

**TAX REDUCTION PROGRAM**

**1**

**THE CURRENT ECONOMIC SITUATION:  
BACKGROUND MATERIAL ON THE  
STATE OF THE ECONOMY**

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PREPARED FOR THE  
COMMITTEE ON FINANCE  
UNITED STATES SENATE

BY THE STAFF OF THE  
JOINT COMMITTEE ON TAXATION



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## INTRODUCTION

This pamphlet summarizes available economic data on the economy to assist the committee in its consideration of H.R. 3477, the tax refund and reduction program, passed by the House. Part I summarizes the current economic situation; Part II summarizes the 1977-78 predictions of several econometric models of the economy; Part III outlines projections of the Federal budget through 1981; and Part IV gives an indication of alternative views on the need for stimulus in 1977 and 1978. Other pamphlets describe the provisions of the House bill, the Administration proposals, and several alternative tax proposals.



## I. THE CURRENT ECONOMIC SITUATION

### A. The Economy in the 1970's Compared to the 1948-69 Record

The performance of the U.S. economy in the 1970's has not been satisfactory. While the unemployment rate averaged 4.7 percent in the period 1948-69, it has averaged 6.2 percent in the 1970's and reached a high 9 percent in 1975. The pace of economic growth has also been disappointing. Over the period 1948-69, real economic growth averaged 3.9 percent per year, but in the 1970's it has averaged only 2.4 percent per year. Similarly, the rate of inflation has been higher in the 1970's than over the period 1948-69: 2.3 percent per year between 1948 and 1969 and 6.5 percent per year in the 1970's.<sup>1</sup>

The recession of 1973-75 was especially severe. Real GNP (that is, the value of goods and services produced in the economy, adjusted for inflation) declined 1.7 percent in 1974 and 1.8 percent in 1975, the first such back-to-back decline in real GNP since the period immediately following World War II. Despite the slow growth rate, however, the rate of inflation was 10 percent in 1974 and 9.3 percent in 1975.

The recovery from the recession began in the second quarter of 1975. Growth of output proceeded at an especially rapid rate of 8 percent in the period between mid-1975 and the first quarter of 1976. However, there has been a distinct slowdown in the growth rate of real GNP since that time: it has declined to 4.5 percent in the second quarter of 1976, 3.9 percent in the third quarter, and 2.4 percent in the fourth quarter. Table 1 summarizes unemployment, GNP, and inflation data for the 1970's as compared to 1948-69.

**Table 1.—Performance of U.S. Economy in the 1970's Compared To 1948-69**

[In percent]

	Unemployment rate <sup>1</sup>	Increase in real GNP <sup>2</sup>	Increase in consumer price index <sup>3</sup>
1970-----	4.9	-0.3	5.9
1971-----	5.9	3.0	4.3
1972-----	5.6	5.7	3.3
1973-----	4.9	5.5	6.2
1974-----	5.6	-1.7	11.0
1975-----	8.5	-1.8	9.1
1976-----	7.7	6.2	5.8
1948-69 average-----	4.7	3.9	3.2
1970-76 average-----	6.2	2.4	6.5

<sup>1</sup> Table B-29, Economic Report of the President, 1977.

<sup>2</sup> Table B-2, Economic Report of the President, 1977.

<sup>3</sup> Table B-48, Economic Report of the President, 1977.

<sup>1</sup> The price index used is the consumer price index, an index of price trends for items purchased by urban workers.

## B. Employment and the Labor Market

The unemployment rate fell below 5 percent in 1973, but the recession caused it to increase to a high of 9 percent in May 1975. Unemployment fell gradually to 8.3 percent in late 1975 and to 7.3 percent in May 1976. However, it rose to 7.8 percent in December 1976.

In January, the unemployment rate fell to 7.3 percent, due primarily to 440,000 persons no longer looking for work. Also, the January unemployment rate was measured before the cold weather set in. In February, the unemployment rate rose to 7.5 percent, reflecting the effect on employment of the cold weather and natural gas shortages. There is a possibility, however, that the rate of unemployment may rise further, as persons who left the labor force because of poor job prospects return to the labor market in search of employment.

