ECONOMIC OUTLOOK FOR FISCAL YEAR 1977

HEARINGS

BEFORE THE

TASK FORCE ON ECONOMIC PROJECTIONS

OF THE

COMMITTEE ON THE BUDGET HOUSE OF REPRESENTATIVES

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CONTENTS

ECONOMIC OUTLOOK FOR FISCAL YEAR 1977

TUESDAY, DECEMBER 14, 1976

House of Representatives,
Task Force on Economic Projections,
Committee on the Budget,
Washington, D.C.

The task force met, pursuant to notice, at 10 a.m., in room 210, Cannon House Office Building, Hon. Thomas L. Ashley (chairman of the task force) presiding.

Present: Representatives Ashley and Broyhill.

Mr. Ashley. The task force will come to order.

Today the task force begins two mornings of hearings on prospects for the economy during the next few months, prospects which frankly do not appear to be very healthy.

For several months, nearly every major economic indicator has provided evidence of a longer and deeper than expected slowdown in the economic recovery. Real growth in GNP has declined steadily and sharply: From 8.9 percent in the first quarter to 4.5 percent in the second and to 3.8 percent in the third; and now, major forecasts call for only a 2.5 to 3.5 percent rate of growth for the fourth quarter.

Furthermore, the unemployment rate has climbed steadily since its early summer low of 7.3 percent. It stood at 8.1 percent in November, rising one-tenth of 1 percent in September and October and two-tenths of 1 percent in November.

It now appears inevitable that the new administration will propose an economic stimulus package early next year. The precise amount and mix, however, are still to be decided, and probably won't be until fourth quarter economic data is available in January.

These hearings will explore the depth of the economic decline underway; the extent and types of stimulus needed to reverse the decline without renewing unacceptable levels of inflation; and the extent to which tax and spending proposals should be temporary or permanent in nature.

We have asked four distinguished economists to give us their views on these questions. Today, we have with us two former members of the President's Council of Economic Advisers—Dr. James Tobin, a member of President Kennedy's Council in 1961–62, and Dr. Herbert Stein, Chairman of President Nixon's Council from 1972 to 1974.

Tomorrow morning, we will hear from Dr. David Grove, vice president and chief economist of IBM, and Dr. Murray Weidenbaum, Assistant Secretary of the Treasury from 1969 to 1971.

Gentlemen, we are happy to have you with us this morning. Dr. Tobin, will you begin, please.

STATEMENT OF DR. JAMES TOBIN, MEMBER, PRESIDENT'S COUNCIL OF ECONOMIC ADVISERS, 1961–62, STERLING PROFESSOR OF ECONOMICS, YALE UNIVERSITY

Dr. TOBIN. Thank you, Mr. Chairman.

I did not have an awful lot of time to do my homework for this assignment because I was busy with the end-of-term homework of my students. I did not get your questions until yesterday, but I will answer them in the order they are listed in the letter.

The first one asks how long and how deep the current economic slide is likely to be.

At best, we will have GNP growth which is subpar for two, three, maybe four quarters. By subpar, I mean less than 4 percent real growth or perhaps 3¾ percent real growth. That represents the growth in aggregate production necessary to hold unemployment roughly constant. If we fall short, as we are very likely to do and have been doing recently, then unemployment will continue to rise.

The principal reason for the slowdown is the weakness of nonresidential investment. Most of the standard forecasts last summer and earlier this fall were based on the hope and expectation that private business investment would revive and take over the job of driving the recovery further forward. We couldn't expect that the consumption stimulus given in 1975 or the inventory restocking which led to the rapid rates of growth early this year, would continue to fuel the recovery. Nor was there prospect in other segments of the economy except for housing, of substantial increases in expenditure. That left is up to nonresidential private investment, business fixed investment. The hope, which was, I think, without real foundation, was that an investment boom in 1977, or even in the latter part of this year, would take over the job of sustaining recovery at 5½ or 6 percent real growth in GNP.

Now, we know how unlikely this is. In the latest Commerce Department survey of investment intentions of business, it appears that nonresidential investment, in real terms, that is, corrected for inflation will be flat for the first half of 1977, perhaps longer.

In order to achieve 5½ or 6 percent in growth in GNP as a whole over 1977, it would have been necessary for this component, real business fixed investment, to grow at least at 7 or 8 percent per year. We are very far from that.

At worst, the slowdown may trigger some inventory disinvestment before it is arrested or averted and produce an actual recession during the first half of 1977. If that should be allowed to occur, then even if the inventory cycle were reversed as early as the third quarter, we would not have recovered our current levels by the end of the year.

In either of these cases, the best or the worst, unemployment will rise. What I have said so far assumes the absence of timely policy to stimulate the economy.

The second question says given No. 1, What level of economic stimulus would you advocate?

I think there are two tasks for Government fiscal and monetary policy right now. The first is to overcome the slowdown, to avert another recession occurring, and prevent the momentum of inventory disinvestment from getting started, and to restore the prospect for 5½- or 6-percent growth from now until the end of 1977.

The second task is to lay the groundwork for a solid extension of the economy in 1978, 1979, and 1980.

Both of these tasks should be kept in mind in forming policy at the beginning of 1977.

As for the first, the more urgent task, I would say that we need to add some 2½ to 3 percent of GNP to the likely path that would occur in the absence of stimulus in 1977 and early 1978. That amounts to some $50 to $60 billion. This is the magnitude of the desired result, not of the needed stimulus, which can be a good deal smaller.

Some of the stimulus can come from monetary policy, most of it in the early stages; most will have to come from fiscal policy. The reason we can't expect too much from monetary policy right away is the pervasive weakness of investment demand. Monetary stimulus can and should be given to the economy with favorable effects later, but those effects probably won't occur in time to avert the danger of recession or continued stagnation.

I suggest, therefore, a fiscal stimulus of the order of $30 billion, considering the multiplier one might expect from Government outlay or tax reduction, this should add all together some $50 billion to the GNP, not all at once, of course, but with lags. If $30 billion seems a larger number let me recall to you that the famous tax reduction of 1964 was $12 or $13 billion in an economy which was about a third the dollar size of the economy today.

Mr. Ashley. Dr. Tobin, is that $30 billion all in a tax cut or partly in tax cuts?

Dr. Tobin. I had in mind the total fiscal stimulus, however it is divided between tax cut and additional outlay.

I turn to the second task, which I described as laying the groundwork for sustained recovery and expansion beyond 1977. There seem to me to be two requirements. One is to have an agreed, coherent, and credible policy to keep the recovery going, a policy and prospect on which businessmen, consumers, can base their current expenditure plans with confidence. They must be considered that we are not going to have a premature downturn. The coherent, credible plan should be a joint effort of the Congress, the new administration, and the Federal Reserve. All these must, more or less, agree to the same objectives for real economic growth and reduction of unemployment.

For sustaining the recovery beyond 1977, my preference would be to rely principally upon monetary stimulus. As I have suggested, the Federal Reserve should begin now to provide that stimulus, knowing that the effects will come later.

I skip now to the fourth question, the design of tax stimulus: Particularly the division of emphasis between consumption and investment, and the temporary or permanent nature of tax cuts.

In the present climate, pessimism and uncertainty, it is really not possible to stimulate the economy in a private investment. The reason is that the response wouldn't be rapid enough. The weakness of investment is to a considerable degree the lack of confident expectation that new capacity will be needed in the next few years.

Nonetheless, I think the fiscal package should include a temporary increase in the investment tax credit, preferably for 2 years. I suggest an increase of the order of 1 or 2 percent. I would confine the temporary credit to investment net of depreciation on the types of capital assets for which the credit is allowed. That would give just as powerful a stimulus to investment and reduce the tax loss at the same time.

An additional incentive to business could be a temporary reduction in employers as well as employees payroll taxes. This has the advantage of giving some help on the price side in the fight against inflation as well as providing stimulus to demand and employment. The reduction in payroll taxes would be covered by an appropriation from general funds to the social security accounts.

The major stimulus in 1977 will have to be for consumption. This is a reason for a temporary, rather than a permanent tax reduction. A temporary cut will preserve the prospects for budget balance or surplus in 1980 or 1981, once we do succeed in returning to a tolerable level of unemployment, 5 or 5½ percent. At that time we will wish to be in a position where the Federal Government is not absorbing a significant amount of the saving of the economy. We will wish to leave that saving free to be used for capital formation which the economy will need in the 1980's. That is the reason why I suggested that the recovery after 1977 should be fueled mainly by monetary rather than fiscal stimulus. That is the reason for not giving away permanent tax revenue, even at this time, to any significant degree.

As for the form of a temporary personal tax reduction in 1977, rebates of 1976 tax, following the pattern of the 1975 legislation, have three important advantages. They are simple; they get funds into the hands of consumers quickly; and they are necessarily temporary.

Some economists are skeptical of the effectiveness of temporary tax reductions of this type. Since they are only temporary, it is agreed, people will save rather than spend them. There is some good economic theoretical rationale for this position. But it has been considerably exaggerated. The experience in 1975 doesn't justify the fear that these rebates will be largely saved. Indeed, they appear to have been fully spent within two or three questions.

To maximize response, it is desirable to direct rebates or other nonrecurrent benefits as much as possible to low-income households and individuals. They are likely to be in a position where their spending is constrained by liquidity. Having exhausted their liquid savings and credit lines, they will spend any additional funds provided them.

I would like to see the "rebates" available to nontaxpayers as well as to taxpayers; so many dollars for each personal exemption, whether already claimed for 1976 income tax or not. That would assure that a large proportion would be spent. It would also be more equitable than confining rebate checks to those fortunate enough to have taxable incomes.

I have already spoken of the possibility of temporary reductions in payroll taxes. I would like to mention another possibility which could be considered for tax reduction in 1977 and 1978 and perhaps as a more permanent feature of the income tax system. This would be to allow a tax credit of something like $200 or $250 per personal exemption as an optional alternative to taking the personal exemption as a deduction from income. That, too, I think, should be extended to nontaxpayers as well as taxpayers. To the extent a credit is not used to reduce tax liability, it should be payable in cash.

The fifth question refers to public expenditure programs, particularly public works and public service employment. The third question, which I skipped earlier, asks about the division of fiscal stimulus between expenditures and taxes.

I very much favor employment programs aimed at disadvantaged, inexperienced, and discouraged workers. Some public service employment programs can be accelerated quickly, and this should be done. However, I doubt enough can be done quickly so that additional expenditure of this kind would have a substantial role in the immediate task of reversing the slowdown.

Providing employment training and employment for the youth of the country for people who have been chronically unemployed, for others who have long since abandoned the labor force should not be regarded as a cyclical problem. It is a chronic problem for which permanent programs are needed. Even when fiscal and macroeconomic policies have reduced the unemployment rate as far as inflationary risks and concerns allow, unemployment will still be unacceptably high, especially among the disadvantaged groups. An early priority of the new administration and Congress should be to design much more ambitious plans to deal with these problems. They should not be regarded as temporary programs for economic stimulus, but rather as programs we are going to have to stay with for the long pull. Those programs should include arrangements for private as well as public employment and training.

Federal funding of State and local public works can, I understand, be increased by several billion dollars, with timely economic effect and useful permanent result. I guess that $5 or $6 billion of the needed fiscal stimulus in 1977 can be provided by public employment programs and public works,

The remainder, approximately $25 billion, would be by rebates or tax reductions. I suggest immediate "rebates" of $15 billion, an average of almost $70 per capita, and reductions of $10 billion a year in personal and business income taxation for 1977 and 1978.

The third suggestion under section V asks whether there should be increases in other areas of Federal spending.

My general answer is no; those programs should be considered and expanded on their merits and not for counter-cyclical purposes. But one can add that it would be a good idea if the Government spent up to the amount of the agreed budget.

It is also possible that expenditures for which authorization already exists, for purposes which have already been decided to be desirable, substantive programs, might be accelerated. If the Congress were, ready to adopt a general program of rationalizing income assistance, 1977 would certainly be a good time to introduce such a reform.

First, in the present situation there is very little risk of doing too much or doing it too soon; there is great risk of doing too little too late.

Second, since quick action is needed, it is probably less important to design ideal programs than to focus on a package stimulus which can be quickly accepted in the Congress and elsewhere. That is why I wouldn't place too much emphasis on my own or other people's gimmicks or complex proposals. I would rather hope a generally agreed program can be adopted very quickly after January 20.

Mr. Ashley. Thank you, Dr. Tobin.

I think we will proceed with Dr. Stein before we ask questions.

81-097—77——2

STATEMENT OF DR. HERBERT STEIN, CHAIRMAN, PRESIDENT'S COUNCIL OF ECONOMIC ADVISERS, 1972–74, PROFESSOR, UNIVERSITY OF VIRGINIA

Dr. STEIN. Thank you, Mr. Chairman.

I should explain, like Dr. Tobin, I received this invitation rather late. I might reveal, the statement was written in large part during the Redskin game on Sunday, which I will take as any cause for incoherence.

However, I do have some points I would like to present for your consideration.

The decisions that have to be made about fiscal policy for 1977 are extraordinarily difficult. You should not be misled by the apparent unanimity of articulate opinion on the need for more fiscal stimulus into thinking that the decision is already beyond question.

You should not be too impressed with this approaching unanimity. I am reminded of the situation that existed in the spring of 1958. We then had the highest unemployment rate of the postwar period. A consensus quickly developed among informed people in favor of a tax cut. All influential people seemed to be in favor of tax reduction except President Eisenhower, Majority Leader Johnson, and Speaker Rayburn. At the end of May I sat in a hearing of the Joint Economic Committee where the expert witnesses argued for a tax reduction. Nobody knew that at that moment the economic decline had ended and would be followed by a sharp recovery. The recovery ran out of steam in 1960, but that did not prove that a tax cut would have been wise in 1958.

While there are people who have been in favor of more stimulus to the economy throughout this year, the current consensus has blown up only in the last 6 weeks or so. It is based on a short period of observation and on limited evidence. The main reason for the consensus is the fact that output has risen at an unexpectedly low rate for the past 6 or 7 months and unemployment has risen to 8.1 percent in November after having fallen to 7.3 percent in May. But that is hardly conclusive for the future. The shift of opinion is mainly a reflection of the natural but unreliable tendency to project the most recent past into the period ahead.

A balanced view of our situation and prospects requires attention to some facts that are being forgotten in the current rush for tax reduction. The disappointment in the performance of the economy in the latter part of 1976 must be understood in relation to the unexpectedly good performance in the early part of the year. Output for the year as a whole will be as high as was expected when the year opened, and the average rate of unemployment for the year will be no higher than was expected. Even though unemployment is much higher than the common expectation for the end of 1976, employment is also quite high.

There were a number of transitory factors in the slowdown of the recovery since this spring. The rapid rise of inventories in the first quarter was naturally followed by a slower rise, but a continued decline in the rate of accumulation was not to be expected, The lag of Federal spending behind its budgeted path in the second and third quarters of the calendar year would not be repeated. The rate of monetary expansion had already increased from its low levels of the second half of 1975, which low levels may have been restraining economic activity in the middle of 1976.

As recently as 6 week ago, one could reasonably say that the pause would soon give way to more rapid expansion. The transitory restraining forces would be left behind. The outlook for business fixed investment was moderately strong, and the outlook for residential construction surprisingly good. Consumers' expenditures were keeping up with their incomes, and, at least by some measures, consumer confidence was high.

Since the beginning of November there have been two worrisome developments. One was the evidence that business inventories were high and rising. This meant that we might have some period of low production ahead of us while these inventories, which apparently were being accumulated involuntarily, would be worked off. And this created the danger that a prolonged period of sluggishness in the economy would depress the revival of fixed investment on which the recovery depended. The second development was the report on December 6 of the results of the survey of business plans for capital spending, which was taken by the Department of Commerce in late October and November. This showed that business planned essentially no increase in real investment spending in the first half of 1977, after an increase of about 3 percent in 1976. This was a much worse picture than had been deduced from private surveys of business plans earlier in the fall.

This news had hardly been digested when we received another surprise. Revised figures for retail sales in October and preliminary figures for November showed much bigger increases than had been previously reported or expected. This raised the possibility that inventories would be worked down quickly, production would rise more rapidly, and the slowdown of business capital spending, if it occurred at all, would be short lived.

