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CONSUMERS AND PRODUCERS IN AMERICA

Remarks by

Henry C. Wallich
Member, Board of Governors of the Federal Reserve System

at a meeting sponsored by

Westminster College,
The Chamber of Commerce, and
The Rotary Club

Salt Lake City, Utah

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I am grateful to Westminster College and its president, Dr. Helmut Hofmann, for giving me this opportunity to address the Chamber of Commerce and Rotary Club of Salt Lake City on the topic "Consumers and Producers in America." In this free enterprise country, the consumer is king. That is elementary. A business will prosper if it can produce a better mousetrap that the consumer wants. It will have to go out of business if it insists on turning out goods that the consumer does not want, or if it just cannot compete. We do not allow the Government to make decisions as to what is to be produced and consumed, give or take a few qualifications. The consumer, by casting dollar votes in a free market, makes those decisions. That is what a free enterprise, market economy is all about. That is why the United States has achieved such a high standard of living.

Thus far the textbook. How about the reality? The consumer, or at least consumer advocates, today are indeed in the saddle. But the consumer occupies this rightful role not only by virtue of competition for his dollar, but through Government mandates laid upon producers. These mandates are far-ranging. They run from rules concerning what is to be produced, how it is to be produced, and on what terms and conditions it can be sold, to regulations affecting the supply of essentials, such as energy, and further to the tax system which determines how much the businessman will have left over to invest and, therefore, how efficiently he will be able to produce. In large part, the thrust of these laws and regulations is to improve the lot of the consumer at greater or lesser expense to the producer. Today, their ultimate consequence is becoming obvious to all: Producers cease to be efficient, their costs go up, the consumer pays more, and our standard of living has almost ceased to rise.

The fundamental truth is, of course, that the consumer cannot live without the producer. In fact, most consumers are also producers, as businessmen, workers, farmers, and in every other endeavor. The notion, therefore, that the consumer should be protected against the producer is _prima facie_ open to logical challenge. The law, and even the language of the law, seems to ignore this obvious fact. In regulatory language today, hundreds of pages of which sometimes come to the Federal Reserve Board for approval in a single week, the word "consumer" is used where in the past one would have said people, or individuals, or Americans, or men and women. The law wants us to be a nation of consumers, in confrontation, it seems, with our enemy the producer.

To document what I am saying, I would first like to go over some of the most serious instances where national policy and legislation pit consumer against producer and then to review some of the consequences which are already becoming only too apparent.

First, there are the transfer expenditures in the Federal budget, which as a per cent of GNP have risen from 5 per cent through most of the 1960's to almost 10 per cent for Fiscal Year 1978. Not all of these transfer payments, to be sure, are pure gifts from producers to nonproducers. To the extent that people paid Social Security taxes, and interest was accumulated thereon, they are merely getting their own money back as they would from a life insurance company. But, of course, Social Security benefits far exceed these amounts, being essentially financed by taxes on the working population to support the retired population. Unemployment compensation, welfare benefits and a variety of other intrinsically meritorious but nevertheless expensive programs swell the transfers from producers to nonproducers.

The tax system is set up to favor the consumer at the expense of the producer. At the corporate level, taxes are levied on profits that the Department of Commerce does not classify as true profits. During the past year some 36 per cent of reported profits after tax resulted from under-depreciation and from inflationary inventory appreciation. These do not add to a company's ability to pay taxes or dividends or to make new investments. Because taxes must be paid on such phantom profits, less is left for corporate reinvestment and for dividends out of which new investments might be made by individuals. In addition, the double taxation of dividends --

once as income to the corporation, and again as income to the stockholder -- cuts down a type of income that has a high probability of being reinvested.

At the level of the individual taxpayer, we have a steeply progressive income tax that is bound to work as a disincentive even for income earners in relatively modest income brackets. On the other hand, we do not tax Social Security income, making it more attractive to retire. At the upper end of the income scale, we distinguish between earned and "unearned" income. On earned income there is a cap of 50 per cent, on "unearned" income the tax reaches as high as 70 per cent, not taking into account State, local, and capital gains taxes as applicable. "Unearned" income is the income from investments that were taxed once before when the taxpayer saved the money and made it available as capital to the economy by investing it. For a society that would like to raise its productivity, this is the most useful type of income and it gets the worst treatment in our tax system.

The capital gains tax is another instance of anti-producer taxation. It is aimed directly at the enterprise and risk taking that is needed in an economy where investment decisions are made by individuals and not by the State. Today, when inflation has doubled prices since 1968 and quadrupled them since 1943, much of what the tax collector calls capital gains is simply the result of asset prices keeping up, more or less, with inflation. In the stock market, as we know, prices have kept up with inflation less rather than more. The capital gains tax, therefore, is in large part simply a tax on capital, not on gains. Either way, of course, it penalizes the successful producer. Capital that is employed essentially in consumption, as in owner-occupied homes, receives preferred treatment through roll-overs and lifetime exemptions.