The persistence of unemployment rates in excess of 7 percent in 1976 results from two opposing pressures in the labor market. First, and most important, the labor force (those at work or looking for work) has grown dramatically. In March 1975, when the recession was at its worst, the civilian labor force numbered 92.0 million. By February 1977, the civilian labor force had grown by over 4 million persons to 96.1 million. Second, over this period, employment grew substantially, from 84.2 million to 88.9 million. Since the increase in employment was just barely larger than the increase in the labor force, the number of unemployed, and therefore the unemployment rate, has remained high. In February 1977, there were 7.2 million persons out of work, compared to 7.8 million persons in March 1975. Thus, while the economy grew in 1976 and generated substantial numbers of new jobs, the number of persons looking for work matched this growth, this kept the overall unemployment rate high. In order to reduce the unemployment rate in the years ahead, the rate of job creation, determined largely by the pace of economic growth, must exceed the rate of growth of the labor force.

Unemployment rates among teenagers, blacks and women have continued at substantially higher levels than for the rest of the labor force. Persons aged 16-19 experienced unemployment rates in 1976 in excess of 18 percent, while blacks experienced unemployment rates in excess of 12 percent. Moreover, experienced wage and salary workers averaged higher unemployment rates in the second half of calendar 1976 (7.5 percent) than in the first half of 1976 (7.2 percent). Of related concern is the fact that the duration of unemployment lengthened in the second half of 1976. For example, in June 1976, 62 percent of the unemployed were unemployed for 5 or more weeks. By December, however, 64 percent of the unemployed were unemployed 5 or more weeks.

## C. Capacity Utilization

The slowdown in the economy in 1976 was highlighted by the decline in capacity utilization<sup>2</sup> in the latter part of 1976 compared to the first half of 1976. In 1975, capacity utilization, as measured by the Federal Reserve Board, was at 73.6 percent. By the fourth quarter of 1976, it

<sup>2</sup> The capacity utilization percentage describes the extent to which existing plant and equipment are being used by business to produce goods and services.

had risen only to 80.5 percent, which is substantially below the 87.5-percent level reached in 1973. As table 2 indicates, the fourth quarter of 1976 was below the third quarter of 1976.

**Table 2.—Capacity Utilization Rates in 1976**

[Seasonally adjusted; utilization rate (percent)]

Quarter.....	1976			
	1	2	3	4
Manufacturing.....	79.0	80.2	80.8	80.5
Primary processing.....	80.2	81.5	82.5	81.5
Advanced processing.....	78.2	79.2	79.6	80.0
Materials.....	79.0	80.6	81.3	80.4
Durable goods.....	73.5	76.2	78.4	76.6
Basic metal.....	72.8	77.4	81.5	74.3
Nondurable goods.....	85.6	85.9	85.0	85.0
Textiles, paper and chemical.....	85.1	85.0	84.0	83.8
Textiles.....	84.3	83.1	81.8	79.0
Paper.....	89.1	90.9	89.9	88.8
Chemical.....	84.2	84.0	82.9	83.9
Energy.....	85.3	84.8	84.0	84.1

SOURCE.—*Federal Resource Bulletin*, January 1977, table 47.

## D. Investment

Spending for new plant and equipment continues to be a sluggish factor in the overall recovery of the economy. In 1973, real gross fixed investment (expenditures for new housing, plant and equipment), measured in 1972 dollars, was \$190.7 billion. In 1974, real gross fixed investment fell to \$173.5 billion, a 9-percent decline, and in 1975 it fell to \$149.8 billion, a 21-percent decline from 1973 and a 14-percent decline from 1974. Real fixed investment rose to \$162.8 billion in 1976, an 8.7-percent increase over 1975; however, to date it is still below the 1974 level. In the last quarter of 1976, expenditures for new plant and equipment adjusted for price changes actually declined.

The weakness in gross fixed investment does not appear to be attributable to the unavailability of funds, for corporate profits have continued to grow throughout 1976. The continued pause in investment, in large part, appears to be attributed to uncertainty about the markets for the goods to be produced by such new plant and equipment and the continuing high interest rates.

