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CLASS II - FOMC

September 17, 1976

SUPPLEMENT

CURRENT ECONOMIC AND FINANCIAL CONDITIONS

Prepared for the
Federal Open Market Committee

By the Staff
Board of Governors
of the Federal Reserve System

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SUPPLEMENTAL NOTES

The Domestic Nonfinancial Economy

Industrial Production increased by an estimated 0.5 per cent in August to 131.4 per cent of the 1967 average. The July index has been revised upward and now shows a similar 0.5 per cent advance. The June increase was 0.3 per cent. Advances in both August and July were concentrated in durable materials, business equipment, and construction products.

Products. Output of consumer goods was unchanged in August. Among durables, a small rise in home goods about offset a slight decline in auto production after allowance for the model changeover period. Output of nondurable consumer goods changed little. Production of business equipment advanced an estimated 0.6 per cent further in August following an upward revised increase of 0.7 in July. Output of construction products and business supplies also rose.

Materials. Output of durable goods materials continued to increase strongly in August; however, raw steel production has weakened in recent weeks. Recent strong advances in durable materials production have brought the level up to 27 per cent above the March 1975 low, but it is still about 4 per cent below the high of June 1974. The materials capacity utilization rate was 81.5 per cent in August.

INDUSTRIAL PRODUCTION
(Seasonally adjusted)

	May	June	July (p)	Aug. (e)	Month ago	Year ago	QI to QII
Total	129.6	130.0	130.7	131.4	.5	8.6	1.8
Products, total	128.9	129.3	129.6	130.1	.4	6.4	1.2
Final Products	127.3	127.5	127.7	127.9	.2	5.9	1.4
Consumer goods	137.4	137.5	137.2	137.2	.0	7.6	1.7
Durable goods	143.2	144.3	142.2	142.1	-.1	10.0	3.8
Nondurable goods	135.1	134.9	135.3	135.3	.0	6.6	.8
Business equipment	134.6	135.2	136.2	137.0	.6	5.5	1.5
Intermediate products	135.0	135.8	136.6	137.7	.8	7.7	.4
Construction supplies	130.9	131.9	132.7	134.1	1.1	10.6	1.5
Materials	130.6	131.0	132.0	133.2	.9	11.9	2.7

p--preliminary e--estimated

Growth of personal income slowed considerably in August. Total personal income increased at a 5.4 per cent annual rate--the smallest increase during the past year. A decline of $3.5 billion (annual rate) in farm proprietors' income between July and August had a substantial impact on total personal income. Total nonfarm income advanced at an 8.7 per cent annual rate.

Wage and salary disbursements rose only moderately in August with the growth of manufacturing payrolls lagging other sectors. Total wages and salaries grew at a 6.2 per cent annual rate in August--

well below their 10.3 per cent growth rate over the past year. The increase in transfer payments was 10.5 per cent at an annual rate in August. It follows a large jump in July due to the Social Security cost-of-living increase.

PERSONAL INCOME
(Billions of dollars, seasonally adjusted at an annual rate; per cent change at a compound annual rate)

	1976	Per Cent Change:		
	Aug. p	Aug. 75-Aug. 76	June 76-July 76	July 76-Aug. 76
Total Personal Income	1,389.5	9.6	12.0	5.4
Total Nonfarm	1,351.2	10.2	14.6	8.7
Wage and Salary Disbursements	896.5	10.3	12.8	6.2
Government	191.7	8.2	7.2	6.5
Private	704.8	10.8	14.4	6.2
Manufacturing	239.1	12.3	9.5	5.7
Other	465.7	10.1	16.9	6.4
Transfer Payments	192.9	7.6	33.1	10.5
Personal Interest	125.8	13.4	15.9	31.0
Other Income	229.4	6.9	-6.5	-12.6

p--preliminary

Private housing starts increased 11 per cent in August to a seasonally adjusted annual rate of 1.54 million units. Single-family starts increased by 6 per cent. Multi-family starts increased by 33 per cent, following a 30 per cent decline in July.

Residential building permits increased further by 7 per cent during August.

The Domestic Financial Economy

Corporate bond market. The Alaskan Pipeline subsidiary of a major U.S. oil company has announced a late September offering of $150 million of six-year notes and $150 million of ten-year notes. The company will use the proceeds to pay part of the unit's share of the construction costs of the Trans-Alaska Pipeline System and retire short-term notes as they fall due. The dual issue increases the volume of expected corporate bond offerings to $1.8 billion in September.

