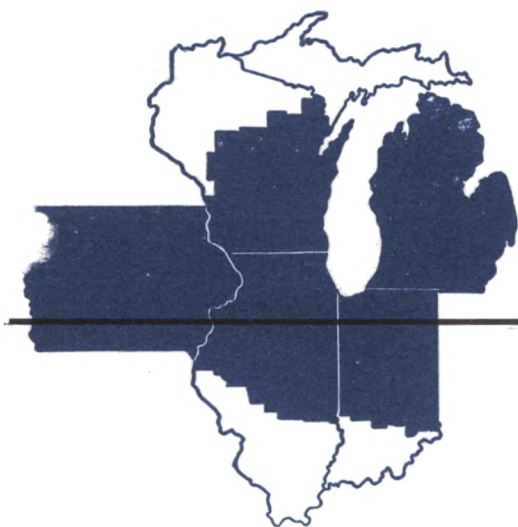


*A review by the* **Federal Reserve Bank of Chicago**

# Business Conditions

**1954 August**



## **Contents**

Reshuffle in autos	4
Building strong with liberal terms	8
State-local spending still climbing	11
Congress rewrites the tax laws	13
<b>The Trend of Business</b>	<b>2-4</b>

# THE Trend OF BUSINESS

Recent months have been marked by an uneasy stability in the over-all level of business. Following the continued gradual slide-off through the winter, most measures of business activity leveled in March or April. Some, notably retail sales and manufacturers' new orders, even advanced moderately in the second quarter. Order backlogs continued to slide, however, and wage and salary employment has fallen somewhat further after adjustment for usual season changes.

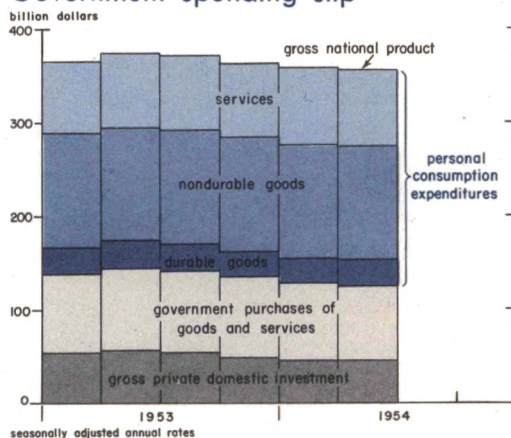
Major impetus for the business downturn which began last summer has come from three sources. First, business inventory policy shifted dramatically from accumulation to liquidation. Whereas business inventories were increasing at an annual rate of more than 6 billion dollars in the spring of 1953, firms began to draw down stocks in the fall and the reduction has proceeded at about a 5 billion dollar rate since the turn of the year. Second, both expenditures and new orders for national defense were cut back sharply. Outlays for such purposes recently have been running at about a 45 billion dollar annual rate, 15 per cent less than a year earlier. Third, consumer expenditures for some kinds of durable goods—and for apparel—dropped off appreciably last fall. Together, the decline in these types of spending since the spring of last year has amounted to more than 20 billion dollars—about 6 per cent of the nation's total annual output of goods and services. Contributing to the generally weaker tone of business has been a continued softening in farm income and farm equipment demand.

Much of the reduction in aggregate demand has been directly reflected in manufacturing activity. Total industrial production dropped 10 per cent from July through March and has

shown very little recovery since then. Durable goods—especially important in the Midwest—have taken the brunt of the decline with output off 15 per cent. Since the turn of the year, nondurable goods have regained about half of the ground lost in a 9 per cent production dip between last May and December, but output of some types of products is still well below a year ago.

Employment of production workers in manufacturing has undergone comparable declines. The total number of such workers has dropped 11 per cent in the past year, with employment in ordnance, electrical and nonelectrical machinery, transportation equipment and primary metals off 15 per cent or more. Production workers in some nondurable lines, such as textiles, apparel and rubber products, have also been cut 10 per cent or more as compared with

## Total personal expenditures hold stable as investment and Government spending slip



a year ago. Outside the manufacturing sector, employment has fallen off substantially only in mining and transportation.