I do not make these remarks to suggest that the outlook is bright. It is not bright. But the outlook is uncertain, and includes the possibility of being brighter than the present consensus.

In other historical circumstances one might say that since the economy is at a low level, and probably not about to begin rising rapidly, we should proceed to pump the economy up, recognizing and accepting the risks this may entail. However, our strategy has to be influenced by the experience of the past 10 years, which reveals a bias toward inflation in our decisionmaking process. We have been slow to recognize the need for restraint and quick to recognize the need for stimulus. The public now understands this bias in policy, and that is a factor making it difficult to slow the inflation down. Policymakers should recognize that bias also, and resist it. That does not mean that policymakers should close their eyes to evidence of the need for stimulus. It means that they should try to make doubly sure of the need before they act.

In these circumstances you should defer making up your minds for at least another 6 weeks or so, although it is desirable to be exploring your options as you are now doing.

If the economic outlook remains as it now seems to be—that is, if evidence appearing by the end of January does not significantly improve the outlook—a reduction of taxes will be appropriate. This is not the samc as saying that a tax cut would be necessary, but it does mean that a moderate tax cut would be reasonably safe, and in that case it should be made.

If a tax cut is made, it should be permanent, in the sense that it has no fixed terminal date. I am not impressed by the argument that a permanent tax cut should be avoided because it would foreclose the the President's future options to spend money. On the contrary, a permanent tax cut is necessary to preserve the taxpayer's option to dispose of his own income unless his elected Representatives have made an affirmative decision to levy taxes on him for important national purposes.

Taxes on both corporations and individuals should be reduced. In my mind, the case for reduction of the corporate profits tax is not primarily the need to stimulate business investment. It is primarily that the present taxation of corporate profits is unfair because it results in income from corporate profits being taxed more heavily than income from other sources.

My preference for reduction of the individual income tax would include an increase of 10 percent in all exemptions and bracket figures. This would approximately offset the effect of the inflation of the past 2 years in raising the real burden of the individual income tax by reducing the real value of the exemptions and brackets. In addition, I would like to see the Congress enact provision for automatic annual increase of exemptions and brackets in the future in proportion to the rise of the Consumer Price Index, so that the Government will not automatically garner the fruits of an increase of real tax burdens from inflation.

The 10-percent increase in exemptions and brackets would reduce revenues from the individual income tax by about $10 billion. If a larger reduction than that is appropriate I would raise the low-income allowances and the maximum standard deduction further. In addition to giving relief to lowest income taxpayers and reducing the tax rolls, this would have the advantage of reducing or eliminating the excess tax burden on low-income people who work as compared with low-income people who do not work.

I would reduce the corporate tax in the simplest way, by reducing the tax rate—perhaps from 48 percent to 44 percent. I prefer this to raising the investment tax credit because my main interest is in correcting an inequity, not in stimulating investment. A case could be made for distinguishing between distributed and undistributed corporate profits, but this will not become necessary until the total corporate tax is reduced much more than is now possible.

I would not favor initiating or expanding Government expenditure programs for the purpose of employing people. I don't think that public service employment programs or emergency public works programs have any advantage over tax reductions in terms of the speed with which they put people to work or in terms of the employment generated per dollar. It seems to me of major importance to the people being put to work as well as to the rest of the society that they should do work that the rest of the society is willing to pay for because it wants the product. This is best assured by letting the taxpayer spend his own money.

Inflation remains at a high rate and there is still a danger it will accelerate. The danger will increase if the Government takes stimulative action. It would be especially unfortunate if stimulative action taken now should lead people to believe that the Government is no longer concerned about inflation. Measures to slow down the inflation are urgently needed, especially if there is to be a tax cut but even if there is not.

Economists in recent years have identified a list of Government policies that work to raise costs and prices and which should be corrected as part of an anti-inflation program. These policies include remaining restraints on some agricultural production, as in the case of peanuts, wage-raising measures, like the Davis-Bacon Act, and limitations on imports, as in the case of steel and textiles. The new administration working with a Congress of its own party should initiate a determined effort to correct these policies.

The President-elect has said that he rejects prolonged unemployment as a way of getting the inflation rate down. He has said that he would use the leadership of the Presidency to create conditions in which we can have both high employment and price stability. No use of that leadership can be more productive than to mount an attack on the policies of government that themselves contribute to inflation. These policies will not be easy to change. They all have support from influential forces in the society. But that is precisely why national leadership is required.

There seems to be no realistic likelihood of a congressional decision on these matters before February. I would hope that Congress would keep an open mind on the subject until then. In January we will have a firmer picture of November retail sales and the first estimates of December sales. We will have a better idea of the course of inventories. We will have another Department of Commerce survey of business investment plans, this time covering all of 1977, rather than only the first half. If these figures show a continued strong rise of retail sales, if inventories are being worked down, and if planned capital outlays for the second half of 1977 show a big increase—stimulative fiscal action may be unwise. None of this is now impossible.

However, without making any commitments at this time we should be preparing for the possibility that some moderate reduction of taxes will be appropriate early next year. It seems to me likely that we will be looking at a probable rise of nominal GNP—GNP in current dollars—around 9 to 10 percent between the end of 1976 and the end of 1977. This would imply a rise around 4 to 5 percent in real GNP and around 5 percent in prices. Unemployment might decline a little, but would still be over 7 percent at the end of the year.

I think it would be desirable to aim at a somewhat higher rise of nominal GNP than that, perhaps to raise the increase to 11 percent, which would be about 1½ percent higher than the forecast. It is better to describe the goal of policy in terms of nominal GNP rather than in terms of real GNP or the unemployment rate, as many people, including Mr. Carter, tend to do. If we describe our goal as getting 6-percent real growth and a reduction of $1\frac{1}{2}$ percentage points in the unemployment rate, for example, two problems arise. First, the growth target may turn out to be incompatible with the unemployment target. Second, the growth target may turn out to be incompatible with some notion, which is present even if unstated, of a tolerable inflation rate. If we set our goal in terms of nominal GNP we make at least rough provision for the second problem. If the goal is an 11-percent increase in nominal GNP, that means, approximately, that real output will rise 6 percent if prices rise 5 percent, but output will rise less if prices rise more, and vice versa, which seems to me an adjustment in the right direction.

There are undoubtedly several ways in which the rise of nominal GNP in the next year could be raised to 11 percent. In the broadest categories, we could increase the rate of monetary expansion, cut taxes, or increase expenditures. I hesitate to rely on a more rapid rate of monetary expansion than is now going on, for two reasons. One is uncertainty about the timing and magnitude of the effects. The other, and more important, is that taxes are high, inflation is continually raising their real burden, and the taxpayer is entitled to get some of his money back if the Government does not need it urgently. This is also my reason for preferring the tax cut route over the expenditure increase route, about which I shall say a little more later.

In the remainder of this statement I shall be considering the possibility that it will be desirable to try to raise the growth rate of real GNP during calendar 1977 by $1\frac{1}{2}$ percentage points, which would involve making the annual rate of nominal GNP in the fourth quarter of 1977 about $26 billion higher than it would otherwise be. Of course, my first recommendation is to wait and see before making up your minds to do that, but I do not want to insert that caution into every paragraph of the rest of my statement.

How much tax reduction would be required to raise nominal GNP by about $26 billion in the fourth quarter of 1977 is, like everything else in this field, uncertain. It depends on the date of the tax cut, and, in ways that aren't understood very well, on its character. However, the answer probably lies between $15 and $20 billion of tax reduction, if it goes into effect by, say, April 1, and I doubt that further analysis of that question in the next 2 months will narrow the range appreciably.

I believe that any tax reduction made in these circumstances should be permanent, or at least should not be of limited duration. The reason for this is not primarily that a permanent tax cut has more effect on total demand, per dollar of immediate revenue loss, than a temporary tax cut. I believe this to be true, but if that was all we were interested in we could compensate for that by making the temporary tax cut bigger. But a permanent tax cut probably has a favorable effect on the supply side—on the willingness to work and invest—that cannot be achieved by any temporary tax cut. Most important, in my mind, is simply the desirability of giving present and future taxpayers control over a larger share of their income than would be the case if the tax cut was temporary. One might also point out that there is realistically no such thing as a temporary tax cut. Congress never takes the candy back from the baby.

Some people oppose a permanent tax cut on the ground that it reduces the Government's options to make decisions to increase spending later. This seems to me a backward way to look at the problem. The money we are talking about is the taxpayer's money. There is no presumption that he has permanently assigned it to the Government. He should have the option of disposing of it privately, or of assigning it to the Government when he makes an affirmative decision through his elected Representatives to do so. Tax reduction is the way to preserve the taxpayers' options.

This view of the tax problems is exactly parallel with the principle of zero-based budgeting on the expenditure side. The rationale for zero-based expenditure budgeting is that we do not want expenditure programs to be routinely and automatically continued without affirmative decisions. The parallel principle, which may be needed to make the expenditure control effective, is that we do not want taxes to be automatically and routinely continued without affirmative decisions. What this means is zero-based taxing.

Congress ought to consider a system under which all Federal tax rates would revert to zero periodically, say every 4 years. This does not mean that the Government would go out of business, any more than zero-based budgeting on the expenditure side means that. It does mean that there would be occasional explicit consideration of the level of taxation.

The permanent tax reduction should apply to corporations as well as to individuals. Our present system of taxation discriminates against income from capital, violating the basic principle of equity that all income should be taxed equally, regardless of the source from which it is derived. The main cause of this inequity is the corporate profits tax which taxes some of the return to capital twice, once at the corporate level and once at the individual level. This inequity becomes greater as we move toward taxing capital gains more like other income, which we are doing and should do.

A case can be made for tackling the double taxation of corporate profits explicitly, by any one of a number of changes which would differentiate between distributed and undistributed profits. If we were to go very far in reducing corporate taxation that would be necessary. But it is not necessary for the rather small reduction of corporate profits taxation which now seems possible. Therefore, I would recommend the simplest approach, which would be to reduce the standard corporate tax rate. I would suggest reducing that rate from 48 percent to 44 percent, which would reduce the revenues by about $5 billion.

I would not favor an increase of the investment credit as a way to reduce corporate taxation. I would like to reduce obstacles to investment that the market would justify; I do not want to push investment that it does not justify. The investment credit already creates inequity as between stockholders of rapidly prowing companies and stockholders of companies that are not growing so fast. I would like the tax cut to improve the equity of the system, not worsen it.

On the individual income tax side the first step should be to restore to the taxpayer the additional real income he is now paying in taxes as a result of the inflation of the last two years—that is, since approximately the decision on the 1975 tax cut. Congress made no decision to impose this added tax which results from the reduction in the real value of all exemptions and tax brackets, and it seems to me appropriate to undo this inadvertent tax increase. This can be approximately accomplished by raising all exemptions, bracket limits, the low-income allowance, and the ceiling on the standard deduction by 10 percent. This would reduce the revenues by about $10 billion in 1977.

We should go beyond this and provide that in the future the exemptions, bracket levels, and so on will be automatically raised in line with the Consumer Price Index. This is a minimum step toward zero-based taxing. It would say that there is no presumption that the Government should have available for expenditure the additional revenue, in real terms, that is generated by inflation, unless the Congress makes an affirmative decision to increase taxes. It would not keep the dollar amount of revenue from rising with inflation, but it would keep the dollar amount from rising faster than the price level because of the progressive nature of the tax system.

If there is room for a reduction of individual income taxes in 1977 beyond the amount of the inflation adjustment I have suggested, I would have no strong preference about its distribution. There would be merit in using at least some of the available revenue to reduce income tax at the low end, by raising the low-income allowance and the ceiling on the standard deduction. This would have a number of advantages, in addition to helping poor people. It would reduce tax discrimination between poor people with taxable incomes and poor people whose income is from nontaxable Government transfer payments. It would get some people off the tax rolls entirely, which would reduce reporting and administration burdens. Raising the ceiling on the standard deduction would simplify tax filing for some people and also reduce discrimination against renters as compared with homeowners.

I do not understand the statements being made these days that job creation comes ahead of tax reduction, with the implication that the way to create jobs is to raise Government expenditures. I am aware of no studies which show that Government expenditure programs, whether or not labeled employment programs, create jobs more quickly, or more jobs per dollar, than tax reduction does. If there were such studies, I would not regard that argument as compelling. It may be that employment programs enable the Government to target the employment increases to selected groups in the labor force, although my understanding about the public service employment program as it was two years ago was that the results in this respect were slight. Moreover, it is not clear to me that we prefer to expand the employment of youths rather than of adults, or to expand employment in declining areas rather than in growing ones.

It seems to me that the dominant consideration, from the standpoint of the morale and career of the worker as well as from the standpoint of the benefits to the rest of the society, is that people should be put to work producing a product that others are willing to pay for, and not just put to work for the sake of working. I think this is more likely to come about if money is returned to the taxpayers to spend on things that meet the test of value to them than if the money is diverted to Government programs which are motivated by the desire to put people to work.

I have a good deal of sympathy for the proposal advanced by Chairman Burns of the Federal Reserve to establish an open-ended public employment program in which the Government would stand ready to employ anyone who wants to work at a wage a little below the legal minimum. This would serve as a last resort for people who want work badly, and who have special difficulty in finding work otherwise. It would help those people whom the Government itself has kept from finding work by setting a minimum wage at which it is not profitable to employ them. And it would not underwrite an inflationary rate of wage increase as public service employment programs which require payment of the prevailing wage do. I made this suggestion to the Senate Budget Committee in the spring and found no takers.

We face a continuing inflation problem, however the economic outlook may appear in January and whether or not stimulative action is taken. It is desirable to attack that problem directly, and will be especially desirable to do so if stimulation is decided upon, to show that we are not entering, or returning to, a stage in which the danger of inflation is neglected. There are a number of things that can be done by Government to reduce costs and prices. I shall list some of them below. Most of them are of a kind that would have a one-time effect on the price level. However, we are in a situation where the rate of increase of wages is closely tied to the rate of increase of prices also depend on the wages. Holding down the rate of increase of either wages or prices, even temporarily, will affect the other and help to get the whole spiral running at a lower rate.

There are a number of steps the Government can take to restrain increases of costs and prices by correcting Governmment policies which tend to raise prices and costs. These policies have come to be known to economists as sacred cows, with the implication that they are politically untouchable, even though useless or positively harmful. In fact, some of these policies have been corrected in the last few years, notably those which restricted agricultural production. Now that we have a President with a Congress of his own party we should make a new determined effort to attack the sacred cows.

A list of the policies which need to be reformed would include at least the following:

1. Limitations on the imports of dairy products, meat and other farm products
2. Limitations on the imports of steel and textiles.
3. Price supports for grains and dairy products.
4. Marketing orders restricting agricultural production and sales, especially of dairy products and fruits and vegetables.
5. Restrictions on the acreage planted to peanuts and tobacco.
6. State prorationing, which limits the output of oil and natural gas.
7. Route and commodity restrictions on licensed motor carriers.
8. Entry barriers into trucking.
9. Davis-Bacon Act requiring payment of "prevailing wages" on Federally-financed construction work.
10. Other prevailing wage requirements.
11. The Federal minimum wage, especially as it applies to youth.
12. The duration of unemployment compensation benefits and their exemption from income tax.
13. The Jones Act which prevents foreign carriers from engaging in U.S. coastal shipping, and there are many more.

These and similar measures have been listed by economists for congressional committees so often in the last 3 or 4 years that the exercise has come to be regarded as a pure ritual from which no result will follow. I hope you will not look at the matter this way. We are at one of those moments when the way seems to be open for imagination and innovation. Nothing would be more imaginative and innovative than doing the right thing.

Mr. Ashley. Dr. Stein, your outlook is more uncertain than that of some of your colleagues. Therefore, is it your judgment that action on the part of the Congress and the new administration should wait until more information is available in January?

Dr. Stein. I just warn against making up your mind too early.

Mr. Ashley. I take from your testimony, Dr. Tobin, that you are of the view there is sufficient information and data available now; that the experience of the country's economy in the last 6 months has been that, while the additional data in January will be of great interest, we can, at this time, at least make some preliminary judgments. Is that true?