The weakness in new plant and equipment expenditures is highlighted by noting that at this point in previous recoveries, such investment averaged 5.3 percent above the previous peak. In this recovery, investment remains 11.8 percent below the previous peak.

## E. Money Markets

While there has been a general decline in short- and long-term interest rates since late 1974, long-term rates continue to be high, and short-term rates increased in January 1977. Triple A corporate bonds now yield more than above 8 percent and the 3-month Treasury bill rate is 4.7 percent, up from 4.3 in December. The persistence of historically high long-term rates not only adversely affects business investment, but also spending on consumer durables and housing. It has been customary for interest rates to decline in recessions and rise during recoveries; however, in the case of the 1974-75 recession, long-term interest rates did not decline as much as they had in previous recessions. The stickiness of these interest rates in the recession can be attributed to partly the high rates of inflation which resulted from OPEC oil price increases, unusually tight commodity markets, and rapid growth in wage rates. Another factor appears to be expectations of tight money policies, such as occurred during the "credit crunches" of 1966, 1969 and 1974. Continued high long-term interest rates must be attributed to pessimism about the likely course of prices. Unless investors believe that the rate of inflation will be permanently reduced, it is likely that long-term rates will remain in the 8 to 9 percent range.

The money stock, broadly defined in terms of currency plus checking and bank savings deposits ( $M_2$ )<sup>3</sup> increased somewhat more in 1976 than in the previous 2 years (11.3 percent in 1976, compared to 8.5 percent in 1975 and 7.2 percent in 1974). When the growth in  $M_2$  is adjusted for price changes, it grew by 6.6 percent in 1976 as compared to a growth of 1.4 percent in 1975 and a decline of 4.3 percent in 1974. The decline in the money stock, adjusted for inflation, is indicative of the tight money policy that prevailed through much of 1974. Because changes in monetary policy can take up to 2 years to ripple through the economy, it is possible that the economy is still feeling the effects of tight monetary policy in 1974. Table 3 shows the growth rates of monetary aggregates for 1972-76, both adjusted and unadjusted for inflation.

**Table 3.—Growth Rates of Monetary Aggregates, 1972-76**

[In percent]

Year	Percentage increase					
	$M_1$ <sup>1</sup>		$M_2$ <sup>2</sup>		$M_3$ <sup>3</sup>	
	In current prices	Adjusted for inflation	In current prices	Adjusted for inflation	In current prices	Adjusted for inflation
1972-----	9.2	5.0	11.4	7.2	13.4	5.9
1973-----	6.0	-1.5	8.8	1.3	8.8	1.3
1974-----	4.7	-6.8	7.2	-4.3	6.8	-4.7
1975-----	4.1	-3.0	8.5	1.4	11.3	4.2
1976-----	5.8	1.1	11.3	6.6	13.1	8.4

<sup>1</sup>  $M_1$  is currency plus demand deposits.

<sup>2</sup>  $M_2$  is  $M_1$  plus time deposits at commercial banks other than large CD's.

<sup>3</sup>  $M_3$  is  $M_2$  plus deposits at nonbank thrift institutions.

SOURCE.—Federal Reserve Board.

<sup>3</sup>  $M_1$  is currency plus demand deposits;  $M_2$  is  $M_1$  plus deposits at commercial banks other than large CD's; and  $M_3$  is  $M_2$  plus deposits at nonbank thrift institutions.

## F. Wholesale and Retail Prices

The rate at which wholesale prices (the prices of basic commodities and raw materials) increase has declined steadily since 1974. Wholesale prices increased 15.4 percent in 1973 and 20.9 percent in 1974; but the rate of increase fell to 4.2 percent in 1975 and was 4.7 percent in 1976. The rate of increase of consumer prices has also declined since 1974. Consumer prices rose by 8.8 percent in 1973 and 12.2 percent in 1974; in 1975 they rose by 7 percent, and in 1976 they rose by 4.8 percent.<sup>4</sup>

<sup>4</sup> These percentage changes in prices are based on December to December changes. The percentage changes referred to in section A for the period 1948-76 are based on annual averages.