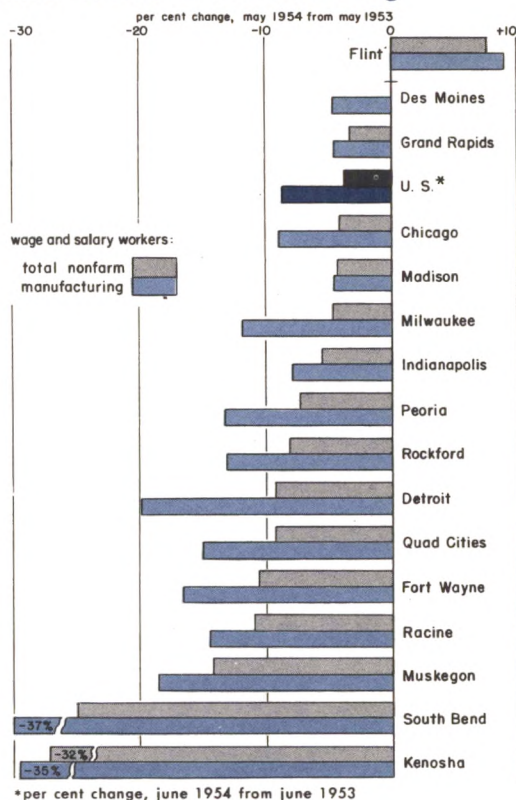
Despite these sizable cutbacks in industrial activity, effects of the downturn on other areas of business have been quite limited. Total consumer expenditures have been well maintained and retail sales after sagging during the fall and winter have increased considerably in recent months. Automobile demand, in particular, has shown increased strength in the spring markets (see pages 4-8). Although merchandise promotions have been widespread and concessions from list price common in some major lines, both the wholesale and consumer price indexes have held firm during the past year. Total business expenditures for new plant and equipment have been maintained so far at close to last year's record pace despite lower output and sales. Finally, the stock market has staged a broad and spectacular advance during the business decline.

### Sustaining factors limit decline

What accounts for the lack of secondary effects normally expected to accompany a business downturn? The lowering of personal income tax rates and termination of the corporate excess profits tax at the turn of the year undoubtedly played a part. Largely owing to the tax reduction and higher unemployment compensation and social security payments, spendable personal income has been virtually maintained despite an 8 billion dollar drop in wage and salary receipts. Corporate profits after taxes in the first quarter were only moderately lower than in early 1953, although pre-tax earnings fell nearly 20 per cent. Moreover, excise taxes on many items were cut April 1 and the new tax bill just agreed upon in Congressional conference committee will further reduce tax payments for some individuals and firms (see pages 13-16).

Prompt and vigorous monetary action to ease the availability and cost of borrowed money has also contributed to limiting the downturn. Ample supplies of short-term funds have prompted banks and other lenders to seek

## Employment declines most severe in manufacturing



additional business and may have reduced financial pressures to liquidate inventories. In the capital markets, lower borrowing costs appear to have stimulated municipal, corporate and institutional bond offerings to finance new capital projects (see pages 11-12). Easier credit terms for Government-insured and conventional mortgage loans certainly have provided a major prop in sustaining home-building activity (see pages 8-11).

Perhaps the most important supporting factor of all has been the maintenance, throughout the downturn, of business and consumer confidence regarding future prospects. In part, this attitude was prompted by the easier tax and monetary policies. But the confident tone of business also has reflected a belief that the

## Decline halted in most business measures

	Per cent change:	
	1953 high to March 1954	March to June 1954
Industrial production.....	-10.2	+0.8
Wage and salary employment..	- 3.2	-0.7
Average hours worked in manufacturing.....	- 3.9	+0.3
Personal income.....	- 1.6	0*
Retail sales.....	- 4.0	+2.9
Manufacturers' sales.....	- 8.7	+0.1*
Manufacturers' new orders.....	-11.7	+1.1*
Manufacturers' order backlogs.	-30.0	-5.6*
Wholesale prices.....	- 0.4	-0.5

\*May data last available.

recession would be short and moderate, and that longer-term prospects include a vigorous growth potential. In any event, continued high-level spending and reluctance to trim earlier goals have done much to buoy up business generally.

### Stability not enough

Continuance of the present level of activity for any appreciable length of time, however, would be increasingly unsatisfactory from the standpoint of utilizing the nation's productive resources. Business has invested 40 billion dollars in the replacement, modernization and expansion of facilities during the past year. Since a sizable part of this spending has been for the purpose of increasing the ability to produce, and since total output is well below earlier levels, idle capacity has developed in many lines. Moreover, if the demand for goods and services does not continue to grow, even present levels of business would soon be endangered. Business confidence that expanding markets are in store might well be weakened by failure of a pickup to materialize in the months immediately ahead.

Equally important is the decline in employment which has taken place. Total employment is 1.1 million lower than a year ago, and has shown little tendency to pick up more than

seasonally as yet. Nonfarm wage and salary employment in the nation is 1.9 million—4 per cent—below July 1953, and many individual labor areas have been harder hit. In the Seventh District, for example, employment has declined by more than 5 per cent in 10 of 16 leading centers during the past year, and is 25 per cent or more lower in 2 (see chart).