Dr. Tobin. Yes; that is my view. I confess I am one of those economists that Dr. Stein referred to a few moments ago. I thought last summer, prior to the present slowdown, that there was insufficient stimulus in store and that the economy didn't have sufficient momentum of increased aggregate demand to carry it into 1977 at the growth rates which the optimistic forecasts were then suggesting.

Mr. Ashley. You are one of the few then. This task force held hearings earlier this year at which there was a very broad consensus that while there might be some slowdown in the second and third quarters of 1976, certainly there would not be the kind of pause we are now experiencing.

Dr. Tobin. I am not an econometric model builder or a professional forecaster. My general view was expressed in testimony—not here, but at the J.E.C.—in the spring and in an article in the Michigan Economic Outlook in the summer. The projected boom in business fixed investment was just not in the bag. The forecasts which were depending on it were whistling in the dark. The investment boom was something which they would like to have happen, but that didn't mean it was probable.

But let us recall also that the so-called optimistic forecasts were forecasts of growth of 5½ percent, 1977 over 1976. Now, starting from the low levels that we were ar then and are at now, 5½ percent real growth, is not a spectacular rate of recovery. It takes roughly 7-percent growth for 1 year to reduce unemployment by 1 point. Four percent would hold unemployment about the same and 7 percent would reduce it about a point a year.

The economic projections which were the basis of the budget resolution did not promise a large reduction in unemployment or a rapid recovery.

Mr. Ashley. The rates of growth which were anticipated were those consistent with reasonable economic stability, that is to say, both the administration and Congress agreed that whatever stimulus package was decided upon, it wouldn't result in another round of surging inflation. Isn't that so?

Dr. Tobin. It is so that many people have said that.

Mr. Ashley. I am simply pointing out that we did the best we could to reconcile two very difficult objectives—lower unemployment and moderate inflation.

Dr. Tobin. I am aware of the difficulty in reconciling those two objectives. The difficulty is acute when the economy is close to full employment and full capacity. But with the economic slack we now have, there is very little evidence that varying in the growth rate of GNP between 6 and 7 percent per year, or even between 5 and 8 percent would make an appreciable difference in the inflation outcome.

Mr. Ashley. Dr. Stein, do you think that the stimulus package adopted for this year has proved to be inadequate?

Dr. Stein. Well, in retrospect and with the information now available I think it was correct, although we might learn more about this later. Professor Tobin is a very good forecaster but I believe he would recognize that his forecast is surrounded by a considerable margin of error. All I am suggesting to you is that you should not close your mind on this question, especially since, you are not in a position to make a decision for 6 weeks or more anyway. However, it is only about 6 weeks that the consensus on this side became a real consensus. I would bet that compared with positions a week ago most forecasters are raising their forecast of GNP by 1 percentage point just based on the figures as to retail sales that have come out. This is a very flimsy piece of evidence we are dealing with. There is a possibility that the inventories are being worked off more rapidly than expected. Retail sales are rising more rapidly than expected. I would place a lot of weight on the figures you will get around January 15 or so as to business investment plans for 1977.

Dr. Tobin. May I make another comment, Mr. Chairman. The present prospects are that we will not even meet the objectives of the Ford administration for real GNP in the fourth quarter of 1977. Those were not objectives which were dominated by a lack of concern for inflation.

Mr. Ashley. There are two questions which are of interest to me and I think to the other members of this panel.

One is the size of a given stimulus package based on the lay testimony and best data with respect to the strength of the economy. You are responsive to this, Dr. Stein, because you say if the economy in January is on the same level it is today, then, you go on and list a number of suggestions.

If we assume that, how do you arrive at a given stimulus package of a certain magnitude. I wonder how you do that. That might explain how you did it last time.

Dr. Stein. I did not do it last time.

Mr. Ashley. Well, certainly you have been called upon to do it from time to time.

Dr. Stein. I came to the conclusion the stimulus package should be $15 to $20 billion of current reduction essentially in this way——

Mr. Ashley. Is this for the future?

Dr. Stein. If I had to make the decision at this moment, which I don't and you don't, or if the information we receive within the next 6 weeks is essentially neutral, leaving our outlook unchanged.

It seemed to me that the likely prospect without a new stimulus was that the GNP might rise by something like 9 to 10 percent between the fourth quarter of 1976 and the fourth quarter of 1977, which would be composed of about 5-percent inflation and 4 percent real growth, leaving unemployment unchanged or maybe down a little bit. But suppose the nominal GNP increase was something like 9½ percent, it seems to me I would like to see it something like 11 percent, comprising 6 percent real output, which by coincidence is Mr. Carter's goal, and 5-percent inflation. I would prefer, for reasons, I give here to set the target for nominal GNP growth rather than in terms of real GNP growth. Suppose we want to raise the nominal increase in GNP by 1½ percent, which would require something like $26 billion of additional GNP in the fourth quarter. Given the common range of multipliers, I thought something like $15 to $20 billion of tax cut would yield that. That is the simple reasoning by which I got the tax cut.

Mr. ASHLEY. Professor Tobin, is that your methodology? Do you agree with that? Do you both agree that a certain magnitude of stimulus, given a certain base of economic activity, produces a given increase in real or nominal GNP?

Dr. TOBIN. I agree basically with the methodology that Dr. Stein just reported on. I am not in agreement with the conclusion, with his numbers. But as a fellow practitioner of back-of-the-envelope calculations, I agree that he is doing it the way I would do it.

May I make a couple of points on the calculation? In the absence of stimulus, I think the median prospect would be about 3 percent per year real growth from now until the beginning of 1978.

Mr. ASHLEY. With how much stimulus?

Dr. TOBIN. With none.

Mr. ASHLEY. With no stimulus, we will have a real rate of growth of about 3 percent.

Dr. TOBIN. Maybe worse than that. There is a significant probability of an actual downturn in the absence of stimulus. Then it would be hard to make the 3 percent. But I will take the more optimistic view and then ask what it takes to get from 3 percent back up to 5½ or 6 percent. So that means adding 2½ to 3 percent to the GNP.

Now, as I said in my brief statement, that is around $60 billion, 3 percent, around $60 billion. Then we ask, what sort of stimulus, what magnitude of stimulus is necessary to get $60 billion adding to GNP. I would figure that within the year the multiplier, is somewhat less than 2 percent, around 1.5 or 1.75 percent. So the $30 billion stimulus I suggested, is certainly not too much.

Mr. ASHLEY. I don't understand. If you are using the same methodology, why do you think it is necessary, in order to get a 5½-percent rate of growth to have a $30 billion stimulus package?

Dr. STEIN. He starts with a lower prospective increase. He started with a lower figure. That is the major reason.

Dr. TOBIN. The second point I wanted to make is that since none of these things are precise or certain at this time, as Dr. Stein has correctly stated, decisionmakers in the Congress and the administration should think about the consequences of being wrong on either side, the risks, on one hand, of doing too little and, on the other hand, of doing too much.

My feeling is there is very little risk of doing too much. Should Dr. Stein's reference path—namely 4 percent real growth in the absence of stimulus—should that turn out to be correct, and should you add my larger stimulus to his reference projection, I don't think that will be bad at all. You would get a faster rate of growth of nominal and real GNP and by the end of the year a larger reduction in unemployment. We can certainly use those things. I think there would be very little marginal effect on the rate of inflation, given the amount of unemployment we start with, and the degree of slack in the economy, excess capacity in industry as well as in the labor force.

Let me add one further point, based on the arithmetic of comparing calendar year over calendar year growth with fourth quarter over fourth quarter growth. A 6-percent growth, for example, from the end of this calendar year to the end of next calendar year will not be that much of an improvement for the year as a whole, 1977 over 1976. It would be closer to 5 percent on a calendar year over calendar year comparison. This happens to be true because of the pattern of quarter by quarter of GNP during 1976.

Mr. ASHLEY. I will have some questions on the composition of the stimulus packages that you both described, but I want to first turn to Mr. Broyhill.

Mr. BROYHILL. Thank you, Mr. Chairman.

To continue the discussion, which I understand is being focused on the question of what has happened with the stimulus package that was proposed last year, I think warnings were given at that time that the package would be temporary only. That is, a package was put together in the form of more Government spending, including public works and public jobs, and increases in spending in many areas of Government programs. And that package, it was warned, would result in only a temporary stimulus and might even result in more inflation.

Did I understand, Dr. Tobin, that you are basically advocating more temporary measures as a package for the future? I very quickly took a few notes. You are advocating a temporary increase in investment tax credits and temporary reductions in payroll taxes. You are advocating tax rebates. Is it fair to say that you are not advocating long range, permanent tax reduction?

Dr. TOBIN. Yes, it's fair to say I am not advocating long range, permanent tax reduction. I do not think that is the proper method of stimulating the economy right now, when the problem is to overcome the downturn or sluggishness that we are now facing.

The permanent structure of the tax system, including the questions that Dr. Stein raised today on corporate taxation, and on the indexing of brackets and exemptions, these are matters the Congress should consider with deliberateness as matters of long run policy.

I doubt very much that Congress can decide those questions quickly. They are complex, controversial. I hope they will be considered by the Congress and the new administration. But in the meanwhile we have this urgent matter of providing stimulus.

I agree that the economy should not be left without stimulus after temporary tax reductions expired. My suggestion was that the Federal Reserve begin now a rational program of monetary ease, which would lay the ground-work for expansion of business fixed investment and housing construction in the latter part of 1977, and subsequent years 1978–79.

Mr. BROYHILL. Well, I note that you do advocate tax rebates. The purpose of this hearing this morning is to examine such proposals. I personally don't feel a tax rebate would be helpful over the long run. In my judgment, what it did before was to put some money into people's pockets and then perhaps acted as some stimulus at the time, from the point of view or the assumption that people would spend it. Of course, all that does, assuming it would be done in the future, would be to reduce inventories and perhaps act as some moderate stimulus to additional production over a shortrun period. But, it seems to me what is needed is a long range solution to stimulate more capital expenditure. That is, expansion of plan and equipment, the construction of new production facilities that provide the jobs that will be necessary in the future. The only way to do that is through long-range tax reductions. The short range or temporary reductions do nothing to affect the decisions of workers of businessmen as they make their decisions on investing or saving, or even working, over the long run.

This is only the shortrun stimulus, and we will be right back in a short while with some of the same problems. Would you want to comment on that?

Dr. Tobin. Yes, I would like to comment on that.

The purpose of short-range stimulus, the temporary tax reductions for example, would be to avoid letting the downslide get out of hand into a real recession. Once inventories begin to be decumulated, we will have a repetition of the inventory downswing that we have had several times in the post war period, most recently in 1974–75.

Once that gets started, it has a momentum of its own. It takes time to get back out of it. This recovery that has been slowly proceeding since the spring of 1975 could be set back by a whole year or more.

Now, that seems to me a real danger, and one that should be averted. It takes quick action. I agree with you——

Mr. Broyhill. I have no argument with you there. But, why would not a general tax reduction, such as advocated by Dr. Stein, accomplish the same purpose and also give more long-range stimulus, particularly from a psychological standpoint, from the standpoint of providing more confidence throughout the entire economy that the long-range stimulus is there rather than short range?

Dr. Tobin. Well, I think that one of the principal sources of the weakness of fixed business investment at the moment is the existence of excess capacity in the economy, a dampening influence on decisions to add to capacity. And I agree with you, that connected with that is a lack of confident expectation about the prospects for sustained and complete recovery, which will put that capacity back to work and create the need for and the prospects of profits and sales on additional capital facilities.

Mr. Broyhill. I happen to disagree with you there very strongly. I think that the reason people are not making decisions on capital expenditures is that they figure they can't make any money in the future.

Dr. Tobin. But the major sources of making money are high volumes of production and sales——

Mr. Broyhill. I think they figure they can sell, but they can't make any money under present conditions.

Dr. Tobin. Well, the other side of my program was to improve the financial climate for financing business investment by reduction of interest rates, lowering long term bond rates, and raising equity values. Thus we would have the needed combination: On the one hand, reduction of excess capacity and favorable prospects of sales and profits on new investment, and on the other hand, a favorable climate for the financing of that investment over several years to come. In these circumstances, I think, we could revive capital investment with the 10-percent tax credit already on the books.

Profits will actually look very good in this economy, once it returns to something like full utilization of the labor resources and capital resources of the economy. The reason profits are depressed is that we have had a severe recession, and we are operating well below the potential of the economy. Business investment in real terms is still, in absolute volume, well below what it was in 1973 and even in 1974. Tax incentives for investment are the same as in those years, or even better. It is not these incentives that are lacking. What is lacking is confidence that the capacity will be used and needed. What is lacking is a strong securities market, particularly for equities, where new ventures can be financed.

It is still true that the corporate bond and corporate equity markets implicitly value the capital facilities of American corporations at less than it would cost to buy those facilities in the commodity markets. Now, that is not encouraging to investment. The situation, I think, could be improved on two sides, both by improving the expectations of earnings and sales, and by a more expansionary monetary policy. The reason I propose that strategy is precisely because I share with you the view that additional capital formation in the economy is desirable and needed for the longer run. That is why I was proposing to hold the permanent revenues of the Federal Government, so that it would be possible to anticipate that the Federal Government would not be using much of the savings of the country once prosperity was restored.

Mr. Broyhill. Turning to Dr. Stein, I was quite interested in the proposal that you were making that the Congress institute a program of zero-base budgeting, that they not only make those decisions on the expenditure side, but also on the revenue side, converting to zero every so often so that the Congress periodically makes a conscious decision on what the tax code or revenues will be.

In other words, what you are saying is that it would force the Congress to review the tax code periodically. Is that the argument that you are making?

Dr. Stein. Well, I wouldn't like to get them in the business of reviewing the code periodically. I am just suggesting that the rates go down to zero periodically. Leave the code there, and then decide on the rates. To get into the fairness of the code more than once every generation I think is cruel and unusual punishment.

Mr. Broyhill. I think we do need to look at the code also periodically.

Dr. Stein. Well, the suggestion is made essentially for didactic purposes. Of course, it wouldn't be necessary to go all the way. You might say that every 4 years we will reduce all of the rates by 50 percent and then you can make a decision. That would be half of zero based taxing.

Mr. Broyhill. I would like to have your comment here just briefly: Do I detect a difference between you two gentlemen in that you, Dr. Stein, would advocate a policy of more permanent reductions in the tax rates early in the next Congress, as opposed to providing temporary reductions or temporary rebates and other temporary stimulus steps that Dr. Tobin recommends?

Dr. Stein. Yes; that is the difference between us. I think this is partly a difference about the need for stimulus. I think lurking behind it is a difference of view about the future size of the Government, the future level of Government expenditures and taxes, and whether this opportunity to reduce taxes should be taken in the way which increases the probability that taxes will be lower in the future or whether it should be taken the way which doesn't increase that probability, but which leaves room and opportunity and incentive for more rapid increase in expenditures.

We have estimates made which the staff of the Congressional Budget Office of the large surpluses that are out there 4 or 5 years from now, with the present expenditure programs and the present tax system. I think one question that has to be decided is what proportion of that prospective surplus should we use for tax reduction and what proportion for increased expenditures. And I think what you are hearing here is some difference of view about that.

Dr. Tobin. Could I say something about that?

Mr. Broyhill. Yes.

Dr. Tobin. My friend, Dr. Stein, and I could debate on another occasion, as we have in the past, about the issues you just raised about the size of the Federal Government and the size of the public sector in general.

I don't want to debate that right here, but only to say that it is not an issue which ought to be decided in the first month of a new administration for all time. It ought not be decided in the haste of trying to do something urgent about a serious macroeconomic problem, incipient recession.

I think the new administration, and the Congress, can have a chance to decide more deliberately, and with more discussion and more debate, with inputs of the sorts that Herb Stein was giving us this morning, as well as others, about how to use the potential revenue capabilities of the tax system in the longer run—whether for permanent tax reduction or for new programs, or whether to run a Government surplus at high levels of employment in order to provide additional saving for the financing of capital formation. Those are important issues, and I would think a new administration and Congress should decide them deliberately, considering their priorities quite carefully.