Mortgage market. According to the HUD (FHA) opinion survey, average interest rates on new commitments for conventional new- and existing-home mortgages remained unchanged in August at levels of 9.05 per cent and 9.10 per cent, respectively. Yields on FHA-insured new-home mortgages for immediate delivery in the private secondary market declined by 6 basis points to 8.93 per cent. These rate movements are generally consistent with the primary and secondary mortgage market series reported in the Greenbook.

AVERAGE RATES AND YIELDS ON NEW-HOME MORTGAGES
(HUD-FHA Field Office Opinion Survey)

End of Month	Primary market Conventional laons		Secondary market 1/ FHA-insured loans		
	Level 2/ (Per cent)	Spread 4/ (Basis points)	Level 3/ (Per cent)	Spread 4/ (Basis Points)	Discount (Points)
1975-Low	8.90 (Mar.)	-70 (Mar.)	8.69 (Mar.)	-91 (Mar.)	2.4 (Dec.)
High	9.25 (Sept., Oct.)	+15 (Jan.)	9.74 (Sept.)	+31 (Oct.)	6.2 (Aug.)
1976-Jan.	9.05	+39	9.06	+40	2.4
Feb.	9.00	+42	9.04	+46	2.2
Mar.	8.95	+42	n.a.	n.a.	n.a.
Apr.	8.90	+32	8.82	+24	2.5
May	9.00	+ 5	9.03	+ 8	4.1
June	9.05	+35	9.05	+35	4.2
July	9.05	+33	8.99	+27	3.8
Aug.	9.05	+58	8.93	+46	3.3

1/ Any gaps in data are due to periods of adjustment to changes in maximum permissible contract rates on FHA-insured loans.

2/ Average contract rates (excluding fees or points) on commitments for conventional first mortgage loans, rounded to the nearest 5 basis points.

3/ Average gross yield (before deducting servicing costs) to investors on 30-year minimum-downpayment FHA-insured first mortgages for immediate delivery in the private secondary market (excluding FNMA), assuming prepayment in 15 years.

4/ Average gross mortgage rate or yield minus average yield on new issues of Aaa utility bonds in the last week of the month.

INTEREST RATES
(One day quotes - in per cent)

	1976			
	Highs	Lows	Aug. 16	Sept.
Short-Term Rates				
Federal funds (wkly. avg.)	5.58(6/30)	4.70(2/18)	5.29(8/18)	5.22(9/15)
3-month				
Treasury bills (bid)	5.57(6/2)	4.68(1/29)	5.14	5.10
Comm. paper (90-119 day)	5.00(6/15)	5.00(4/29)	5.38	5.38
Bankers' acceptances	5.95(6/2)	4.80(4/21)	5.33	5.30
Euro-dollars	6.81(6/1)	5.19(4/22)	5.69	5.56
CD's (NYC) 90 days				
Most often quoted new	5.75(6/16)	4.88(4/21)	5.30(8/18)	5.30(9/15)
6-month				
Treasury bills (bid)	5.96(5/27)	4.95(1/29)	5.39	5.31
Comm. paper (4-6 mo.)	6.00(6/22)	5.13(4/29)	5.50	5.50
Federal agencies	6.42(5/27)	5.31(2/2)	5.78	5.63(9/10)
CD's (NYC) 180 day				
Most often quoted new	6.50(6/2)	5.38(4/21)	5.65(8/18)	5.60(9/15)
1-year				
Treasury bills (bid)	6.39(5/27)	5.27(1/29)	5.61	5.53
Federal agencies	6.86(5/28)	5.82(4/14)	6.09	6.06(9/10)
CD's (NYC)				
Most often quoted new	6.75(6/16)	5.38(2/4)	6.25(8/18)	6.05(9/15)
Prime municipals	3.70(5/28)	3.00(1/30)	3.15(8/13)	3.00(9/17)
Intermediate and Long-Term				
Treasury coupon issues				
5-years	7.82(5/27)	7.12(4/21)	7.23	7.13
20-years	8.20(5/21)	7.77(4/14)	7.88	7.78
Corporate				
Seasoned Aaa	8.66(1/2)	8.34(4/15)	8.43	8.39(9/15)
Baa	10.34(1/2)	9.31(9/15)	9.46	9.31(9/15)
New Issue Aaa Utility	8.95(5/28)	8.28(9/10)	8.49(8/11)	8.30(9/16)
Municipal				
Bond Buyer Index	7.13(1/8)	6.50(9/16)	6.60(8/18)	6.50(9/16)
Mortgage--average yield in FNMA auction	9.20(6/1)	8.83(4/19)	9.01(8/9)	8.92(9/6)