Underutilization of the available labor force probably would gradually become more widespread should business activity remain at current levels. Accompanying an expanding population, the number of job seekers is expected to grow at an annual rate of around 600,000 in the years immediately ahead. A gradually rising rate of labor productivity, resulting largely from installation of new and better tools and introduction of more efficient processes, will also tend to reduce the number of available jobs relative to the total national output. Moreover, rising levels of output and sales of goods are required to provide job opportunities for those workers shifting from less productive activities—a tendency which has been especially marked in the downward trend of agricultural employment.

## MIDWEST INDUSTRY

### Auto output in seasonal trough

**I**n June automobile dealers delivered an estimated 560,000 new cars to their customers. This total, the highest for any single month since 1950, made a sizable dent in the heavy inventories which had been reported in April and May. A further reduction in the number of cars on hand is anticipated during July and August. With dealers' stocks above their year-ago level, producers are curtailing production schedules to reduce the overhang of 1954 models by the time the '55s are first offered to the public later in the year.

Almost 3 million passenger cars were produced in the first six months of 1954. This

first-half total was exceeded only three times before—in 1950, 1951 and 1953. The drop from last year was 9 per cent. First-half truck output was off about 12 per cent.

The over-all results so far in sales and output have been satisfactory on the basis of expectations at the start of the year. They have been achieved, however, under conditions of strenuous competition which have eroded profits of most manufacturers and dealers. There can be little doubt, moreover, that the highs for the year were established in the second quarter.

### Seasonal pattern to return

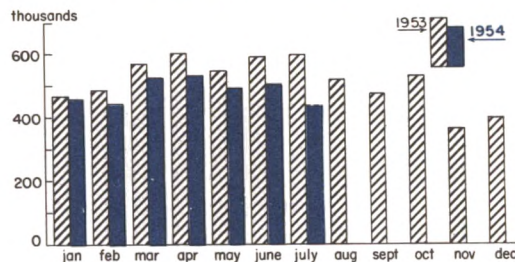
Like most other important Midwest industries, the motor vehicle producers had been singularly free from production snags until the Chrysler walkout in July. Labor peace plus the ready availability of components which had been on allocation in past years allowed producers to gear output schedules to sales programs. As a result, the stage appears set for a true reflection of seasonal demand tendencies.

In prewar years, 55 to 57 per cent of all passenger cars usually were produced in the first half of the year. Prior to 1953, in the postwar period, this pattern had been obscured by a shortage of men and materials and by demand backlogs. Even last year the pattern was distorted by work stoppages and other production difficulties in the first half which hampered certain producers, particularly Ford. As a result, output continued at a high level through October before sharp cutbacks were made in the final months of the year. Nevertheless, tabulations show that 53 per cent of all cars produced last year were made before July 1. If a seasonal pattern similar to prewar emerges in 1954, second-half output would be 15 to 25 per cent less than in the first half. Preliminary reports indicate that July automobile output will total only 450,000, compared with 500,000 in June and 600,000 in July a year ago.

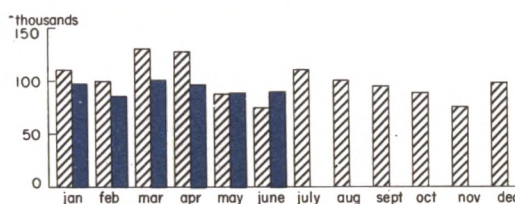
### Exports help truck output

In the first half of 1954 factory sales of trucks to American dealers and the Govern-

## Passenger car production falls as model changeover nears



## Truck output more stable than last year



ment were 22 per cent below last year; a decline which reflects lower demand of business firms and farmers as well as reduced buying by the military. The drop in total truck output was much less than this because of an increase in exports.

For the first five months of this year 78,000 trucks—17 per cent of total output—were sent abroad, compared with 59,000 a year ago. There has been a rise in exports of automobiles over last year also, but this is of minor importance since foreign sales in recent years have amounted to only about 3 per cent of U. S. production.

### Behind the aggregates

Producers of automobiles and parts throughout the nation have been employing about 775,000 workers this spring—200,000 fewer than last year. In the Detroit area alone the drop has been 115,000 or 27 per cent. In addition, average hours of production workers fell from 41.9 in April of 1953 to 40.7 in April of this year. Higher hourly earnings, however, have held the decline in weekly earnings to a much smaller proportion. Auto workers con-

tinue to be well paid relative to those in other industries. They are averaging about \$89 per week compared with about \$70 for all manufacturing workers.