There is some concern about whether these favorable trends in wholesale and retail prices are sustainable throughout 1977 and 1978. The slowdown in consumer prices has been due in part to unusually favorable food prices. During 1976, food prices rose by only 0.6 percent. It is unlikely, in view of water shortages in the West, natural gas shortages in the South and East, and the severe damage of cold weather on winter crops throughout the country, that food prices (and therefore in part consumer prices) will continue to rise so slowly in 1977. Reduced supplies of these products, together with no changes in demand for them, will tend to raise prices even if demand remains unchanged.

## II. FORECASTS OF THE U.S. ECONOMY IN 1977 AND 1978

### A. General

Predictions of the course of the economy can be made in several ways. One approach is to examine the past and create a mathematical model of the behavior of the major sectors of the economy with the use of statistical techniques. The resulting equations that describe the past can be used to predict the future by making assumptions about the course of certain factors that are not predicted by the model but rather are taken as "givens." For example, to predict GNP in 1977, one must take as given the level and composition of Federal spending. Such models are termed "econometric models."

While the use of these models of the economy is becoming increasingly widespread, the accuracy of their predictions depends in part on the accuracy of these "givens" which necessarily must be assumed. Also, their accuracy is fundamentally affected by the occurrence or nonoccurrence of unforeseen or unique events. For example, none of the forecasts made in November and December 1976 included assumptions to account for the effects of the unusually cold winter which subsequently transpired. On the other hand, many forecasts earlier in 1976 tried to take into account a likely substantial increase in the price of OPEC oil, which turned out to be more modest than most observers had expected. On balance, forecasts with econometric models of the economy have been as or more accurate than purely judgmental approaches to economic forecasting.

### B. Forecasts by Wharton EFA, Chase Econometrics and Data Resources Models of the U.S. Economy Without Stimulus

Table 4 summarizes the forecasts of three econometric models constructed by Wharton-Economic Forecasting Associates of Philadelphia, Chase Econometrics, Inc. of Philadelphia, and Data Resources, Inc. of Lexington, Massachusetts. The predictions relate to the course of the economy in 1977 and 1978 without the introduction into the economy of any tax or spending stimulus in 1977 or 1978.

The forecasts are markedly pessimistic, with the Chase forecast the most pessimistic. Under the assumption of no stimulus, two of the three models project real growth rates below 6 percent by the end of the fourth quarter of 1977. The Data Resources model predicts a strong fourth quarter of 6.6 percent; however, the growth rate in the preceding three quarters does not exceed 4 percent. By the third quarter of 1978, the end of Federal fiscal year 1978, real growth without any stimulus is predicted to be in the 4-percent range by Wharton and Data Resources, and only 1.4 percent by Chase.

These forecasts have taken into account the severe winter weather. Such weather is likely to have several economic effects, most of which will be temporary. The curtailments of natural gas deliveries and resultant layoffs have reduced personal income in the first quarter of 1977, which has probably reduced consumer spending; however, much of this lost income will probably be made up later in the year. The higher food prices resulting from the cold weather and drought will exert a depressing effect on the economy, and this may be longer lasting if these price increases generate compensatory wage increases by way of cost-of-living clauses in collective bargaining agreements. Finally, there is a concern that the energy problem may further reduce both consumer and business confidence and thereby reduce consumer and investment spending over a longer period of time.

Unemployment rate projections are also pessimistic. All three models project that the unemployment rate at or above 7 percent by the end of calendar 1977 in the absence of any tax and spending stimulus, and all three project an unemployment rate above 6.5 percent by the end of Federal fiscal year 1978. Again, the Chase forecast is the most pessimistic of the three; its higher unemployment rate parallels its much slower real growth rate in 1978.

The predicted rate of inflation is expected to remain in the 5-6 percent range by Wharton and Data Resources and in the 4 to 7 percent range by Chase. The pattern of inflation rates is predicted by Wharton and Data Resources to be a rise in the first half of 1977 and then a decline at the end of 1977, followed by an increase again in 1978.