APPENDIX A*
Brief Summary of Some Major Provisions of the Tax Reform Act of 1976

On September 16, Congress approved the Tax Reform Act of 1976, the most comprehensive piece of tax legislation since 1969. The bill is expected to be signed into law shortly by the President. The legislation provides many structural changes in the tax laws; it also extends the antirecession tax cuts enacted last year. The tax reform provisions are estimated to result in a net revenue gain of $1.6 billion in fiscal year 1977, while the extension of last year's tax cuts is expected to lower taxes in this period by $17.3 billion.

Extension of Tax Cuts 1/

For individuals, the personal credit and the earned-income credit have been temporarily extended through 1977. The personal credit allows taxpayers to reduce their taxes by an amount equal to (a) $35 per person, or (b) 2 per cent of the first $9,000 of taxable income, whichever is greater. The earned-income credit provides families with dependent children a refundable credit equal to 10 per cent of earned income. The credit has a maximum of $400, and is gradually phased out as income increases from $4,000 to $8,000.

Last year's increases in the minimum standard deduction (low-income allowance) and maximum standard deduction have been made permanent. The low-income allowance equals $1,700 for single persons and $2,100 for joint returns. The regular standard deduction equals 16 per cent with a maximum of $2,400 for single persons and $2,800 for persons filing jointly.

For corporations, last year's reductions in tax rates on the first $50,000 of profits have been extended through 1977. The first $25,000 of profits is taxed at 20 per cent, while the next $25,000 is taxed at a rate of 22 per cent. Profits above $50,000 are taxed at 48 per cent.

The temporary increase in the investment tax credit from 7 per cent to 10 per cent has been extended through 1980, both for new equipment and for $100,000 worth of used equipment. These credits are made more attractive by a new provision which allows unused credits

1/ This section also discusses some related reforms in the investment tax credit area.

* Prepared by Frank S. Russek, Economist, Government Finance Section, Division of Research and Statistics.

from earlier years to be used before current credits. This change reduces the chance that past credits will be lost because of the 7-year carry-forward limit. Companies with perennially low profits or losses, such as airlines, will especially benefit from this provision.

The bill also introduces other changes in the investment tax credit, which will benefit specific industries. Railroads and airlines will be allowed to take investment tax credits up to 100 per cent of tax liability in 1977 and 1978. This limit will drop 10 percentage points per year until it returns, in 1983, to the regular 50 per cent limit generally applicable to other industries. Owners of ships used in U.S. waters will now receive a 5 per cent investment tax credit on that portion of a vessel's construction financed with money from a "capital construction fund". Formerly, IRS rulings have held that since the income allocated to such funds is tax exempt, extending tax credits to that part of ship construction financed by these funds would result in a double tax benefit. Finally, companies which install pollution control equipment in an older plant--one in existence on January 1, 1969--will receive a larger tax break. Previously, a company could choose to use a 5-year amortization option instead of the 10 per cent investment tax credit. The new bill extends the amortization provision through 1980, and provides, in addition, a special 5 per cent investment credit on equipment placed in service after 1976.

To provide continued strong incentives for the growth of employee stock ownership plans (ESOPs), the bill extends through 1980 last year's measure which allows companies to take an additional 1 per cent tax credit if the company contributes to an ESOP. A new provision allows yet another 1/2 per cent credit (raising the total to 11.5 per cent) if employees agree to match the company's contribution to the plan.

Individual Tax Reform

The bill contains over a hundred tax reform measures. Some of the major ones are:

(a) tax shelters - There are three basic elements to most tax shelters:

(1) the use of capital cost expensing and accelerated deductions on capital expenditures to offset current income, and thus defer the payment of taxes,

(2) reliance on leverage to purchase larger tax shelter investments, and

(3) the conversion of ordinary income into capital gains.