As I understand it, the size of the Federal budget on the basis that Dr. Stein just stated would be around 20 percent of GNP if, new programs weren't added and if we got GNP up to the levels that would be consistent with 5-or-5½ percent unemployment. Whether that should be reduced to 19 percent or increased for new programs to 21 is not something that ought to be decided in the course of trying to do something rather urgent about the economic situation in 1977.

That is my point of view.

Mr. Broyhill. It seems to me these are just the continuations of the arguments we have been hearing up here for a long time. Many have been advocating permanent tax relief but all we have been getting is temporary solutions, and we have been debating this for a long time, and it's past the time that we should have made these decisions, it seems to me. So I have a basic disagreement with you.

Thank you, Mr. Chairman.

Mr. ASHLEY. I am a little confused as to why it's necessary at this time to decide between a temporary and permanent tax reduction. We are running enormous deficits. And, more importantly, we are going to have to make use of already scarce revenues to pay for current services, to reduce the deficit, and to finance new initiatives. Isn't talk about a permanent tax cut somewhat premature?

Dr. STEIN. Well, how much revenue you need will depend on expenditure decisions that still have to be made, and they are out there to be made.

Mr. ASHLEY. Certainly, but when we have such a huge gap between expenditures and revenues, it seems to me we are really not at a juncture when we can decide how to use any surplus that might be available.

Dr. STEIN. Well, for the present, or for next year, the size of the surplus will not be affected by whether the tax cut is made temporary or permanent. The difference will appear, if it appears at all, in the future years when under the permanent tax cut you will have lower revenues than you would have had under the temporary tax cut system, on the assumption, which I think is rather unrealistic, that you can make a temporary tax cut.

But, in those future years you will then have a decision whether to confine the expenditures within the limits of those reduced revenues, or if that seems absolutely intolerable, of course, Congress is here and and can raise the tax rates. Again, I just think the present system creates a bias toward spending whatever revenue there is, and whatever revenue, additional revenue the inflation generates, and the only occasion in which there is very much consideration being given to reducing taxes is when it seems necessary to do that for the sake of stimulating the economy. This probably being one such occasion, I think it should be taken to consider a permanent cut.

Mr. ASHLEY. I don't suppose a permanent tax cut is any more permanent than a temporary tax cut is temporary.

Dr. STEIN. Well, I think there is a difference. Congress is very reluctant to raise tax rates and very willing to cut them, so I think there is a difference.

Mr. ASHLEY. Dr. Burns, with whom I discussed this just in the last day or so, takes a very different position than you do, Dr. Stein, on this.

Dr. STEIN. Well, there are lots of differences among economists.

Mr. ASHLEY. Of course. Your case for a permanent tax cut, as I read the testimony, has little to do either with the amount of stimulus or its precise economic impact. Your case is put simply to help achieve fairness.

Dr. STEIN. That is right.

Mr. ASHLEY. That is sort of philosophic. Suppose we subtract that, fairness, from the argument.

Dr. STEIN. I don't think we can subtract fairness from the argument. I mean, that is a long shot. That is an important ingredient in the decision.

Mr. ASHLEY. Well——

Dr. STEIN. I mean, if that is your desire, to subtract fairness from the argument, well then, I am not making the point there is any considerable difference from the standpoint of shortrun stimulus between

81-097—77——4

a permanent and a temporary tax cut, and if there was such a difference, it could be taken care of by making the temporary tax cut bigger, as I said in my statement.

Of course, my attitude is it is not entirely a matter of fairness. It is a matter of trying to predispose a future course of the budget.

Mr. ASHLEY. Yes, but when you talk about lowering the corporate tax rate from 48 to 44 percent, and say that your main interest is in correcting an inequity, not stimulating investment——

Dr. STEIN. Well, that is to explain why I chose that particular method of reducing corporate taxes.

Mr. ASHLEY. You come down very strongly for a stimulus package designed to respond to your assumptions.

Dr. STEIN. Yes.

Mr. ASHLEY. Entirely on the tax side.

Dr. STEIN. Yes.

Mr. ASHLEY. Would you cut back on current public service employment programs?

Dr. STEIN. Well, if I could get an equal tax reduction——

Well, I would, yes, I think I would.

Mr. ASHLEY. That, I gather from your testimony, is based on your judgment that it's best to let the taxpayer spend his own money.

Dr. STEIN. Yes, unless there is some clear national need for the product of Government spending.

Mr. ASHLEY. Congressman Giaimo has asked me to direct to both of you some questions on the high rate of teenage unemployment, especially among minorities, even when the economy is healthy. What is your assessment of current manpower training programs for youth? Are the problems caused by a lack of funds, or basic direction and objectives of the programs? I think Congressman Giaimo would like to know to what extent a tax reduction would have a beneficial impact on this distressing problem of persistent teenage unemployment?

Dr. STEIN. Well, it would have a relatively small effect on that problem. The problem does have to be attacked in other ways.

I think our difficulty is we haven't known how to do it very well. I think the proposal for differential minimum wage laws with lower minimum wage for young people certainly is sensible, although I don't think that is the whole solution. I think that the problem probably goes back into the educational system. It's not being very well addressed by the post high school training programs that we have tried to develop for this purpose. I don't think the problem is basically lack of money, I think we just don't know how to do it very well.

But, I think that's one of these problems that we have to work on and we will not settle by January 30.

Mr. ASHLEY. Dr. Tobin?

Dr. TOBIN. I think a strong overall recovery will improve the prospects for teenage employment. It will be improved more for whites than for blacks, unfortunately, but full recovery will improve the state of the labor market for everybody. However, the problem won't be solved even if we should have a rapid return to the unemployment rate we had as recently as 1973, around 5 percent. We would still have a longrun chronic problem that needs to be attacked more vigorously and imaginatively than it has been up to now.

That is why I said in my original statement that this should not be regarded as something that is just a way of giving stimulus to the economy or helping people who are just temporarily unemployed. The problem that will still be there even after we get the overall unemployment rate down to more tolerable levels.

I don't think that we have had great success with this problem so far, and possibly the main reason for that is just what Dr. Stein says, we haven't known how to do it, and we haven't stuck with the problem persistently and imaginatively enough.

One of the problems is that we can't just provide deadend, menial type jobs and expect to induce the kind of motivation and ambition that is needed among the teenagers that we are trying to help, and to turn into constructive and longrun participants in the labor force.

I personally have been attracted to the idea of a voucher system which would give to eligible teenagers and others certificates they could present to employers, who would hire them for designated minimal lengths of time and give them training. Those employers could be public employers or nonprofit institutions or private business. The vouchers would be redeemable from the employer by the Federal Government, provided the employer also met some other requirements which would be designed to prevent substitution of voucher holders for regular employees.

I think what we really need is to get the job specifications and the technological setup of American industry, public and private employers, geared to the composition of the labor force we actually have, including youth, women, and other adults, not geared just to experienced and trained and skilled white, male adults. The problem has to be attacked from both sides in the improvement of the capabilities of these unemployed persons, and realistic improvement of the job specification and tables or organizations of American employers.

Mr. Ashley. The CETA program has run into all kinds of trouble, particularly the substitution problem. We have it in the city administration in Toledo, Ohio, and I am sure in every other city as well. I applaud your comments. I do see real difficulties in preventing substitution.

Dr. Tobin. Well, I think those are real difficulties, but I don't think they are beyond solution. You can tolerate a certain amount of slippage there. But the criterion for full value of the voucher reimbursements in the plan I was mentioning before to would be based on the overall expansion of the total labor force of the employer during the year for which he submits the vouchers for redemption. There could be a sliding scale so that they are redeemed at full value if he has increased employment by certain amounts, and at lesser values for less good performance.

In the case of CETA and other programs like that, maintenance of effort is difficult to enforce. At the same time, the benefit is all lost even if substitution of Federal for local funds occurs. Actually there could be a good case for including in a fiscal package in 1977 additional special revenue sharing for State and local governments which are in difficult financial straits.

Mr. Ashley. That's true, it would just make it that much more expensive.

A question to you, Dr. Stein, from Congressman Butler Derrick. Can you compare the impact of reduced Federal taxes on employers and employees with an equal reduction in corporate taxes or individual income taxes? That is to say, on unemployment or inflation?

Dr. STEIN. Well, that's a very complicated matter, especially when you put the corporate profits tax into that picture, because there you are talking not simply about incentives to spend out of disposable income, but out of incentives resulting from future profit prospects or from future prospects for profits after tax, and I don't think we really know the course given us very well.

I would think there would not be as between reduction of the payroll tax and reduction of the individual income tax, there would not be a very great difference in the effect on employment, but the reduction of the payroll tax would have some beneficial effect with respect to the rate of inflation. The reason I don't prefer that is that the whole structure of the social security system is a complicated problem. I would not like to abandon without a great deal more thought the idea that the social security system is supported by the payroll tax, and we are certainly far from having an adequate payroll tax for that purpose now.

So, I would not like to change the payroll taxes as an instrument of general tax reduction at this time.

Dr. TOBIN. May I comment on that?

Mr. ASHLEY. By all means.

Dr. TOBIN. I think the advantages of partial remission of payroll tax for a temporary period would be threefold. One, is to give stimulus to demand: In this aspect it would be much like a broad based income tax reduction.

Second, is to have a disinflationary effect by reducing labor costs, and to that end the remission could be shared as between employers and employees.

The third is to give some direct employment incentive by reducing labor costs relative to those of other inputs business firms use.

On all those counts I think that the proposal has a lot to recommend it.

I don't think that need foreclose the longrun questions of social security finance. The temporary remission could be coupled with general appropriation to maintain the social security reserve fund. The payroll tax system as a way of financing social security would be maintained.

Mr. ASHLEY. Dr. Tobin, your stimulus package includes employment producing expenditures, along with tax reductions. Have you concluded that job creating investments do provide stimulus and are you prepared to compare the stimulus from this form of effort as against the kind of approach suggested by Dr. Stein, namely, to rely entirely on tax reduction.

Dr. TOBIN. In terms of "bang-for-a-buck" stimulus per dollar of revenue loss or of additional outlay, I am inclined to agree with Dr. Stein that there is not an awful lot of difference. The difference is that some of the tax reductions, whether permanent or temporary, are initially saved, not spent, whereas Government expenditures by their nature are all spent.

So, you have some difference there per budget dollar, and the leakage is perhaps a little greater for temporary tax reduction than for permanent tax reduction. That is probably not terribly important, given the fact that, as Dr. Stein mentioned, to the extent we can anticipate the leakage in the first round of tax reduction, you could just make the tax reduction somewhat larger and get the same stimulus.

The major reason that I would like to see some inclusion of direct job creating expenditures is not because I think it gives the overall economy significantly more stimulus per budget dollar, but rather because of the structural problems of unemployment and State and local finance that we were talking about earlier. There seem to be meritorious, desirable ways in which Federal outlays might be used, having and doing some good on the chronic longrun problems of inflation and unemployment.

One of the advantages of public service or general programs for employment and training of chronically unemployed or out-of-labor-force individuals is that they may yield some gains in the tradeoff between unemployment and inflation. The point is to employ people whose unemployment has very little restraining effect on wage inflation, who can be put to work without the same effects on the course of money, wages, and prices that the untargeted reemployment of average members of the labor force might have.

Those gains are probably small, but they are worth seeking. There is important advantage in terms of the longrun equity and efficiency of the economy in bringing people who are outside the mainstream line of the economy into it.

Mr. Ashley. What have we learned from the experience of last year with respect to the stimulative effect of a tax rebate?

Dr. Tobin. Well, I think that matter is still controversial among economists. I have heard in the last month flat statements by friends of mine on both sides of the issue. Some say that the tax rebates were spent in the same proportion as any other income received; others say that they weren't spent at all. My own judgment is—which is not based on econometric calculations—is that they were substantially spent, almost as much as a permanent tax reduction would have been.

Mr. Ashley. Of course, the impact was a one shot impact, wasn't it?

Dr. Tobin. Yes. We observed a temporary increase in the saving rate during the quarter when those rebates were disbursed. Presumably they were first deposited in checking or savings accounts and then spent. I think a part of the improvement in the economy in the latter part of 1975, the improvement in the consumption component, was the spending of those rebates along with the tax reductions that affected withholding. My recommendation was to generalize the rebates to include payments of similar lump sums to people who didn't have sufficient tax liabilities or any tax liabilities. One reason is to direct them to people whose circumstances, given their inability to borrow money and their lack of savings, make it very likely that they will spend whatever cash they can get their hands on.

Mr. Ashley. Dr. Stein?

Dr. Stein. I guess I agree with what Dr. Tobin has said about this. I think it's very hard to measure, but while we did see an increase of savings particularly in the second quarter of last year, we also saw considerable increase in consumer expenditures beginning around the same time, and it seems to me it would be hard to argue that a tax cut, whether temporary or permanent, has no effect on total output or unemployment, unless you will simultaneously argue that the effect of a deficit in the Federal borrowing was particularly restrictive, in other words that you have a high amount of crowding out. The experience of 1975 and 1976 with interest rates moderate and falling doesn't suggest we were in an environment where crowding out was at least for the time being very important.

So, although it's always very hard to disentangle these things, I would stand with the view if you give people money they will probably spend some of it.

Mr. ASHLEY. Gentlemen, you have been very helpful to this task force, and to the budget process in general. We appreciate your coming here this morning. Your testimony will be made available to all of the members of the Budget Committee for its future deliberations.

I would have just one final question. This is not meant to be argumentative at all, but I have a thought I do want to ask about. In your statement, Dr. Stein, you say that:

> A permanent tax cut is necessary to preserve the taxpayers' option to dispose of his own income, unless his elected Representatives have made an affirmative decision to levy taxes on him for important financial purposes.

The budget process itself takes a rather major step in this direction, doesn't it?

Dr. STEIN. Yes, I think the new budget procedure is helpful in that way, but I think that there is a considerable inertia in the tax system. The existing tax rates tend to go on. Therefore, expenditures are adjusted to the expected revenue of the tax system. I think that people, or at least many people, are now arguing against a permanent tax cut, because they want to make sure the money is there and available for expenditure.

Mr. ASHLEY. Dr. Tobin, with respect to your suggestions relative to a stimulus package, both fiscal and monetary, assuming that your fiscal proposals were to be adopted, would you have any specific recommendations with respect to M_1 and M_2 growth rates?

Dr. TOBIN. My major suggestion would be that the Federal Reserve reduce further their target Federal funds rate which is now 4⅞ percent, I believe. I would reduce it gradually, not too gradually, by at least a full point, bringing further downward pressures on long-term bond yields, giving further stimulus to equity markets. The point is to improve the general opportunities for long-term financing of private investment.

Since that process takes time to have effect on actual investment expenditure, I would start doing it now. But I wouldn't anticipate any dramatic effects in the early months of 1977.

There is some truth to the central bankers' historic excuse for not intervening aggressively to combat recessions when they are already underway, "you can't push on a string." Well, I think they should start pushing on the string. It's not that slack, but it will take a while for the push to eventuate in additional housing construction, and additional business fixed investment.

The Fed should do that without particular concern about quantitative targets for the monetary aggregates, M_1, M_2, M_3 or any other M.

Maybe my prescription will result in faster growth in those aggregates than the current targets would allow, and maybe they won't. We have now a couple of years of experience in which it is shown that the connection between the rates of growth of monetary aggregates and the course of interest rates in the economy is a lot more uncertain and a lot looser than previously thought.

The important point I think is not to be concerned so much with indicators of rates of growth of M_1, M_2, and so forth, as with the rate of growth of total dollar volume of GNP, as Dr. Stein was suggesting earlier. That is why I would hope that the deliberations leading to the Congress' budget resolutions could focus explicity on objectives for the economy in terms of real growth of GNP and prices. The goal might be summarized in target brackets for growth of nominal dollar value GNP, as Dr. Stein suggested.

The important things is that the Federal Reserve should be gearing its policies toward the same objectives of GNP growth as the Congress and the President. We should have a coherent strategy, monetary and fiscal, which will get us there. In that process M_1, M_2 targets are instrumental; they are not the ultimate objectives at all.