Finally, long-term bond yields are expected to remain high. Both Wharton and Data Resources expect long-term bond yields to be about 8 percent through 1978. In 1978, Chase expects somewhat lower long-term rates, in line with their lower projected rate of inflation.

**Table 4.—Forecasts of U.S. Economy in Absence of Stimulus Program: 1st Quarter 1977-3d Quarter 1978**

Quarter.....	Actual 1976	Predicted							
		1977				1978			
		IV	I	II	III	IV	I	II	III
<b>Percent growth rate in real GNP, annual percentage rates:</b>	<b>2.4</b>								
Wharton-EFA <sup>1</sup> .....		4.8	7.3	5.7	5.8	3.9	4.1	3.5	
Chase <sup>2</sup> .....		3.4	4.5	2.3	2.7	1.1	0.9	1.4	
Data Resources <sup>3</sup> .....		3.7	3.7	3.1	6.6	7.5	4.6	4.6	
<b>Unemployment rate, percent:</b>	<b>7.6</b>								
Wharton-EFA <sup>1</sup> .....		8.1	7.8	7.6	7.5	7.4	7.4	7.3	
Chase <sup>2</sup> .....		8.3	8.0	8.1	8.3	8.5	8.7	9.0	
Data Resources <sup>3</sup> .....		7.8	7.5	7.5	7.3	7.1	6.9	6.7	
<b>Percent change in consumer price index at annual rates:</b>	<b>4.4</b>								
Wharton-EFA <sup>1</sup> .....		6.7	6.7	6.9	5.5	5.6	6.2	6.7	
Chase <sup>2</sup> .....		3.9	7.0	6.9	7.5	4.3	4.5	4.4	
Data Resources <sup>3</sup> .....		8.7	6.1	5.1	5.0	5.2	5.1	4.9	
<b>Yields on high quality corporate bonds, new issues, percent:</b>	<b>8.1</b>								
Wharton-EFA <sup>1</sup> .....		7.9	8.0	8.0	8.1	8.1	8.1	8.2	
Chase <sup>2</sup> .....		8.1	8.0	8.1	8.1	7.7	7.6	7.4	
Data Resources <sup>3</sup> .....		8.1	8.3	8.3	8.3	8.4	8.1	8.0	

<sup>1</sup> Wharton Economic Forecasting Associates, Feb. 10, forecast.

<sup>2</sup> Chase Econometrics, Feb. 4, 1977.

<sup>3</sup> Data Resources, Inc. Quarterly Model.

### C. Forecasts of Economy With Stimulus

The models used to predict the course of the economy without the stimulative package can also be used to predict the impact of the tax and spending proposals on the economy.

Table 5 sets forth the predicted level of GNP under the assumption of no stimulus, and under the assumption that a stimulus is provided. All three models predict that the tax reduction and spending program will raise the level of GNP, adjusted for inflation, through 1978, as compared to what would happen if there were no stimulus program. The difference is especially pronounced in the second quarter of 1977. The higher levels of GNP predicted as a result of the stimulus imply increases in the rate of economic growth in that quarter of two to four percentage points at annual rates.

The reduction in the unemployment rate as a result of the stimulus program is set forth in Table 6. While the forecast levels of the unemployment rate vary among the three models, all three predict that the unemployment rate will be reduced by four-tenths of a percentage point to eight-tenths of a percentage point. These low and high figures correspond to a range in the creation of new jobs of from 500,000 to 900,000 more than what would be created in the economy if there were no stimulus program.

With respect to the inflation rate, the three models indicate that the stimulus adds, at most, two-tenths of a percentage point to the rate of inflation by the third quarter of 1978. Similarly, in terms of the impact on long-term bond yields, the stimulus impacts only very modestly. By the third quarter of 1978, the long-term bond rate is predicted to be one- to two-tenths of a percentage point higher as a consequence of the tax and spending programs.