Each of these items is treated in the reform package. For example, investors in most real estate ventures will no longer be able to immediately deduct construction-period interest and tax payments. Instead they will have to capitalize and amortize these costs over a period of years which gradually will be increased to 10 years by the 1980's. The advantages of leverage for limited partnerships will be reduced somewhat by a requirement which limits the deduction for losses from ventures such as oil and gas production, equipment leasing, and syndicated farming to the amount the individual investor has "at risk." That is, the limited partner will no longer be able to claim a deduction on that portion of an investment financed by a loan for which he is not personally liable. Finally, residential real estate will be subject to the more restrictive rules which now govern commercial real estate regarding the recapture (as ordinary income) of capital gains resulting from the use of accelerated depreciation. Formerly, the portion of such gains recaptured, in the case of residential investment, was reduced if the property was held for more than 100 months. Under the new law, all depreciation in excess of straight line depreciation will be recaptured regardless of the holding period.

The immediate effects of these provisions are likely to be mildly depressing on the still weak commercial construction sector, since the law requires all of 1977 (as well as half of 1976) construction period interest and taxes to be amortized over a 4-year period. For residential investments, the amortization provision does not take affect until 1978, and the short-term impact of the new recapture provisions would seem to be less important.

(b) minimum tax - The minimum tax was introduced in 1969 to insure that every high-income person would pay at least some tax. Because of its generous exemptions, low rate, and restricted coverage, however, it has been disappointing in its revenue impact. The reform bill raises the rate from 10 per cent to 15 per cent. The amount of "preference" income exempted from the tax has been reduced to $10,000 or half the taxpayer's regular income tax bill, whichever is greater. Formerly, the amount of this exemption was equal to $30,000 plus all the taxpayers' other income taxes. The minimum tax has also been extended to cover, a certain portion of itemized deductions, equipment leases, and some intangible drilling costs for oil and gas. (Similar types of changes have been made for the minimum tax on corporations.)

(c) maximum tax - In 1969, a maximum marginal tax rate of 50 per cent was introduced for earned income, partly in an effort to discourage the use of tax shelters by those in marginal tax brackets above 50 per cent. The law required, however, that income eligible for the 50 per cent rate be reduced by all "preference" income (one-half of capital gains, etc.) <u>in excess</u> of $30,000. The failure of the maximum tax to discourage the use of tax shelters is partly attributable to the presence of the $30,000 exemption which reduces the effect of "preferences" on the earned-income calculation. Under the new law, the $30,000 exemption is eliminated, so that earned-income must be reduced by <u>all</u> "preference" income before the 50 per cent rate can be applied. Thus, a person earning $200,000 and receiving preference income of $100,000, would have only $100,000 of income eligible for the 50 per cent maximum tax rate. This tightening in the maximum tax, however, is partly offset by provisions which make pensions and annuity income eligible for the 50 per cent maximum tax rate.

(d) <u>capital gains</u> - Since 1934, a holding period has been used as an objective means for distinguishing long-term from short-term capital gains. The most recent dividing line for holding periods was 6 months. There are two reasons for providing special tax treatment for long-term capital gains. First, without special tax treatment the gain realized from long-term appreciation of an asset would be bunched in one year, and taxed at progressive rates in the case of individuals. Second, it is argued that there should be special tax treatment of assets held for investment, but not those held for speculative profit. The new law increases the holding period to 9 months in 1977, and 12 months in 1978 and thereafter. These new holding periods were judged more appropriate for distinguishing long-term from short-term capital gains. (NOTE: the bill omits the Administration's proposal for a sliding scale for reducing the amount of capital gains to be taxed according to the amount of time the asset is held.)

(e) <u>capital losses</u> - Since 1942, only $1,000 of yearly ordinary income could be offset by half of the excess of net long-term capital losses over net short-term capital gains. Given the substantial increase in the price level experienced since 1942, it was considered appropriate that this $1,000 limitation should be adjusted. Under the new law, the limitation will be increased to $2,000 in 1977, and to $3,000, thereafter.

(f) miscellaneous -

(1) The limit on an individual's deductions for nonbusiness investment interest is reduced to $10,000 plus net investment income. Interest payments in excess of this amount can be carried forward to future years.

(2) The bill makes permanent the current tax exemption of the interest foreigners receive on their U.S. bank accounts. This provision was due to expire at the end of 1976.

(3) The retirement income credit and the tax break for childcare expenses have been made simpler, more generous, and more widely available.