At present and for most or all of 1977, real investment demand is very weak. The financial climate for financing in equities markets and in investing retained earnings, can stand a great deal of improvement. In the past 2 or 3 years monetary growth has been down. In these circumstances I think I wouldn't worry too much about numbers for M growth.

The Federal Reserve and its Chairman are in the best position to explain to the country convincingly and credibly that rates of monetary growth which would not be appropriate to continue forever are quite appropriate to current economic circumstances. Rates of monetary growth quite acceptable now would not be appropriate when the economy is much closer to full employment levels. The Chairman could give assurance that the Fed would not continue them then. They are part of the recovery package. The same rates of growth of monetary spending, of nominal value of GNP, which are appropriate and are not inflationary during recovery from deep recession are not appropriate as a longrun policy, and would be excessively inflationary if continued indefinitely.

Confusion on that point is one of the reasons, I think, for the paralysis of both public and private policy observed recently.

The best institution and best person for clarifying the point are the Federal Reserve and its Chairman.

Mr. Ashley. Do you have a comment on that, Dr. Stein?

Dr. Stein. Well, gentlemen, we are, as Professor Tobin said, very uncertain about all of these relations. I do tend to think the rate of growth of M_2 that we have been having, which has been a little bit above the Federal Reserve targets for M_2, that that rate of growth is consistent with the rate of expansion of nominal GNP that I would like to see in 1977, and in 1978, although at some point we want it to slow down.

Now, we haven't been getting the rate of growth of nominal GNP you would expect out of this monetary expansion, and that is one of the reasons. So, we have a choice of how to approach that problem, and I think what we are saying is to approach this problem by stimulus from the fiscal side, and I would not propose to speed up the rate of growth of the money supply.

Now, whether Professor Tobin's guidance would lead to faster or slower rates of growth of money than we have been having recently is uncertain. That is, it may be if the economy is as weak as he believes it to be, that interest rates would fall anyway, even with this rate of monetary expansion and perhaps that guidance might suggest some contraction of the rate of monetary expansion; but I wouldn't favor that. I think we would do well to stay at something like the 10 or 11 percent rate of growth of M_2 we now have.

Mr. ASHLEY. Mr. Broyhill, do you have any further questions?

Mr. BROYHILL. No, thank you, Mr. Chairman.

Mr. ASHLEY. One final area that interests me particularly. The primary rate is what, 6 or 6¼ percent?

Dr. TOBIN. Split.

Mr. ASHLEY. The mortgage rate on new single family homes is around 8¾ to 9 percent, and on multifamily around 10 percent; is the difference between mortgage rates and the prime rate a historically large one? Are mortgage rates holding at a higher level for some particular reason?

Dr. STEIN. Well, I don't think this is an extreme gap. I am sure it was observed at other times, and simply reflects the fact that although people can only get a lower rate on short-term loans, if they can find the loans, they don't want to tie their money up for 20 or 30 years at something less than the present mortgage rate, because they think that other opportunities will come forward later.

Mr. ASHLEY. Does this include the savings and loans? They have a lot of money to lend, but they are not lending.

Dr. STEIN. Well, they have some alternative uses for their money also.

Mr. ASHLEY. True. What do you think it will take to get mortgage rates down?

Dr. STEIN. Well, I don't know that we will get them down.

I remember when Dr. Burns testified on this subject about a year ago or so he said, well, 8 or 9 percent is a very low rate when you have a 5-and-6 percent rate of inflation. But I think what would get the mortgage rate down would be demonstration that the rate of inflation is at least not going to revive; so, when you look out 4 or 5 or 6 years you would not expect interest rates to be much higher than they are now.

Mr. ASHLEY. Dr. Tobin?

Dr. TOBIN. In the main, I agree with what Dr. Stein said on your question. I think the spread between short and long rates is rather high at the moment. Even the spread between short term open market rates—the Federal funds rate, commercial paper rate, and Treasury bill rate—and the prime has been rather high. These spreads reflect in fact greater concerns about risks both of business loans and of mortgage loans, particularly mortgage loans on multifamily dwellings. These concerns, are, of course, connected with some unfortunate experiences in the last few years.

But I think that a continued pressure on those long-term rates from the short-term side where the Federal Reserve operates will yield dividends. We will see the longer rates gradually come down, especially if it is made clear that the short-term rates are not just temporarily low, that the Federal Reserve is not going to raise rates at the first signs of economic improvement. If the market is convinced that the Federal Reserve will not react prematurely with a tight money policy, or with adherence to monetary aggregate targets that would bring sharp rises in short term interest rates, then I think you will see the mortgage rate decline further, and the prime rate decline further and long-term rates in general decline further.

Mr. Ashley. I will let you go this time. Thank you very much indeed, for your excellent testimony this morning.

Dr. Tobin. Thank you, Mr. Chairman.

Dr. Stein. Thank you, Mr. Chairman.

[Whereupon, at 12:15 p.m. the task force recessed, to reconvene Wednesday, December 15, 1976, at 10 a.m.]

ECONOMIC OUTLOOK FOR FISCAL YEAR 1977

WEDNESDAY, DECEMBER 15, 1976

House of Representatives,
Task Force on Economic Projections,
Committee on the Budget,
Washington, D.C.

The task force met, pursuant to notice, at 10 a.m., in room 210, Cannon House Office Building, Hon. Thomas L. Ashley (chairman of the task force) presiding.

Mr. Ashley. The task force continues this morning with testimony on the economic outlook for 1977 and the possible extent and types of stimulus proposals necessary to deal with the prolonged pause in the economic recovery.

We had outstanding testimony yesterday and look forward to the same today. We have with us Dr. David L. Grove, vice president and chief economist of IBM, whom our Economic Projections Task Force has heard before, and Dr. Murray L. Weidenbaum, former Assistant Secretary of the Treasury, 1969 to 1971.

Gentlemen, we are very pleased to have you with us today. Dr. Weidenbaum, if you will be so good as to begin.

STATEMENT OF DR. MURRAY L. WEIDENBAUM, DIRECTOR, CENTER FOR THE STUDY OF AMERICAN BUSINESS, WASHINGTON UNIVERSITY, ST. LOUIS, MO.

Dr. Weidenbaum. Thank you, Mr. Chairman. It is a real privilege to be asked to testify again. I hope my testimony will be of some use to you in your important deliberations.

This is the time of year that the innocent bystander gets caught in the crossfire of conflicting economic forecasters. Many liberal economists are urging ambitious new expenditure programs and large tax reductions in order to prop up what they see as a sagging economy. In contrast, conservative economists are generally defending the status quo in economic policy.

Some perspective is necessary, some middle ground. Despite the moanings of the professional doomsayers, the trend of economic activity in the United States is not headed downward, but continues upward. In the July–September 1976 quarter, the gross national product rose at an annual rate of 8.2 percent. Even after adjusting for the impact of inflation, "real" growth for the quarter was 3.8 percent, a positive rate of growth. Virtually every economic forecaster is projecting a growth rate in 1977 at that level or higher.

Total employment is also rising steadily, from 85.6 million in November 1975 to 88.1 million in November 1976—an increase of 2.5 million jobs in 12 months.

In terms of the future, here is what my economic crystal ball shows: For 1976, economic growth will be 6 percent and the inflation rate will average 5 percent, with the gross national product rising 11 percent for the year. In 1977, I expect another 11-percent increase in GNP, but with the growth and inflation rates reversed—5-percent real growth and 6-percent inflation. Unemployment is likely to average 7 percent, with a moderate declining trend through the year.

There will be no boom areas in 1977 in my crystal ball. In recent months, the economy has been growing more slowly than generally expected, in part because of the recent and now settled strikes in rubber and autos. I foresee an upturn, but one of modest proportions. This moderate expansion will be accompanied by a recovery in housing, especially the construction of single family units, a rise in business inventories, and some expansion in capital investment. Consumer spending will grow at about the same rate as the economy as a whole. Witness, a case in point, the recent upturn in retail sales.

The Federal budget for fiscal 1977 is anticipated to show a deficit of $55 billion or more on the basis of present policy. Although a decline from the fiscal 1976 deficit of $66 billion, that would still be a substantial injection of purchasing power into the economy.

An important policy issue is emerging: Are the projected rates of economic growth and job creation rapid enough to be accepted by the public and the Government? Before answering that question, we must consider the important subject of inflation.

Over the past 12 months, the consumer price index rose by about 6 percent, while the wholesale price index is now 4 percent higher than 1 year ago. This is not double digit inflation, but it is substantially above historical experience. Future price prospects are not rosy. Another round of oil price increases is being seriously considered by the Organization of Petroleum Exporting Countries. Major union agreements provide for increases in wages and fringe benefits substantially above productivity growth, in addition to cost-of-living increases. Surely, the potential for another acceleration in the rate of inflation is present.

The concern about inflation is not limited to conservatives. Liberal economists now talk about guideposts, jawboning, and other forms of governmental involvement in private wage and price decisionmaking. President-elect Carter already has done some mild jawboning in the case of steel.

Surely the economy is growing, but not at a pace rapid enough to make substantial progress in bringing down the unemployment rate, which appears to be stalled at a high level close to 8 percent. Simultaneously, the inflationary pressures in the economy are clearly evident and painful past experience tells us that they should not be ignored.

The upshot of all this is not to oppose all proposals for action or change. Rather, we should be wary of bold initiatives which attempt to deal with one of the two major economic problems while ignoring the other, and which would damage public confidence generally. For example, it has become fashionable to urge upon the incoming administration that it embrace a major program of public works and Government employment as a stimulative device. That approach would be undesirable for many reasons, both technical and philosophical.

Such long leadtime expenditure programs cannot be cranked up quickly. They involve lengthy authorization and appropriation hearings in the Congress and extended contracting and hiring procedures on the part of the many Federal, State, and local governments units that would be involved in carrying them out.

With reference to defense spending, my study convinces me such expenditures should be made not for economic impact reasons, but only for national security reasons.

Also, the expenditure approach means a bigger public sector of the American economy, and thus less opportunity for private activities. In addition, adverse incentive effects on the labor force of the private sector will occur as Government becomes the employer of last resort. Moreover, the advocates of greater Government spending ignore the likelihood that much of the celebrated underrun in Federal expenditures during the past year will be made up by an overrun in the coming year, a sort of fiscal whiplash. Once again, the danger in turning on the spending spigot is that the resulting flow will be too much too late.

A moderate degree of additional stimulus is now a sensible and desirable move in economic policy, and I would urge it on the committee. The tax side of the budget is more promising than the expenditure side. But here the danger is that the result may be a disguised welfare-type handout rather than a legitimate reduction in existing tax burdens. Witness the rising interest in a refundable tax rebate with a low ceiling.

In plain English, such proposals mean that Treasury checks will be sent to taxpayers and nontaxpayers alike, and that citizens with high tax loads will not get much more if any of a tax reduction than those with low tax loads. Also, the concentration on personal tax reduction ignores the continuing problem of the corporate income tax becoming increasingly severe in its real effects during an inflationary period, when depreciation allowances, for example, do not cover the cost of replacing capital equipment.

Those of us who have been contending that American industry is operating closer to full capacity than the official statistics show have recently been vindicated. The Federal Reserve Board has now amended upward its data on capacity utilization. For the July–September quarter of 1976, it now shows that manufacturing companies are operating at 80.9 percent of capacity, while the earlier figure for the same time period was 73.6 percent.

We are not that far from the peak of 87.8 percent of capacity which occurred in the shortage-prone third quarter of 1973. A reduction in corporate tax rates would provide additional financing for the increases in industrial capacity which will be required to avoid bottleneck situations as the economy grows during 1977 and beyond.

A permanent across-the-board reduction in personal and corporate tax rates is the preferred way of providing added fiscal stimulus to the economy—equivalent to approximately $10 billion of current Federal revenue. This approach would provide a degree of confidence to consumers and business executives alike in their private planning. It would also demonstrate a high degree of responsiveness by the President and the Congress to the widespread voter concerns over both big government and high taxes. We need to recall that the social security tax rises in January 1 in the form of increasing the maximum amount of annual earnings subject to social security taxation from $15,300 to $16,500.

Unlike a one-shot rebate, a permanent tax reduction would avoid the problem of a sudden increase in tax payments during the following year, and it would provide more bang for the buck. It would also enable the Federal Reserve System to follow a more stable monetary policy, which is necessary to support economic growth while continuing to dampen inflationary pressures. Of perhaps greatest importance, especially to the Committee on the Budget, a permanent reduction in Federal taxation would mean that longrun expenditure planning in the public sector would have to be made in the context of a smaller flow of future Federal revenues than would otherwise be the case in year to year one-shot tax reductions. That could be a a useful restraint on the proponents of vast new expenditure programs, who tend to surface at the beginning of every Presidential administration.

But fiscal and monetary policy changes will not be adequate to deal with the problem of high unemployment in an inflation-prone economy. The Congress needs to face up to the difficult but necessary task of reducing and hopefully eliminating those Government programs which give a inflationary bias to the economy—and often increase unemployment at the same time—programs which are an anacronistic legacy of the 1930's, ranging from trucking regulations to maritime subsidies.

It is no coincidence that unemployment is highest in those sectors of the labor market where Government regulation is most severe. Unemployment rates in construction, for example, are higher than in the industrial economy. In the construction area, the Davis-Bacon Act, that legacy of the 1930's, tends to inflate costs and thus price homes and other construction out of the reach of many potential buyers.

With reference to the serious problem of high unemployment among teenagers, we must turn to that triumph of the heart over the mind: The minimum wage law. A recent study published by our Center for the Study of American Business showed that one increase in the statutory minimum wage law literally priced 320,000 teenagers out of the labor market.

Surely, jobs at or below the minimum wage do not yield incomes sufficient to support an entire family. But they do provide that essential work experience which enables now unemployed youth to gain the skills that subsequently will earn them adequate wages and enable them to participate fully in the mainstream of our society.

My basic point here is that it is unwise to try to offset the effects of these and other Government regulations with an overly expansionary and, hence, overly inflationary, macroeconomic policy approach. The more sensible approach is to reduce those Government-imposed obstacles to employment and price stability.

With the prospect of continued steady improvement in the economy, we now have an opportunity to provide cautious, moderate stimulus with one eye to decreasing unemployment, but with the other eye trained on continuing to control and to reduce inflationary pressures.

A forward looking economic policy for 1977 would indeed give a needed lift to a slow-growing economy—hence the rising support for stimulus in the form of a tax cut. But a new departure in public policy should be more comprehensive. It is essential that any new approach to economic policy begin by shucking off the lingering vestiges of policies of a bygone era, and thus reducing the continuing burden of budgetary and economic costs that restrain the discretion of policymakers.

The elimination of the subsidies—regulatory, tax, expenditure, and credit—enacted during the 1930's and 1940's would free up the public and private resources to deal with current and future priorities. Otherwise, the Congress and the Carter administration will find—as did their predecessors—that they lack the resources to continue the existing gamut of activities and simultaneously take on important new responsibilities.

Thank you.

Mr. Ashley. Thank you very much. That was an excellent statement, Dr. Weidenbaum. Dr. Grove.

STATEMENT OF DR. DAVID GROVE, VICE PRESIDENT AND CHIEF ECONOMIST, IBM

BUDGETARY POLICY IN THE CURRENT ECONOMIC SETTING

It is a pleasure for me to be here today, to meet with this distinguished committee and to have an opportunity to make a contribution to your work. I should emphasize that I am here in a personal capacity and do not presume to speak for anyone else, especially in respect to policy assumptions and recommendations. In response to the request made by your staff in the invitation to appear before you, I shall briefly review the near-term economic outlook and then move to an assessment of what kinds of budgetary actions would seem to be called for by the situation.

THE CURRENT ECONOMIC SITUATION

It is widely known that the recovery has faltered during the past two quarters. We can expect no better performance in the current quarter.

The principal reason for the slowing of the recovery has been the failure of real disposable personal income to rise at a rate capable of imparting any strength to consumer spending.

