to defense, rather than its initiation. We get closer to a true indicator of the economic impact of defense outlays if we look at the trend in the "obligations incurred" by the federal government when it places its orders and starts the process going.

On the "obligations incurred" basis (see line 5, Table 1) the trend appears quite different. A large increase is indicated between fiscal 1966 and fiscal 1967, but the total remains almost level between the current fiscal year and the one that begins in about four months.

These estimates may have to be revised, depending on political and military developments. But the revision could as well be downward as upward. We conclude that it is reasonable to assume that the nation is at, or close to, the peak of business activity related to the defense effort.

3. *A reduction in the rate of inventory accumulation.*—Goods added to inventories are as much a part of the annual output as those sold to final purchasers. In 1966 the nation produced $11 billion for that purpose.

It is universally agreed that production for inventory will be much less in 1967 than in 1966, although there may be room for disagreement as to the amount. The leveling-off of the defense and capital-goods booms will reduce the need for adding to goods-in-process.

The CEA estimates that inventory accumulation will be only half as great in 1967 as in 1966, but even this seems optimistic. We conclude that the reversal of the inventory boom will reduce national output by between $5 and $10 billion between 1966 and 1967.

4. *A reduction in profits and profit margins.*—On general considerations, it will be difficult to increase, or even maintain profit levels in 1967. A strong upward thrust of labor costs is anticipated. It may be expected that this will partly be passed on in prices, supporting an inflationary trend, but (as is usually the case) it will also partly be absorbed, reducing profit margins.

The Administration's estimates of before-tax profits in 1967 indicate only a nominal rise—about 1%—over 1966. Since an increase of 6½% in the gross national product is assumed, this implies a reduction of about 5% in before-tax profit margins. And if a tax surcharge of 6% were imposed in the middle of the year, after-tax margins would be reduced by close to 9%.

This is, of course, a matter of immediate concern to manufacturers. It should also be a matter of concern to the nation generally. The profitability of business operations is the chief determinant of the willingness of business to produce, invest, and employ people. Table 2, appended, shows the close inverse connection between profit margins and unemployment rates. Unemployment reached its lowest levels when profit margins were at or near their peaks. With only one exception among the 13 years listed, unemployment never fell below a 5% rate in years when profit margins were under 5%. The process of reducing unemployment to the 4% goal during the past 6 years has been achieved through a steady rise in the profitability of business activity.

We conclude that, in the interests of maintaining a high employment economy, it is undesirable for the government to take deliberate steps to reduce profit margins—whether through a tax increase or through jaw-bone techniques. There will be enough of a problem without that.

Some of the other aspects of economic activity in 1967 are less foreseeable than those discussed above. Automobile sales have been sluggish, and no one expects the industry to have anything better than its "second-best" year in 1967. Consumer non-durables and services will certainly show an increase in volume but there is no reason to expect it to be exceptionally great. Thus it appears that the economy will have a serious burden in 1967 in adjusting to the new, less favorable trends we have described.

The Administration evidently hopes for a substantial expansion of the housing industry to take up the slack. But this is a slender reed to lean upon. The housing industry accounts for only about 3% of total economic activity. It is only about ⅓ as great in dollar volume as capital goods expenditure, or defense expenditure. This makes it hard to see how even a major recovery in housing could offset the less favorable trends in those two areas.

The Council of Economic Advisers foresees a period of slow growth in the first half of 1967, to be followed by a period of renewed economic strength in the second half. This assumed pattern is their chief justification for recommending a tax increase to take effect on July 1. But the assumption of a pronounced upward change in trend to start at that time seems unconvincing. It is based largely on the hope of an expansion of housing activity in the second