(4) Finally, the bill contains a "deadwood" provision which eliminates many obsolete portions of the tax code.

(g) estate and gift taxes - The Congress also approved the first major reform of the nation's estate and gift taxes in almost 30 years. During the 1940's legislation was enacted which allowed a $60,000 estate tax exemption, and a $30,000 exemption for gifts made over a lifetime. Because of past inflation, the size of these exemptions has been deemed inadequate. The reform legislation combines the estate and gift tax exemptions into a single $30,000 credit in 1977, and allows the credit to rise to $47,000 by 1981. This is equivalent to an exemption of about $120,000 next year and $175,000 in 1981. The use of a credit in lieu of an exemption provides the same dollar benefit to all estates, regardless of the applicable rate bracket.

The estate tax system has also been criticized for its adverse impact on estates which are comprised of farms and closely-held businesses. Under the old law, land was valued for estate tax purposes at its highest and best use rather than at its current use, sometimes resulting in the need to break up estates to pay the taxes. The new legislation permits an executor--for family farms and small businesses--to value an estate on the basis of current use, provided this option does not reduce the estate's value by more than $500,000.

Under the old law, the assets of an estate were valued on a "stepped up" or current market value basis. Then, if the inherited property were sold, the heir was required to pay a tax only on the gain in value from the time of the decedent's death. Thus, all the gain accruing to the decedent during his lifetime would escape taxation when passed to the heirs. To remedy this, the bill sets everyone's basis for inherited property equal to its value on December 31, 1976, and provides a minimum basis of $60,000 per estate. Thus, for someone who dies after December 31, an heir's basis will be the value on December 31, or his share of the $60,000 minimum basis, or the original purchase price, whichever is greater.

Finally, the new law places a tax on "generation-skipping" trusts, but allows a $250,000 exclusion for transfers to a grandchild.

Business Tax Reform:

Some of the major provisions which will affect businesses are:

(a) loss carryovers - Currently, businesses are allowed to carry losses back 3 years and forward 5 years in search of income to offset. (For transportation companies, the carry-forward period is 7 years.) Given the severity of recent business losses, and the slow-to-moderate pace of recovery, there is concern that short-term future profits might not be sufficient to fully offset large recent losses. The new bill, therefore, allows companies to carry losses forward 7 years (9 years in the case of transportation companies.)

(b) foreign income - Present law permits taxpayers subject to U.S. tax on foreign source income to take a foreign tax credit (against U.S. taxes) for the amount of foreign taxes paid on income from foreign sources. Currently, there are two ways of calculating the limitation on the use of foreign tax credits to offset U.S. taxes. Under the "overall limitation", the credit against U.S. taxes on worldwide income is limited to what the U.S. tax would be on aggregate net foreign income (which may reflect losses from some foreign operation.) Under the "per-country limitation", the credit is limited to what U.S. taxes would be on foreign source income calculated on a country-by-country basis. This second alternative produces a larger amount of tax credits since losses in one country do not offset taxable income from another country, as is the case under the overall limitation procedure. The omission of such losses from the per-country limitation calculation not only increases the amount of foreign credits in a given year, but since such losses are not carried forward to offset positive profits earned in that country in future years, there is a double tax benefit received from using this option.

The new bill requires companies to use only the "overall limitation" when calculating their foreign tax credits. Also, foreign losses that reduce U.S. income subject to tax in one year will be "recaptured" in later years when deficit foreign operations become profitable.

(c) DISC - Since December of 1971, firms engaged primarily in export trade have been permitted to establish subsidary corporations known as Domestic International Sales Corporations (DISCs). The purpose of the provision was to stimulate export sales and domestic employment. Under the former law, the DISC could be allocated up to 50 per cent of the parent firm's taxable income from export sales. Taxes on this income were deferred until such time as income was redistributed to the parent corporation. The new legislation reduces the tax advantage attributable to DISC by limiting the tax deferral privilege to only that portion of export-related income which exceeds 67 per cent of the average income from 1972 to 1975. This four-year period will be moved forward in 1980.

(d) international boycotts - The bill provides that any U.S. company which participates in an international boycott based on race, nationality, or religion shall lose a portion of three tax benefits: the foreign tax credit, tax deferral on foreign earnings, and DISC benefits for exports. For those already participating in such a boycott, however, the denial of benefits will not take affect until after 1977.