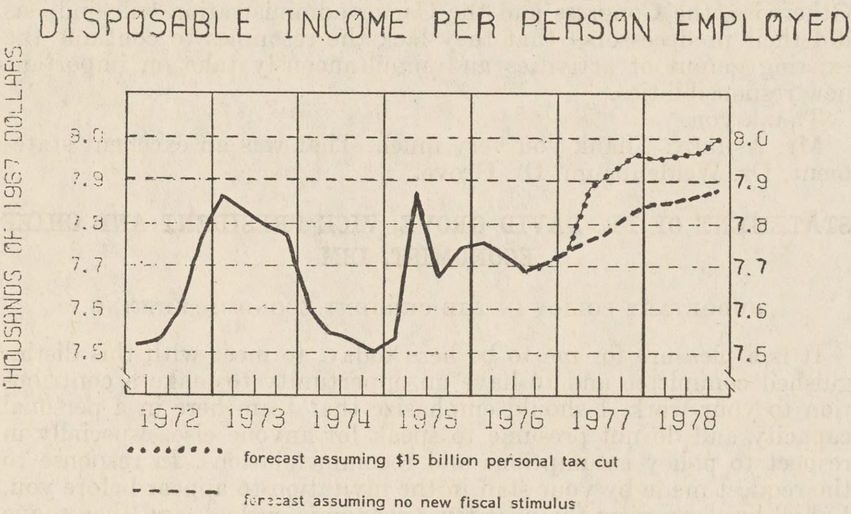
With lackluster consumer buying, business plans to invest have been cautious. The latest Commerce Department survey verifies this impression. Investment, therefore, has been contributing much less to the continuation of the recovery than one would expect, given the stage of the recovery and the volume of corporate profits.

The unemployment rate has risen, and currently is higher than it was in the spring of this year. Inflation, however, as measured by the Consumer Price Index, has not diminished significantly and remains close to 6 percent, on average.

I have just stated that weakness in consumer buying power explains the slowdown in the recovery. I have passed out copies of a chart which shows the situation quite clearly. It plots real disposable income per person employed. This series is one which my staff calculates from published data; however, the series itself is not published. Perhaps it should be, because it sheds a great deal of light on how well or poorly the average employed worker is making out.

On the chart you can see the spurt in the spring of last year. This was occasioned primarily by the tax rebate and cuts. Retail sales quickly responded to this improvement in the consumers' buying power. The tax cut was a success.

[The chart referred to follows:]



Dr. Grove. The rebate portion was a one-shot affair, of course, so there was almost bound to be a temporary dip in the following quarter. But then there were two quarters of growth, into the first part of 1976. Since then, real disposable income per person employed has drifted downward, as the initial fiscal stimulus wore off and overall demand for labor failed to rise sufficiently to permit any significant growth in real wages. With the bottom of the recession a year and a half behind us, the average employed person's real disposable income still is less than it was in 1973. No wonder consumer spending has been weak, even with the improvement in October and November, and excess capacity is substantial and widespread.

THE NEAR-TERM OUTLOOK

What is the outlook for the period ahead? There is a good, but by no means certain, prospect of a temporary improvement in the economy's growth rate in the first half of next year. Wage increases in the nonunion sector will be somewhat larger than they have been recently, and the decline in farm income is likely to come to an end. The first of these two developments will provide a moderate boost to real income and the second will remove a recent drag. Both will be beneficial to consumer spending. There also are likely to be modestly higher increases in business investment and in total Government spending. The recovery then will decelerate again in the second half of next year and in 1978.

The principal reason for the renewed deceleration is that, in the absence of new fiscal stimulus, real disposable income per employed person will be rising quite slowly, as you can see from the chart. Of course, total real disposable income could rise strongly, even though income per employed person did not, if there were to be a large increase in the total number of people employed; however, this is not in prospect.

Therefore, in the absence of additional fiscal stimulus, the outlook is for decelerating economic growth in the second half of next year and through 1978. The unemployment rate would average 7.7 percent in 1977 and would be 6.8 percent by the end of 1978. These and the other forecasts I shall be presenting today came from simulations run on an econometric forecasting model developed by the Economic Research staff at IBM.

Two elements will make it difficult to lower the unemployment rate. The first is an anticipated high rate of growth in the labor force—3.7 percent between the third quarter of this year and the end of 1978. The second is improvement in output-per-man-hour, this is, in labor productivity. This is estimated to rise 4.4 percent over the same period. Thus, productivity gains and labor-force growth will total 8.1 percent, from third quarter 1976 to the end of 1978. In other words, total output would have to rise 8.1 percent just to keep the unemployment rate where it presently is. With a forecasted growth in real output of 8.8 percent over that period, this leaves only a small margin that will exert any net compression on the unemployment rate.

What is the outlook for inflation? Will the anemic economic situation push the rate of inflation down? Unfortunately, probably not. Most price increases then, as now, will be impelled by cost increases that will have been built into the economy—for example, through previously negotiated contracts—or which are of external origin, such as OPEC price hikes. These cost increases will continue to work their way through the system almost regardless of the level of overall demand. They will not be caused by excess demand or by tight supply conditions, and they cannot be suppressed, to any great extent, by choking demand.

This, then, is a very brief survey of the current economic situation and its near-term prospects in the absence of any additional fiscal stimulation. With your permission, I have appended to my testimony a table which presents the forecast in a bit more detail, under this and some alternative assumptions about fiscal policy.

CAN THE ECONOMY GROW FASTER WITHOUT ACCELERATING INFLATION?

Some observers of the current scene have expressed the view that it would be dangerous to provide additional fiscal stimulus because it would run a very grave risk of setting off a new upward spiral of price and wage increases. Those who take this position base their arguments on one or both of the following two assertions: First, the economy is closer to peak levels of capacity utilization in manufacturing than is realized; in this connection, reference generally is made to the recent revisions in the Federal Reserve Board's index to buttress the contention; and second, the unemployment rate exaggerates the amount of slack in the labor market because many of the unemployed are really not employable, or, at least, would be workers with quite low productivity and therefore capable of making only a very limited contribution to increased production. Let's look at these two issues.

1. PLANT CAPACITY

The recent revision in the Federal Reserve Board's Index of Capacity Utilization has resulted in a spate of ill-informed comment. The point generally made is that the revised index indicates that the rate of capacity utilization in total manufacturing in the third quarter of this year—(80.9 percent)—was only 7 percentage points below the level just prior to the eruption of the 1973–74 inflation. The conclusion then is drawn that the economy is uncomfortably close to the flash point once again.

While the statistics are correctly stated, the use of the overall index is misleading, because in 1973 there were no shortages in the industries producing finished goods. These industries have a heavy weight in the total index. The shortages were concentrated in the materials industries. The overall index has exceeded 90 percent on previous occasions without causing inflation on anything like the scale experienced in 1973–74.

Insofar as capacity pressures are concerned, sources of the inflation in that period were the shortages and bottlenecks in the materials industries, such as basic metals, textiles, chemicals, paper, and refining. In this group of industries, the average operating rate currently is running nearly 13 percentage points below the 93.1 percent peak reached in mid-1973. This demonstrates substantial excess capacity. Furthermore, using our current forecast of economic activity, which, by the way, assumes a $15 billion tax cut, we calculate that capacity would have to rise by less than 2 percent per year to keep operating rates below 90 percent over the coming 2 years. The historical average rate of growth in capacity in the materials industries has been 4 percent, so there should be little risk of not achieving a rate of at least 2 percent, especially in the light of the prospects for some pickup in capital spending.

2. LABOR RESOURCES

The current unemployment rate of 8.1 percent is the highest since 1948, except for the peaks reached during the 1974–75 recession and the early months of the ensuing recovery. Even allowing for the changes in the age and sex mix of the labor force over the past three decades—which would raise the so-called "4 percent full employment" rate to between 4.5 percent and 5 percent—the current rate is at least 3 percentage points higher than "full employment." Furthermore, much of the current unemployment is concentrated among breadwinners and skilled segments of the labor force.

Three categories often used to measure the primary labor force are: (1) Married man; (2) household heads; and (3) experienced wage and salary workers. If, for each of these categories, we calculate the ratio of the current rate of unemployment to the one that was recorded for the same category at the peak of economic activity in October 1973, we find that the ratio in each case is higher than the comparable ratio calculated for the overall unemployment rate. All but 1 million of the 7.8 million persons currently unemployed are experienced workers; 38 percent are heads of households. Only 22 percent of the currently unemployed are teenagers; this compares with 30 percent of the unemployed in October 1973. In other words, not only has the unemployment rate overall risen very substantially, but it has risen relatively more for the primary labor force—those who want to work, have to work, and possess the skills to do so.

These measures, like their plant-capacity-utilization-rate counterparts, indicate that the supply of labor presently is more than ample to support a strong economic recovery. Even with the additional fiscal stimulus embodied in our forecast, the unemployment rate will remain over 6 percent at the end of 1978.

POLICY SIMULATIONS

Before making any recommendations about budgetary policy, I thought it would be helpful to run some policy simulations that would illustrate the results that reasonably could be expected from alternative courses of action. I believe you have the summary table in front of you.

[The table referred to follows:]

SIMULATION COMPARISONS

	CPI[1]	Real GNP[1] (percent)	Real consumption[1] (percent)	Real business fixed investment[1] (percent)	Unemployment rate (percent): Average for year	Unemployment rate (percent): 4th quarter	Federal deficit (NIA basis) (billions)
1976							
Case A	5.8	6.1	5.3	4.3	7.7	7.9	59
Case B	5.8	6.1	5.3	4.3	7.7	7.9	59
Case C	5.8	6.1	5.3	4.3	7.7	7.9	59
1977							
Case A	6.0	4.6	3.7	8.6	7.7	7.4	61
Case B	6.0	5.0	4.2	9.4	7.5	7.1	74
Case C	6.0	5.6	4.4	10.0	7.3	6.7	78
1978							
Case A	6.1	3.6	3.6	5.6	7.0	6.8	62
Case B	6.1	4.1	4.0	8.2	6.5	6.2	73
Case C	6.3	4.9	4.3	10.0	5.7	5.3	81

[1] Percent change year over year.

Note.—Case A assumes no tax cut, no special spending increases; case B assumes a $15,000,000,000 personal tax cut; case C assumes a $15,000,000,000 spending increase in addition to case B tax cut. See text for fuller explanation.

Mr. Grove. Case A assumes no tax cut and no special increase in expenditures. Case B assumes a $15 billion personal income tax cut. Case C assumes a $15 billion tax cut plus a $15 billion increase in Federal expenditures. The tax cut, in cases B and C, is assumed to take effect on April 1, 1977, but retroactive to January 1. The mechanism would be a readjustment of withholding rates to provide a $20 billion rate of reduction for the last three quarters of 1977; for 1978, the effective rates for calendar 1977 are spread over the four quarters of the year. The results would not be materially different if the retroactive portion in 1977 were to be given as a rebate and the withholding rates from April 1, 1977, set at the same level as in 1978.

The assumption in case C about a higher level of Federal spending is that there will be a package of increases starting at a $7 billion annual rate in the second quarter of next year, moving up to a $15 billion annual rate by the first quarter of calendar 1978, and remaining there through the balance of the year. The assumptions about the content of the package are as follows:

Five billion dollars in Federal nondefense purchases of goods and services;

Three billion dollars in Federal transfer payments to persons;

Three billion dollars in grants-in-aid to State and local governments for public-service jobs—$2 billion for compensation at $8,000 per employee and $1 billion for administration and overhead;

Four billion dollars in other types of grants-in-aid.

I believe that the results of the forecast simulations shed some interesting light on fiscal and budgetary policy requirements for the next 2 years. In the absence of fiscal and budgetary actions to raise the rate of economic activity, real GNP would advance only 4.6 percent next year and 3.6 percent in 1978. Real consumption would grow by only 3.7 percent in 1977 and 3.6 percent in 1978. There would be a pickup in business fixed investment in 1977, but the rate of growth would sag in 1978. The unemployment rate would remain at this year's high average of 7.7 percent in 1977 and would average 7 percent in 1978. Clearly, this would be an unsatisfactory performance for the economy over the next 2 years—not only in terms of our domestic needs but also in terms of providing some support to other nations which similarly are trying to get their recoveries back on the track again.

Case B shows the results of a $15 billion personal income-tax cut. I shall not discuss the figures because you have them before you in the table. Instead, I shall go to the conclusion which I think you, too, will draw from the numbers; namely, that the performance of the economy still would fall short of what is required, though there would be a fair amount of improvement over the conditions that would prevail in the absence of the tax cut.

Case C would achieve further improvement in the growth rates in real GNP, consumption and business fixed investment. The unemployment rate would decline to 5.7 percent for 1978 as a whole, and, at 5.3 percent, would be within the neighborhood of full employment by the fourth quarter.

I conclude, therefore, that it will take approximately $30 billion of total fiscal stimulus to have any significant chances of achieving the employment and growth goals of the new administration over the next 2 years.

IMPLICATIONS FOR THE DEFICIT AND FOR INFLATION

But what would such a fiscal program do to the Federal budget and to inflation? As you can see from the numbers in the last column of the table, the deficit would be larger than it would be in the absence of the fiscal stimulus. This cannot be denied. I am confident, however, that the additional sums of borrowing could be financed without any so-called crowding out of private borrowers. Interest rates in 1978 would be somewhat higher.

One would expect somewhat higher interest rates in an economy that was moving closer to its economic potential instead of slipping into the doldrums. I should add that the ability of both consumers and businessmen to pay the moderately higher interest rates would be more than compensated for by their improved income and profit prospects.

Similarly, there would be a marginally higher rate of inflation, not in 1977 but in 1978, but the difference is quite small, as the table shows.

VIEWS ABOUT THE FORM OF FISCAL STIMULUS

I should like to wind up my presentation by quickly addressing several options within a total program of $30 billion of stimulus. For convenience, I shall put the issues in the form of questions and responses.

1. Why not rebates instead of a cut in withholding rates?

The near-term results would not be materially different, provided the total increase in disposable incomes was the same, although the quarterly pattern would not be identical. The withholding-tax route, however, conceivably might evoke a more optimistic response by businessmen. They might be less cautious about expanding their inventory purchases and their new orders for capital goods if they anticipated a spreading out of the stimulus than they would be if they regarded the improvement in consumer spending as a bubble which might not last long.

2. Should a reduction in withholding rates be temporary?

Any reduction in withholding rates should be for not less than 2 years. Otherwise, both consumer spending and business investment might not respond as much as is anticipated. There would be some advantage in limiting the period to 2 years, however, because that would make it easier for Congress to review the situation in the second half of 1978 or early 1979 and extend or not extend the reductions, according to the economy's needs and the political priorities at that time.

3. Should part of the tax cut go to business?

There is a longer term need to be sure that incentives for business fixed investment are adequate. Over the next 2 years, however, the problem will not be adequacy of productive facilities or the volume of internal funds to finance investment. As I have described earlier, there is ample capacity in general and in practically all industries. That is why the increase in the investment tax credit, which Congress enacted in 1975, has not yet produced great results. What is needed in the period immediately ahead is to raise consumer incomes. That would boost consumer spending, and that, in turn, would give businessmen reasons for planning to enlarge their productive facilities sooner than they otherwise would. At that point, additional investment incentives could be very effective.

By early 1978, therefore, I believe that Congress should begin giving active consideration to measures which would insure that the recovery not be brought to an end by shortages and bottlenecks. Such a situation can be avoided only if there is a clear prospect of an adequate aftertax rate of return on new capital investment over the years ahead.

Congress may wish to accelerate this process by granting a $3 billion tax cut to business now and give consumers $12 billion instead of $15 billion. This would be roughly equivalent to reducing the corporate income-tax rate by 2 percentage points. I have had a simulation forecast run on that basis. I am not presenting it, however, because there is no material difference between that and the $15 billion personal tax reduction over the next 2 years.

The advantage of giving the business community part of the tax reduction would be mainly psychological. It would be early evidence that Congress does recognize the need for capital formation as well as for consumer spending. The beneficial effects on business attitudes may well warrant the action, especially inasmuch as it would not reduce the size of the personal tax reduction very significantly.