A third area in which the consumer is favored at the expense of the producer is in the treatment of savings. This discriminatory treatment is effectuated through government regulation and through the tax system which does not allow adjustments for inflation. It is difficult enough, in a country of rising taxes, rising inflation, and diminishing growth, to make ends meet. It is more difficult, under these conditions, to hold expenditures below income to put aside regular amounts. What is most difficult of all, today, is to preserve the real value of what has been saved.

Unlike practices in some other countries, in the United States the saver gets no special tax advantages. At most, savers who happen to be debtors can look upon the deductibility for income tax purposes of the interest paid as a form of subsidy to saving since debt repayment is a form of saving. The mechanism of the subsidy, which, of course, is quite unintended by the legislator, works as follows. At today's high rate of inflation, the interest rate contains a sizable inflation premium. In an economic sense, this can be thought of as a form of repayment of capital. The value of the principal of the debt diminishes through inflation, while the debtor compensates the lender by paying him the inflation premium. Tax deductibility of the full nominal interest rate, including the inflation premium, can, therefore, be viewed as a special aid to saving. But in order to get this subsidy to saving, the consumer must first have borrowed. All the forces of inflation and taxation work against those not in debt. Essentially it is consumption on credit, rather than net saving, that is supported in this way. On balance, tax deductibility of interest on housing and consumer credit turns out to be simply one more of many devices favoring the consumer against the saver.

The net saver, on the other hand, is really hurt by the same tax mechanism. The interest that the saver receives usually contains some compensation for inflation, even though inadequate in many instances. This premium is not income in an economic sense, any more than are insurance benefits paid for losses from accidents or fire. The latter, naturally, are not treated as taxable income. The inflation premium, whose function it is to make up for the damage from inflation, is taxable. Money is the only depreciating asset on which even a business user cannot charge depreciation.

Unless the saver is well-to-do or even wealthy, moreover, worse treatment looms. Savings or time deposits are the natural investment medium for a small saver. Interest rates on all such deposits below $100,000 are subject to ceilings under Regulation Q of the Federal Reserve and other Federal regulators. Passbook savings at commercial banks are limited to 5 per cent; time deposits for various periods are capped at somewhat higher rates. All of these rates are below market rates and have been for some time, with the exception of the recently introduced six-month money market certificates which have been snapped up by many savers who could put up the minimum of $10,000. The plight of the small saver has come very much to the forefront in recent weeks and is under intensive study by Government agencies. It urgently calls for redress.

Another area in which the saver encounters adversity is the stock market. I have already commented on the depressive effects of the capital gains tax, the double taxation of dividends, and the taxation of phantom profits in times of inflation. These factors combine with high Government-mandated costs for health, safety and environmental purposes in reducing the attractiveness of American equities. Pension fund regulation makes it difficult for investment managers to buy stock, particularly in small and new businesses, and contributes to the dismal experience that savers who invested in common stocks have had over many years. Financial success, in recent years, has been limited largely to those who purchased homes, usually by incurring debt rather than by using savings.

The adverse treatment and experience of the saver in the American economy must properly be viewed as part of our general tendency to penalize the producer and favor the consumer. Without saving, production is bound to suffer. To grow, the economy needs investment. To invest, there must be savings. The United States has become a low saving country, compared to other nations. The personal saving rate in the United States is in the range of 5 per cent of disposable personal income. This compares with about 14 per cent in Germany and 24 per cent in Japan. Accordingly, investment and growth in those countries historically have been on a much larger scale than in our own country. Savers are, in fact, among the most important producers, since they produce capital. Their neglect, to the benefit of the consumer, is part of the syndrome of favoring consumption at the expense of production.

Government regulations of a wide variety have also tilted the balance between consumption and production. These regulations are of many entirely different sorts. It is only their common denominator -- less production -- that is the same.

Many regulations, needless to say, pursue and sometimes achieve good objectives including monetary savings. Thanks to environmental investments imposed on business, we breathe cleaner air and enjoy cleaner water, and, as a result, may have less illness and lower expenditures for medical care. Workers are safer on the job and drivers are safer in traffic, provided we do not allow the greater safety of seat belts, etc. to lure us into more risky driving. But the costs are undeniable. The annual compliance costs of energy and environmental regulation imposed upon industry have been estimated at $7.8 billion. For consumer health and safety, the analogous costs have been estimated at $5.1 billion. The additional cost of safety features in automobiles have been estimated at $666 per car. Confronted with such numbers, one is bound to wonder whether the consumers appreciate what they get, and where they bear measurable cost, whether they consider it worthwhile.