**Table 5.—Predicted GNP Levels With and Without Stimulus Program, Adjusted for Inflation**

[Billions of 1972 dollars]

	1977 (quarter)				1978 (quarter)		
	I	II	III	IV	I	II	III
<b><i>No stimulus:</i></b>							
Wharton .....	1, 296. 7	1, 319. 7	1, 338. 0	1, 356. 8	1, 369. 9	1, 383. 6	1, 395. 5
Chase .....	1, 294. 6	1, 309. 2	1, 316. 8	1, 325. 7	1, 329. 2	1, 332. 1	1, 336. 8
DRI .....	1, 293. 5	1, 305. 5	1, 315. 6	1, 337. 3	1, 362. 4	1, 378. 0	1, 394. 3
<b><i>With stimulus:</i></b>							
Wharton .....	1, 296. 7	1, 330. 6	1, 344. 2	1, 363. 7	1, 378. 1	1, 392. 5	1, 404. 4
Chase .....	1, 294. 6	1, 315. 9	1, 327. 9	1, 340. 4	1, 346. 7	1, 349. 4	1, 352. 7
DRI .....	1, 293. 5	1, 319. 8	1, 337. 4	1, 353. 6	1, 372. 9	1, 386. 4	1, 401. 6

**Table 6.—Predicted Unemployment Rates With and Without Stimulus Program**

[In percent]

Model	1977 (quarter)				1978 (quarter)		
	I	II	III	IV	I	II	III
<b>No stimulus:</b>							
Wharton.....	8.1	7.8	7.6	7.5	7.4	7.4	7.3
Chase.....	8.3	8.0	8.1	8.3	8.5	8.7	9.0
DRI.....	7.8	7.5	7.5	7.3	7.1	6.9	6.7
<b>With stimulus:</b>							
Wharton.....	8.1	7.6	7.1	6.9	6.6	6.5	6.5
Chase.....	8.3	7.8	7.8	7.8	7.7	8.0	8.3
DRI.....	7.8	7.5	7.3	6.9	6.6	6.5	6.3

### III. FEDERAL BUDGET PROJECTIONS

In deciding between temporary and permanent tax reductions, it is useful to consider them in relation to the Federal budget.

Table 7 shows a projection of Federal outlays and revenues derived from the Ford Administration's budget for fiscal year 1978. This "current policy" budget assumes extension of existing tax laws without any new temporary tax reductions and no new Federal spending programs, although existing programs are adjusted for inflation. It does not include the budget effects of any economic stimulus enacted in 1977. The projection assumes that the unemployment rate will decline to 4.9 percent by 1980. Under this assumption, the economy would be close to full employment by fiscal year 1981.

**Table 7.—Federal Budget Projections**

[In billions of dollars]

	Fiscal year—		
	1977	1980	1981
Current policy: <sup>1</sup>			
Revenues-----	361	526	585
Outlays-----	411	509	541
Surplus-----	-50	+17	+44
Alternative projection: <sup>2</sup>			
Revenues-----	361	526	585
Outlays-----	411	504	551
Surplus-----	-50	+22	+34

<sup>1</sup> Current services budget with full adjustment of outlays for inflation from the *Budget of the United States Government, Fiscal Year 1978*.

<sup>2</sup> Outlays equal to 20 percent of GNP.

Under this assumption, the Federal budget surplus would be \$44 billion in fiscal year 1981, which is equivalent to a surplus of \$29 billion at 1977 income levels. A permanent tax cut now of \$12.8 billion, the amount of the tax portion of the stimulus package in fiscal year 1977, would thus reduce the surplus in fiscal year 1981 to \$31.2 billion.

This "current policy" budget projection may be misleading, and the available surplus in the absence of a permanent tax cut may be, accordingly, less than \$44 billion. It is unlikely that there will be no new spending programs between now and fiscal year 1981. Table 8 shows data on Federal outlays as a percentage of GNP in times of high employment. Except for wartime, Federal spending has fluctuated between about 18 percent and 20 percent of GNP in such years. (In years of high unemployment, the ratio of Federal spending to GNP tends to be higher than this because GNP is low and spending for such purposes as unemployment compensation is high.) In 1973, this ratio was 19.9 percent. A more realistic projection of spending in 1981 would assume Federal spending to be 20 percent of GNP. This increases spending by \$10 billion over the current policy budget projection, reducing the surplus to \$34 billion (\$22 billion at 1977 levels). Thus, under the assumption of some increases in spending based on the past, a permanent tax cut of \$13.8 billion might result in a fiscal year 1981 surplus of \$20.2 billion (\$13.3 billion at 1977 levels).