4. Why is the proposed $30 billion stimulus divided between tax cuts and spending increases?

It must be recognized that there are special income and employment situations in our economy at the present time, and special State and local financial situations, which will respond only slowly to higher levels of aggregate demand. These call for special programs. In my description of case C. I outlined a $15 billion package of programs that would be aimed in that direction. The specific composition of that package should be regarded as merely illustrative.

The important point is that the economy would benefit most from a combination of general and specific budgetary actions.

5. Is $30 billion of fiscal stimulus large, in historical perspective?

Given the size of the economy then and now, the tax cuts in 1964 would be equivalent to one of $35 billion today. The reason the proposed stimulus of $30 billion seems so large is simply because most of us tend to forget how large our economy is today. This year, GNP in current dollars will be nearly $1.7 trillion.

6. To be effective, would the budgetary stimulus have to be backed by wage/price controls or guidelines?

The simulations I have presented make a convincing case that such controls or guidelines would not be needed. In fact, talk of them by congressional and administration leaders would be counterproductive. First, both controls and rumors of control would be a deterrent to investment; second, the prospect of controls would introduce a new anticipatory element into the pricing decisions of firms which fear that guidelines or controls would injure them; third, controls, in practice, would tend to set de facto floors on price and wage increases as well as de jure ceilings; and, fourth, there would be the usual problems that such controls create for the future; namely, distortions in resource allocation and surges in prices when the controls are relaxed.

Mr. Chairman, I have tried to cover, I think, at least most of the many questions listed in the invitation, and I apologize for requiring so much time to do it.

Thank you.

Mr. ASHLEY. On the contrary, Dr. Grove. You couldn't possibly have responded to the questions posed by the task force in a shorter period of time, at least in my judgment. It was excellent testimony.

Gentlemen, we have been asked by several members of the minority, who could not be with us today to present questions in writing to you which I hope you will be kind enough to answer in a timely fashion. And while I am dealing with absentees, my colleague, Butler Derrick, wishes to ask this question of you, Dr. Grove:

Would you comment on the relative merits of a reduction in payroll taxes as opposed to an increase in the investment tax credit or a reduction in the corporate tax rate?

Dr. Grove. I think I answered that question in my testimony, Mr. Chairman, where I made a great deal of the point that the fundamental problem limiting investment now is absence of a sufficiently strong level of consumer buying, which in turn is related to consumer real disposable income.

That, combined with a substantial amount of excess capacity, in my opinion, indicates that the thrust of public policy has to be directed at raising consumer income, and that direct stimulus to investment would not provide much additional benefit at this time, except possibly through having a favorable psychological effect.

But I think I covered this point quite thoroughly in my testimony.

Mr. Ashley. Dr. Weidenbaum, do I understand that the stimulus package that you might recommend, if the economic indicators remain as they are in January, is in the neighborhood of $10 billion?

Dr. Weidenbaum. Yes, sir. That is the package that I am now recommending to the committee.

Mr. Ashley. That is, on the basis of the information we are now looking at?

Dr. Weidenbaum. Yes, sir. I don't see any prospect for sufficient improvement in the economy to avoid the desirability of additional deficit financing, additional stimulus by the Congress. As the situation worsens, I think the risks are really on the downside.

Mr. Ashley. It is possible the growth in the fourth quarter might continue to slip.

Dr. Weidenbaum. I really, very frankly, have tried to take an openminded attitude. Before the recent, most recent disappointing report on capital investment, which I expected to be the second stage fuel for the recovery, I was not willing to recommend any stimulus. I was saying let's wait until the new indicators come in. But when this major indicator came in, and it was clearly disappointing, clearly indicating there is no oomph in the economy, it just struck me that it's time, the proper time, for the Congress to shift its policy to additional stimulus.

Now, if that situation continues at this moderate rate of growth we see, I think the $10 billion will be sufficient. If my foggy crystal ball is wrong, and the batting average of forecasters doesn't inspire the greatest of confidence, whether computer forecasts or others, if our forecasts are off, and the economy in the early next year is softer than we anticipate, then no doubt additional stimulus should be considered.

I think we need to tailor the remedy to the condition, and I have tried to tailor my suggested remedy to the current condition.

Mr. Ashley. Well, I am a little concerned. I am not sufficiently experienced in the task and responsibility I have as a member of this committee to know whether it's a good idea to try to provide adequate stimulus for a prolonged period into the future as far as performance of our economy is concerned, or only a little bit, as we did a year ago, and then find ourselves, perhaps because of the inadequacy of the amount of stimulus, back with the same problem confronting us.

Dr. Weidenbaum. Very frankly, Mr. Chairman, I think part of the softness in 1976 resulted from the second stage effect of the 1975 tax rebate. Surely consumer spending got a shot in the arm in 1975 as people spent their tax rebate checks. And then retailers started stocking up in 1976 because retailers usually do their planning comparing a month this year with the same month last year.

Well, the month of May last year, was a very strong month, because consumers were spending their rebate checks. But came May 1976, no rebate checks, softness in consumer spending, and we get the weak inventory situation, which is, I think, one of the causes for the softness in the economy, and the adverse feedback effect on business investment.

I think the way to avoid that situation is to have a permanent tax reduction, so that a year from now we won't be talking about dealing with the second stage effect of a one-shot tax rebate that you are going to enact early in 1977.

Mr. Ashley. It seems to me there are two separate, but related issues here. One is the size of the stimulus package, and the second, obviously related, is the composition of the stimulus package.

Yesterday, as you may know, we had Dr. James Tobin and Dr. Herbert Stein with us. Oddly enough, they took very much the same position as between themselves as you and Dr. Grove takes. One suggested a stimulus package of rather greater magnitude than the other, with the composition of the stimulus packages really quite, quite different. You suggest an exclusively tax stimulus package, whereas Dr. Grove suggests a combination tax and spending stimulus. That was precisely the situation yesterday.

There are differences, however, between yesterday's testimony and that of today, both as between Dr. Grove and Dr. Tobin, and as between you and Dr. Stein. And I want to explore it a little bit as well as I can.

You are working on data, or the interpretation of data that really does sharply conflict with the testimony of Dr. Grove, particularly with respect to utilization of plant capacity. You have heard the testimony of Dr. Grove, which seems to me to be important testimony, and should be discussed by you and Dr. Grove.

Dr. Weidenbaum. I agree, Mr. Chairman. Very frankly, Dr. Grove is an economist that should command your and our respect. He certainly commands mine.

On the capacity utilization figures, I am not sounding alarms about an impending capital shortage, however. One of the reasons that I had over the past 2 years been publicly concerned about the data that we were using on the utilization of capital capacity, was that it was obvious to me that the financial statistics do not convey the reality.

In other words, the environmental and safety regulations alone have a double and negative impact on capacity, which is virtually ignored by the compilers of these aggregate statistics.

That is, the capital stock that we start within any given period, the existing plant and equipment, is overstated simply because the traditional measures of measuring capital capacity do not take account, certainly they do not adequately take account, of the accelerated closings of existing factories, existing production facilities which do not meet environmental and safety regulations.

So, the capital stock at any point in time, the effective capital stock that can economically be used in the period of rising Government regulation, is less than the data show.

Mr. ASHLEY. May I ask a question? I would be interested to know what figures you are using to support that statement. I would like to know Dr. Grove's view on that.

Dr. WEIDENBAUM. I have in mind two sets of data. One, the data on plant closings. I will be glad to supply for the record a detailed study, for example, of the foundry industry showing hundreds of plants which have closed in the last 5 years because they could not economically continue in the face of environmental and safety standards.

The second point I would like to make is that a rising percentage, approximately 10 percent of the supposed expansion in plant equipment, is not to increase capacity to produce goods and services but to meet, again, safety and environmental requirements. I am not attacking the safety and environmental requirements.

Mr. ASHLEY. I understand.

Dr. WEIDENBAUM. What I am saying is the effect on capital and the increases in capital stock are somewhat lower than we have been led to believe because of the operations of their regulatory programs.

Mr. ASHLEY. Dr. Grove?

Dr. GROVE. Well, the figure Professor Weidenbaum gave you of 80.9 percent as the overall utilization rate for manufacturing was identical with the one I used.

Where I think he gets into difficulty is in not disaggregating that index, therefore establishing the level which occurred in the third quarter of 1973 as a peak level of capacity.

If one breaks the index down into its two main components, one finds indeed that capacity utilization in the basic materials area was at a very, very high level, too high at that date.

But if one looks at finished goods which represent 65 percent of the total index, one finds their level was only 85 percent, as contrasted with 91.5 percent in the second quarter of 1966.

So, in the third quarter of 1973, you get an average consisting of two parts; one is as high as it could be, the other is relatively low.

Now, let me take the finished goods industrics, or, more accurately, the "advanced processing industries," which I mentioned represent 65 percent of the total index and let us break them down. The Federal Reserve breaks them down into 16 industry categories. Let us see what the difference is between their capacity utilization today and what it was during that industry's peak in the postwar period.

If we look at food products, it is one-tenth of a percentage point below its peak level. Obviously, there is no excess capacity there. I gave that one to Dr. Weidenbaum.

For textiles the shortfall is 16.5 percent; for paper, 18.6 percent; chemicals, 9.4; petroleum products 9.2 percent; rubber and plastics, 22.1; clay, glass, and stone, 21 percent; iron and steel products, 17 percent, notwithstanding the closing of founderies, nonferrous metals, 16.2 percent; fabricated metals, 19.8 percent; nonelectrical machinery, 22.1 percent; electrical machinery, 30.9 percent; motor vehicles and parts, 22.2 percent; aerospace and miscellaneous transportation equipment, 23.7 percent; instruments, 8.3 percent; other, 8.8 percent.

Now, those figures indicate that to me there is a substantial amount of underutilized capacity. The numbers are very high for nearly all the industry categories.

I conclude from that that the evidence doesn't support a contention that the economy can't grow at, say 5 or 5½ percent over each of the next 2 years without pressing against capacity.

Now, if we look at the basic materials industries they are presently operating at 13 percentage points below the peak level that Professor Weidenbaum took as his reference point for the third quarter of 1973.

We could have expansion of 5½ percent in real GNP over the coming 2 years and keep the operating rate in the basic materials industries below 90 percent with only a 2-percent annual growth in those industries capacity. The historical growth in their capacity has been 4 percent. Moreover, we are in a stage of the cycle when we should be getting more than the average additions to capacity.

Of course, any of those forecasts may be wrong. But the only way I know of looking at the issue is to look at the evidence, make reasonable judgments, consider the risks, and try to make a decision.

Dr. WEIDENBAUM. Would Dr. Grove comment on the point that the available data he is using as well as the data in my statement do not adequately take account of the accelerated plant closings due to the Government regulations and the increase in capital stock going to meet Governmental social regulations. Hence, the effective capacity is thereby lower than any of these official numbers show. That is the problem.

Dr. GROVE. That is certainly a possibility. It should not be too difficult, however, to ask what does that imply and then test it. What it implies is the capital output ratio should be rising, because it should take larger incremental increases in the capital stock to produce an increment of growth in output. I am not aware there is evidence that shows this has been happening. It is very easy to find anecdotal evidence along the lines you have mentioned, but whether it really proves anything is another matter.

Moreover, why hasn't business added more to its capacity if those additions to capacity which it has undertaken does not really contribute very much to its ability to increase output? Notwithstanding the fact that corporate profits have shown a vast improvement, we are getting far less response, in the form of investment, to the improvement in corporate profit positions than we have ever gotten in the past. It is reasonable to conclude that the reason is that there is so much excess capacity that there is no need to add to additional capacity at the present time. The figures I gave as to industry utilization rates tend to sustain that hypothesis. I merely say that I have not seen any evidence which persuades me that that is not at the heart of the problem.

I would like to think I am openminded enough that if there was some evidence and somebody showed it to me, I would be impressed, but I would like to see the evidence.

Dr. WEIDENBAUM. Point one: You don't have to indirectly do any tests. All you have to do is see how the existing measures of capital are developed. If you close down 10 foundries or 100 foundries, is that going to affect the way they measure capital utilization? The answer is, "No." As long as that is that case, it is simple extrapolation which ignores the new trend, that is, the new effect of governmental regulations over the years.

But I think Dr. Grove is right. That may not be the basic reason. Let me suggest what may be a basic reason for the disappointing trend in business investment. I have recently come across a study done by the Mellon Bank. It takes the capital stock on replacement cost, takes the return adjusted for inflation. In other words, they ask the question, what is the real return business is getting on the capital stock? They come up with a figure of 9½ percent. This is the real return on capital stock in American industry.

Their conclusion is: The small margin between that return and long-term borrowing cost is, no doubt, a factor in the disappointing trend in capital spending this year.

Dr. Grove. Of course, not all their capital has to be borrowed, and the cost of that part of their capital which comes from retained earnings is not that high. If businesses perceive a need for substantial capacity at the present time and since they are in a much improved financial situation, why are they not spending more for that purpose and why don't they put less into Treasury bills? I have what I think is a reasonably hypothesis which I have explained and I still think, in the absence of more information which would contradict that, that it is the most plausible one. If one looks at the latest Commerce Department survey on business equipment spending plans, what does it tell us? That business equipment spending plans, what does it tell us? That business sees little need for additional capacity immediately ahead. As they look at what is happening in retail sales and look at what their capacity needs are versus what they presently have, one gets a plausible and rational explanation of what is happening. Farther down the road, there will probably be a need for additional investment incentives but I don't see how they have a chance of doing much good until the level of consumer incomes and spending can be raised. After all, in effect there was a corporate income tax cut last year. The investment tax credit was increased but we have not gotten any great results from that thus far. We might farther down the road.

Dr. Weidenbaum. All I have suggested is an across-the-board reduction of income tax rates, personal and corporate.

Mr. Ashley. Assuming that you are both right, and it may be that you are, it would appear that, except for the food industry, there is a rather considerable amount of idle capacity at the present time. Should that situation change within the next year or 18 months it will be the responsibility of Congress to respond to the situation. Wouldn't that be true? Yet it would appear that plant capacity is not one of the major problems at this time.

Dr. Weidenbaum. One of the reasons I am concerned about the corporate as well as the individual tax, is the need for balance in our revenue system. I am well aware of the fact if there is any long leadtime item in our economy, it is capital spending. If you want an addition to our electric power in 1980, if you have not begun designing and building that generating plant, you won't get the electric power. In other words, you can't wait until a year or two to provide industrial capacity to get that capacity in place. It is a long leadtime operation.

Mr. Ashley. Do you have any information for me as to the extent to which the more favorable tax treatment of 1 year ago has generated increased activity in this sector?

Dr. Weidenbaum. No; I have not and that is why I have not made any recommendation for increasing investment credit at this time.

Mr. Ashley. At a time when we are running a substantial deficit, I would be reluctant to put in $3 billion or $5 billion of so-called stimulus into an area, especially where similar aids have not proved to be particularly productive. Certainly there must be some information which might be useful to me in that regard.

Dr. Weidenbaum. Very frankly, over the years I have urged, instead, a straightforward reduction in the corporate income tax rate.

Mr. Ashley. Dr. Grove says he thinks that might be all right, if only from a psychological standpoint, if I recall his testimony.

Dr. Weidenbaum. It reduces the role of a tax collector in business decisionmaking.

Mr. Ashley. What I am trying to get at is this: Assuming that a stimulus package is going to be proposed by the administration and considered by the Congress early next year, what should be the magnitude and the composition of that package? Dr. Weidenbaum, do you take the view that $10 billion or $12 billion might be prudent at this time and if it doesn't prove to be sufficient we can provide more later on? Is that basically your approach?

Dr. Weidenbaum. I am cautious. To me, $10 billion or, to use your figure, $12 billion, even though we have a very large economy, that is still a large sum of money. I still would urge a degree of caution. We need to be mindful of the problems which have occurred, particularly on the spending side, when Congress has been generous in expanding Government spending, sometimes far more rapidly than the ability of the Government to efficiently spend the money.

Mr. Ashley. Well, I am cautious too, from that standpoint. So I am sympathetic with that. On the other hand, the real question is, What is it going to take to stimulate the economy so that it can be productive, return people to work, and generate the tax revenues which will reduce the deficit without doing violence to price stability? So, whereas $10 billion or $12 billion is a lot to you and me, as it certainly should be, the performance of the economy is the critical problem.