Regulation proliferates rapidly in many other areas, including the financial, which I have an opportunity to observe and participate in at close quarters. Its purpose usually is to protect the consumer against the producer, although in many cases it also deals with issues of producer versus producer and among competitors. Sometimes it is the public interest in a broader sense that regulation seeks to protect. Usually it is difficult to quarrel with the objective. The problem is with the unintended side effects.

Sometimes these side effects simply imply higher costs. Sometimes, however, there are unintended anti-competitive effects. It is particularly small businessmen, the small bankers, who are hard hit. They cannot personally keep up with the flood of regulation and often cannot afford in-house legal talent. A large firm or large bank, with a specialized staff, obtains a competitive advantage.

A few days ago, The Washington Post ran an editorial entitled "Regulation, Regulation, Regulation," in which they took to task the Congress and the Federal Reserve Board for producing 3,000 pages of interpretations and explanations on one single regulation, dealing with Truth in Lending. Few regulations had a better purpose, and few have ended up creating so much difficulty for bankers and other lenders. Not long ago a banker told me that he could not spend time with customers any more because he was so busy studying Federal Reserve regulations. Since he can be sued and penalized for failing to obey them, he is probably making a wise allocation of his time. But it is not clear that the customer gains.

In Washington, there exists a built-in momentum of regulatory activity that is a cause for deep concern. The Government, through all its labyrinthine channels, is geared up to produce regulation the way Detroit produces automobiles. Many thousands of people in Washington, dedicated and sincere, have assigned to them the job of turning out more regulations. They cannot go home at night with a sense of a job well done if they have not turned out some more regulation. Many people's careers, in Congress and in the agencies, depend on their success in accomplishing more regulation. Their families' livelihood depends on more regulation being written. This way, the supply of new regulations becomes independent of the need for it.

The final result of anti-producer orientation of the U.S. economy is to be read in the productivity statistics. Historically, productivity, that is, output per work hour, has grown at 2-3 per cent, on the average, over many decades. Since the late 1960's, there has been a dramatic slowdown. The Council of Economic Advisers estimates annual productivity gains over the past five years at less than one per cent, down by one-half if not by more. Consumers' real per capita income and living standards accordingly have stagnated. Much of this slowdown must be attributed to regulatory, although the tax system and other factors also have contributed. The effort to benefit the consumer has turned against itself.

Low productivity has contributed to inflation. Because wage earners have been accustomed to good annual gains in the past, gains which the economy can now no longer provide, they have sought to overcome the slowdown of income gains by escalating their demands. They have only escalated inflation, and inflation, by hurting saving and investment, has further reduced productivity.

The value of our currency has declined in consequence. Compared to D-mark and yen, the dollar is worth roughly one-half of what it used to be. The United States has an enormous trade deficit while Germany and Japan have large surpluses. We are being outproduced and outsold around the world, as our nation of consumers vainly tries to compete with these nations of producers.

What is to be done? To continue along the present path will bring continuing dissatisfaction at home and diminishing strength abroad. As we become poorer in relation to others, our influence and our ability to defend ourselves diminish. We need a new orientation.

1. We need to restore a better balance in the relative role of producer and consumer. We must stop taking production for granted, like rain from heaven that falls alike on the just and the unjust. The consumer cannot flourish when the producer cannot perform.

2. We need to review our tax system. The corporate tax, the capital gains tax, the treatment of "unearned" income must reflect the need for greater saving, investment, and productivity. Particularly during a period of inflation, the anti-production effects of these taxes need to be corrected.

3. The saver must be given a better break, especially the small saver. The present imbalance in our regulatory and tax framework which favors debt and penalizes thrift must be recognized as part of the anti-production syndrome.

4. The institutionalized outpouring of regulation needs to be restrained. Whether this overpowering proliferation of Government activity is consistent with a free society may be debatable, but it certainly is not consistent with a productive society.

In a free society, it takes time for people to realize that Government is encroaching. In a totalitarian society, people naturally are much more conscious of encroachments. I had never believed that I would find myself appealing to the authority of the late Chairman Mao Tse Tung, but his thought "The struggle against corruption, waste, and bureaucracy should be stressed as much as the struggle to suppress counter-revolutionaries" has a ring of political wisdom about it. As Jefferson put it many years earlier, "The natural progress of things is for liberty to yield and government to gain ground." Very different points of view lead to the same conclusion on this subject.

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