**Table 8.—Government Spending as Percentage of GNP in Years of Prosperity**

[Dollar amounts in billions]

Fiscal year	Federal outlays	GNP	Federal outlays as percentage of GNP
1953-----	\$76.1	\$360.1	21.1
1955-----	68.5	381.0	18.0
1957-----	76.7	433.3	17.7
1965-----	118.4	658.1	18.0
1966-----	134.7	722.4	18.6
1967-----	158.3	773.5	20.5
1968-----	178.8	830.2	21.5
1969-----	184.5	904.2	20.4
1973-----	246.5	1,238.4	19.9

#### IV. ALTERNATIVE VIEWS OF NEED FOR ECONOMIC STIMULUS PACKAGE

In public discussion of the issue, economists have expressed a variety of views concerning the need for the administration's economic stimulus package.

Some economists believe that no fiscal stimulus is needed at this time. They acknowledge that the rate of economic growth declined steadily through 1976, but note that this has resulted in large part from a decline in inventory accumulation, which is likely to be reversed in 1977. They point out that final sales of goods and services, without regard to inventory and price changes, increased throughout 1976, from an annual rate of increase of 3.6 percent in the first quarter of the year to 4.7 percent in the fourth quarter. This may suggest that the economy did not "pause" in 1976. Also, those who oppose any stimulus tend to think inflation is a much more serious problem than unemployment, so that fiscal policy should err on the side of restraint rather than expansion.

The more common view is that fiscal stimulus is needed because there is a large gap between what the economy is producing and what it is capable of producing. Accordingly, it is contended that there is relatively little risk of inflation by increasing the growth rate at this time. The Council of Economic Advisers recently estimated the gap between actual and potential production at \$134 billion at the end of 1976, which is large relative to a \$15 billion program of economic stimulus in fiscal year 1977. In this view, the high rate of unemployment is a source of concern and justifies a quick stimulus in early 1977. Some economists argue that the severe winter weather will depress economic activity, a situation that strengthens the case for economic stimulus.

There is also considerable disagreement over whether tax cuts or increases in spending are better ways to stimulate the economy. Those who favor tax cuts maintain that they allow the consumer and the investor to determine what goods and services they want produced to generate the economic stimulus. This is considered preferable to government spending. Those who favor increased government spending claim that, since consumers may save a large part of any tax cut or businesses may not respond to business tax cuts, tax cuts are a much less certain stimulant than government spending. However, some Federal spending programs take a long time to implement or may simply substitute Federal government spending for State or local government spending, in which case Federal government spending may not be an effective stimulant either.

Another issue on which there is disagreement is the extent to which any tax reduction should include an incentive for business investment. Some persons argue that there should be such an incentive, such as an increased investment credit, since business investment has been one of the weakest sectors of the economy, and since the recent rapid growth in the labor force makes more investment desirable. Others argued that the effectiveness of such investment incentives is problematical and that an alternative way to increase business investment would be to reduce the amount of unused capacity in the economy. Those who favor a direct stimulus to greater employment argue that it would be more effective in reducing unemployment than an investment stimulus.

With respect to individual tax cuts, the principal issue is whether they should be temporary or permanent. Those favoring a temporary tax cut, like the proposed refund on 1976 taxes, emphasize that such a reduction will provide an immediate economic stimulus and also will not erode the revenue base in the future. Advocates of permanent individual tax reductions argue that tax cuts are needed to offset the effect of inflation in raising taxes (an estimated \$5 billion in 1976), that permanent individual tax cuts are more effective in stimulating consumption than is a one-shot refund, and that permanent reductions now will create pressure against higher government spending in the years ahead.



