of the "natural" unemployment rate, and I have assumed that

$$(Y^* - Y)/Y = 2.5(U - U^*),$$

The public would not endure this and therefore elected, politically accountable officials will not pursue the necessary draconian policies for any sustained period of time. Instead, unless inflation miraculously abates without policy intervention in the near future, it is likely that President Carter (or his successor) will impose some form of wage and price controls. Perhaps the preferences of the people (and the likely actions of the politicians) are on sounder ground than the views of the economists. The costs described above justify quite a lot of control-induced distortion and inefficiency in the marketplace. Moreover, we have no solid empirical evidence that wage-price controls (or tax/penalty based incomes policies) are ineffective *when* accompanied by monetary and fiscal moderation.¹⁹ It is at least arguable that the combination controls and fiscal and monetary restraint would produce more disinflation per unit of foregone real output and employment than orthodox alternative policies. In other words the politically feasible policy may also be the economically efficient one.

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where U and U^* are the actual and "natural" rates of unemployment, and
 Y and Y^* are actual and "natural" levels of real output, respectively.

For recent estimates of Okun's law coefficient see Perry, 1977, and the comments and discussion of that paper.

19) Virtually all the evidence relevant to a peacetime U.S. economy is from 1971-1973 when fiscal and monetary policy was excessively expansionary.

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