Dr. Weidenbaum. Mr. Chairman, there is another vital reason for thinking in terms of installments, if you will. First of all, I think prompt enactment of an easily understood tax reduction of $10 billion would have a positive effect on the American consumer.

In terms of the second installment, if you think along those lines, I hasten to add the subject of tax reform. In my observation over the past quarter of a century, if you are ever going to stand a chance of getting serious tax reform enacted, it will have to be coupled with the sweetner, if you will, of substantial tax reduction. And if you shoot——

Mr. Ashley. Aren't you doing that with a permanent tax cut at this time?

Dr. Weidenbaum. That is why I say $10 billion.

Mr. Ashley. $10 billion in permanent cuts. It seems to me that you are giving away something you might want to trade off later on.

Dr. Weidenbaum. Well, of course, I really do not think in terms of the Government giving up. It is usually the taxpayer who gives up the income to the Government. But compromise, that is the essence of the activity that you are engaged in.

Mr. Ashley. Dr. Grove, I wish you would address yourself briefly to the desirability of an incremental approach to economic stimulus, as against a larger infusion of stimulus which hopefully wouldn't require additional amounts later on.

Dr. GROVE. If one takes the gradual approach and one ends up with an even softer economy than my forecast would indicate, one has to ask what the longer term effects would be in a much broader sense.

The employment rate would come down very slowly. When I was a student at Boston Latin School, I recall a statement uttered by Cicero to Catalina: "Quo usque tandem abutere nostra patiencia, Catalina."

Mr. ASHLEY. Will you translate that for us, please?

Dr. GROVE. That means, "How long will you continue to abuse our patience, Catiline?"

The longer there is a substantial body of citizens unemployed, many of them articulate and politically active, the more one has to form some judgment as to what the costs are likely to be of our continuing not to be able to provide adequate job opportunities to those capable of taking and holding a job. That is why I devoted a couple of minutes in my testimony to analyzing the unemployment rates. It is a myth the unemployed are mainly unemployables or persons whose productivity would be very low. That is simply not in accord with the facts.

This is a consideration which makes me reluctant to say, "Let's go very slow; there is a pretty good chance we may have overestimated the need for a fiscal stimulus, and we can always increase it if we are proven wrong." I am afraid the risks are too high that we would indeed be wrong.

Therefore, my personal judgment is to make a policy recommendation based upon what the most probable outcome is and that is what I embodied in my forecasts. I think there is something to be said, as I mentioned, to making the tax cuts temporary for a period of 2 years because then it would be possible not only to fail to extend them, but to announce they will not be extended sometime in the middle of 1978, and that, in itself, would begin to have some braking effect if it should turn out the stimulus had been too much. So I wouldn't want anyone to think there are not some safety valves in my proposal. Similarly, the spending programs would be phased in over a period of 1 year. I think there would be possibilities for adjusting to the emerging information which we get over the course of 1977. We wouldn't be running any risk, given the idle capacity and the labor situation, in starting us off to the races again. I place as high a premium on avoiding inflation as anybody else does. It is just that the evidence doesn't suggest to me that the kind of program I have outlined would in fact accelerate inflation. I would go back to the point that the stimulus shown in my case C is not out of line with the relative size of the economy.

Mr. ASHLEY. Do the assumptions in case C represent recommendations?

Dr. GROVE. I did not present it as a recommendation. I would say it would be my recommendation if one thought the rates of growth in real GNP and decline in unemployment were the results one wanted to attain. They would be my personal recommendation on that basis, because I think the results are not all that unreasonable as goals. In other words, I don't really imagine that anyone would say we should not try to achieve 5½ percent real GNP growth next year and 5 percent in 1978. If someone thought the goal of our society should be less than that and wanted to accept the implications for higher levels of unemployment and lower levels of business investment, and what this would mean farther down the road as far as bottlenecks are concerned, I would say that would be their value judgment, not mine.

Mr. ASHLEY. What kinds of nondefense purchases and services did you have in mind for $5 billion?

Dr. GROVE. Examples would be national parks improvements, research on health and other matters, energy research and development, perhaps increased Federal outlays on stockpiling of potentially scarce materials. In the area of Federal transfers, there should be greater assumption of welfare costs, the Federal Government could assume a greater portion of the deductibles of medicare recipients. As far as the $4 billion in grants and aid, other than for public service jobs, I would suggest environmental improvements and water purification projects. Community development grants to poorer cities for rehabilitation, increased general revenue sharing. I give these merely as illustrations. The breakdown of $15 billion is again illustrative. I wouldn't quarrel if someone wanted to move $2 billion from one category to another.

Mr. ASHLEY. $3 to $4 billion for public jobs would be under the CETA program?

Dr. GROVE. The objective would be to recognize there are pockets of unemployment which can't be reached directly by tax reductions or rebates and so forth. At the same time there are a number of cities and towns which have urgently needed projects which don't require people with great skill to undertake and I would like to see some way of bringing these two together. Now, the precise form in which this would be done is something to which I have not given much thought.

Dr. WEIDENBAUM. Mr. Chairman, may I suggest in addition here, obviously I am not recommending this route, but if you do go this route of increased expenditures the Congress does have an opportunity to carry out some of the points I mentioned in my statement, that is to shuck off some of the accumulation of subsidies which have outlived their usefulness. For instance, in the construction area it is well known the Davis-Bacon Act, that sacred cow, pushes up the cost of construction and the construction workers have away above average unemployment rates. If you do go the route of adding several billion dollars to Government construction budgets, that would be the sweetener, perhaps, for a measure which is surely overdue and that is the elimination of the depression legislation, that is, the Davis-Bacon Act.

In so many other areas we have legislation in the form of regulatory restrictions which do have an adverse effect on employment.

Dr. GROVE. I think Professor Weidenbaum is right. I would add one other thing. I would like to see an experiment in one or more cities with a program which would remove or substantially lower the minimum wage for a stated period of time and give us an opportunity to see what this would do for increased employment, for youths and blacks, and others who traditionally find it very difficult to get employment. I think that would be one way of resolving this issue which would avoid having to remove it nationally, which would be difficult to do politically. I would like to see some experimentation in two or three places so Congress could have a chance to see what the results would be.

I would like to see a number of projects set up on an experimental basis. I think the programs I have outlined would provide an opportunity to extend a number of pilot projects and to allow Congress to get a better idea over the longer run about what types of programs would show promise and what types would not. So I would urge there be an experimental frame of mind in setting up any broad program of additional Federal spending stimulus.

Dr. WEIDENBAUM. The majority of teenagers are not employed or unemployed. Despite the obvious, the great majority of teenagers are in school, they are not in the labor force, in any event. Those figures refer to drop-outs, that is the group of the population you would expect to have more than average difficulty in finding jobs. So mere stimulation of the GNP surely will help, but isn't going to solve the problems of the marginal workers, the teenagers who lack the skills to earn their way in our society. So, again, let us think of a package here, if you go this route, of temporarily removing the adverse effect of the minimum wage law, with some incentive, whether it is directly to the worker or to the employer, to provide that vital on-the-job training.

What is the case of the millions of teenagers who, as I say, are neither at work nor unemployed? They are paying us. Here I speak as a college professor. There is no problem with the minimum wage law as to the great majority of teenagers. They literally pay us to give them the skills to earn their future in our society. So, what unskilled, unemployed teenagers really need is, to use that awful economic term, investment in human capital, the skills, the work habits and not misguided Government regulations.

Mr. ASHLEY. I listen to your words and I know they come from the heart, but I don't find any recognition of the need for funds in your stimulus package to accomplish that.

Dr. WEIDENBAUM. Very frankly, I would see great advantage in shifting funds within the existing Federal budget to this area. Here I think Dr. Grove has a fine idea of some demonstration projects. It is not a large crash program but carefully crafted experiments. You are not talking about large sums of money but carefully developed important social experiments.

Dr. GROVE. I would like to point out if these demonstration projects are to yield valid results, it supports the case for giving an adequate amount of fiscal stimulus initially rather than in phases. Many of these programs could be predicted to fail if the overall economy remains weak. In other words, there is no need in providing additional funds for training if the people who already have those skills, their unemployment is quite high. This is another reason for——

Dr. WEIDENBAUM. Unfortunately, I will forecast, if you think you are going to deal with the teenage unemployment problem with fiscal stimulation and increase the minimum wage law another notch to index it for inflation, it will be another classic example of the Lord giveth and the Lord taketh away. You really have to join the issue.

Mr. ASHLEY. Let me just ask this question, Dr. Grove. Given your recommended level of stimulus, Dr. Grove, what should be the posture of the Fed with respect to the ease or tightness of the money supply?

Dr. GROVE. I am not a monetarist, therefore, I can't give you figures as to M_1 or M_2. I would say the Fed should be accommodative. That is a very big general word. What it means is that the Fed should provide whatever growth in the aggregates is necessary to permit the additional demands for credit to be accommodated without a feeling of pressure in the credit market which would thwart growth in output. That is something the Fed can determine on a month-to-month basis. It should have no trouble doing this if it accepts the overall goals and objectives. This might mean a lower or higher rate of growth in some months. I wouldn't venture as to what the result would be during the year as a whole.

Dr. WEIDENBAUM. This is a vital point. The Fed, they have to offset it to avoid another round of inflation. You won't achieve the objective.

Mr. ASHLEY. The Fed was accused last year, at the time of the rebates, of playing that role. Frankly, this is bothersome to me.

Dr. WEIDENBAUM. I would forecast as an outsider a $25 or $30 billion package of stimulus would scare the Fed into a more restrictive position.

Mr. ASHLEY. That won't be decided here this morning.

Gentlemen, you have been very, very instructive and generous with your time. Your testimony will be most helpful in the immediate weeks ahead, I can assure you, as the committee comes to grips with the issues we have been discussing this morning.

Thank you for being with us.

[The following are questions submitted by the members of the minority staff along with the replies of Dr. Grove and Dr. Weidenbaum:]

Question 1. Dr. Grove spoke of the need to raise consumer income as if it were possible to raise real income prior to a rise in real production.

What is the nature of the supply function in Dr. Grove's econometric model?

Question 2. Dr. Grove made statements to the effect that the corporate profit picture is good, but that firms are not investing their ample retained earnings in additions to their productive capacity because of existing excess capacity as a result of insufficient spending. However, U.S. Department of Commerce data show that retained earnings, after inventory valuation and capital consumption adjustments, were only $1.6 billion in 1974 and only $10.3 billion in 1975.

Does Dr. Grove think these amounts of retained earnings are ample to finance enough investment to provide new jobs for a growing labor force?

Question 3. Witnesses have testified that increased spending stimulates production, because it means more buying power and a larger market for products. However, they have not related this increased buying or spending stimulation to tax rate levels.

Would increased spending lead to increased production if the marginal tax rate was 100 percent? 98 percent? 90 percent? 80 percent?

Would the witnesses agree that the lower the tax rate, the greater the increase in production in response to any increase in spending?

Question 4. U.S. Department of Commerce data show that corporate profits, after inventory valuation and capital consumption adjustments, were taxed at effective rates of 59 percent in 1974 and 51 percent in 1975.

What allowance is made in your account of unemployment and GNP trends for the fact that the high inflation rates of the recent past have raised the effective tax rate on corporate earnings above the 48 percent statutory rate, thereby more than offsetting the stimulation of the investment tax incentives?

Question 5. An editorial in the October 28, 1976 issue of the Wall Street Journal argued that the economy is in healthier condition than a lot of news reports indicate: both total employment and the demand for goods and services as measured by final sales have increased steadily throughout 1976. However, since inventory accumulation was especially high in the first quarter of 1976, the GNP growth rate during the same period was also high (9.2 percent). Inventory adjustments produced subsequent lower rates of increase in GNP in the second and third quarters. However, final sales as a measure of economic recovery reveal steadily increasing demand for goods and services.

Do the witnesses agree that final sales are a good indicator of economic recovery and that they reveal steadily increasing demand for goods and services?

Question 6. Do the witnesses consider it unusual during a recovery year for the rate of increase in GNP to decline during the course of the year?

REPLIES BY DR. DAVID L. GROVE

Answer 1. In our model, real production responds primarily to demand, which is heavily influenced by income. The supply function consists primarily of the labor supply—i.e., the quantity and productivity of labor. The supply of plant capacity and raw materials are not explicitly included in our model. However, we have analyzed their availability outside the context of the model and concluded that the supply of these resources is adequate to support greater economic recovery.

Answer 2. The comment is misleading in a number of ways:

a. It neglects to mention the prime source of corporate financing of capital spending: capital consumption (or depreciation) allowances. Even without adjustment to account for higher replacement costs, these allowances amounted to $80 billion in 1974, $89 billion in 1975 and $98 billion (annual rate) in the third quarter of 1976.

b. It focuses on the recession and disregards the recovery. Retained earnings, after the two adjustments, increased by $8.7 billion in 1975 and by another $10.8 billion from 1975 to the third quarter of 1976.

c. These adjustments overstate the negative impact of inflation on corporate liquidity. As described in a recent Brookings paper by Shoven and Bulow, inflation also has a helpful effect on corporations by easing their debt repayment problem. The authors estimate that failure to account for this effect produced an understatement of $26 billion to $32 billion in nonfinancial corporate profits in 1974.[1]

d. The question implies that capital spending can only be financed internally. Corporations can and do borrow extensively for this purpose. And the availability of external funds and their cost have become very much more favorable.

Conclusion.—By every reasonable measure there has been an enormous improvement over the past year and a half in the internal liquidity and external borrowing conditions affecting corporations. These are ample to finance substantial increases in investment.

Answer 3. Increased spending would lead to increased production with present marginal tax rates and with any projected marginal tax rates which are even remotely realistic.

The second question here is peculiarly stated. There would be an increase in output with an increase in spending, as long as the economy is operating below potential; this occurs in the context of any given tax rate structure. If taxes are lowered, then the beneficiaries would have more disposable income and spend more and output would increase.

Answer 4. Our econometric model incorporates both adjustments and thus reflects the corporate taxes paid on "inflated" profits.

Answer 5. The editorial is correct that the slowdown in real growth from the first quarter to the second was due to a change in the rate of inventory investment, and that final sales have risen steadily during the entire recovery. Final sales are a good indicator of economic recovery, or economic performance, and while they have risen steadily, the rate of rise is highly inadequate. During the first three quarters of 1976, the rise in real final sales decelerated to a 4 percent annual rate from about a 5 percent annual rate in the last three quarters of 1975. This is a rather poor performance coming off the worst recession in forty years. Furthermore, even if real final sales were to continue rising at a 4 percent rate, the growth in total output will not be rapid enough to reduce unemployment from the current extremely high rate unless inventory investment accelerates. Such an acceleration of inventory accumulation is not likely, nor desirable, however, in view of current inventory/sales ratios and the performance of final sales.

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[1] Arthur Okun and George Perry (editors), ***Brookings Papers on Economic Activity,*** 1976—I, p. 50.

Answer 6. It is possible during a recovery year for the rate of increase in real GNP to decline during the course of the year, especially in the second year of recovery. However, the 1974–75 recession was far worse than any of the others in the post-war period, so that the current level of economic activity relative to the level at the previous peak is well below that at comparable points in previous recoveries. Furthermore, the unemployment rate has always been at least 2.5 percentage points below the current rate after a year and one-half in prior recoveries. Thus, in the current setting, the deceleration of economic activity is highly undesirable.

REPLIES BY DR. MURRAY L. WEIDENBAUM

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Answer 3. High marginal tax rates have of course serious adverse consequences on incentives.

Yes, I would. Please note that my proposal for stimulating the economy is entirely in terms of a permanent cut in taxes.

Answer 4. I am seriously concerned about the situation, as covered in my testimony. This is why I would extend the tax reductions to the corporate as well as the individual income tax.

Answer 5. As I stated in my testimony, the American economy is continuing to grow and recover from the recession laws. The pertinent policy question is the adequacy of the anticipated growth trend.

Answer 6. No, but I am concerned about the low rate of real growth in the last two quarters.

[Whereupon, at 11:45 a.m., the task force was adjourned].

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