Some of the over-all decline in automobile industry employment is doubtless a result of defense contract completions or cancellations. Representatives from certain cities have appealed to Washington for additional defense work since unemployment in many of them substantially exceeds 6 per cent, a ratio which entitles a locality to special consideration in awards of new contracts. So far, however, little new business has been acquired. The likely decline in output in the second half of 1954 suggests that unemployment will be aggravated further before a betterment occurs.

Not all elements of the automobile industry have fared equally well in the competitive drive for sales. The following table and the accompanying chart portray the shift among producers which became noticeable last year and was intensified this year. In general, the least favorable results have been chalked up by the smaller producers. Per cent changes in passenger car output between the first halves of 1953 and 1954 were:

General Motors .....	- 0.9%
Ford .....	+40.6
Chrysler .....	-45.8
Other producers .....	-64.7
Total .....	- 9.1

Changes in output among producers have affected employment and business conditions in the areas in which the various firms have their principal operations. Thus, South Bend and Kenosha, the homes of Studebaker and Nash respectively, have suffered severe unemployment. In Detroit the favorable showing of Ford and certain GM installations has not been sufficient to outweigh the declines at Chrysler, Packard and Hudson. The General Motors cities such as Lansing (Oldsmobile) and Pontiac (Pontiac) have maintained employment fairly well. Flint (Chevrolet and Buick) has enjoyed a substantial rise in employment since last year.

One of the reasons frequently cited as encouraging the merger trend is the need to strengthen dealer organizations. Producers are almost completely dependent upon these thousands of independent businessmen to merchandise their products. Dealers must have, in addition to skill and customer goodwill, financial capacity and credit resources adequate to carry sufficient stocks of new and used cars.

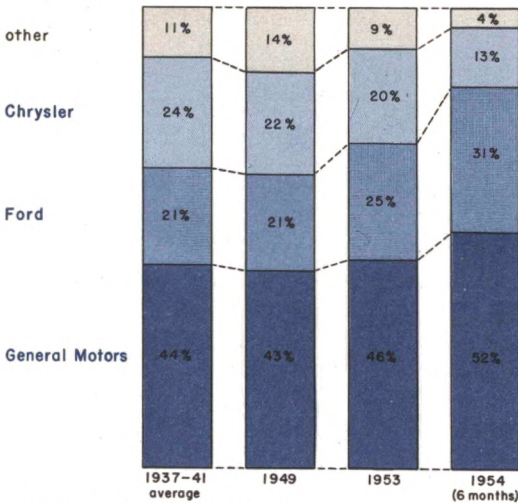
### Some dealers in difficulty

The National Automobile Dealers Association (NADA) has complained that it has lost over 800 of its 30,000 members in the past year. Dun and Bradstreet reports that failures of retailers in the automotive group through May were up 32 per cent over last year and double the number for the 1952 period. Moreover, NADA states that over-all dealer profit margins so far this year have been 0.8 per cent of sales as compared with 2.2 last year. Obviously, many dealers, particularly those handling less popular makes, have lost money even during the peak selling period just past.

Many dealers have received new cars faster than they believed that these vehicles could be sold without undue sacrifice of profit margins. This condition has led to "bootlegging" of the new cars; that is, resale at little or no premium over cost to a wholesaler or used car dealer who removes them from the local market. Usually this process has moved cars from rural or semirural areas to larger centers. As a result, new cars of various makes have been offered for sale by dealers who are not authorized representatives of the manufacturers. This practice, of course, increases competitive problems of the franchised dealers in some areas.

Dealers who believe they have been injured by these developments have responded by complaints to manufacturers, threats of anti-trust actions and attempts to create "codes of ethics" which would proscribe such practices. Manufacturers have attempted to keep down the secondary market in new cars by threatening offending dealers with the loss of their franchises. This threat does not, however, carry the weight it did a few years ago when dealer

## Growing share of car market won by large producers



SOURCE: Ward's Automotive Reports

profits were at high levels. Some of these dealerships, moreover, have changed hands since the lush years and present owners do not have a reservoir of past earnings to sustain them.

### The urge to merge

Automobile manufacturing has long been considered an example of an industry characterized by "economies of scale." That is, low cost operation depends on the ability to take full benefits from mass production; to buy in huge quantities; and to spread overhead and developmental expense over many units.

Under these conditions a small operator has difficulty competing with a large concern on a price basis. As a result, the "independents" in the automotive industry have turned to mergers in an attempt to improve their sales and earnings prospects. Proponents of the mergers have hoped to cut costs principally by fuller utilization of productive facilities and by reducing administrative expenses.

If the Studebaker-Packard combination is approved by stockholders all of the independents will have been involved in mergers. Kaiser and Willys have joined to form Kaiser Motors, and Nash and Hudson are now merged as American Motors. Additional combinations

are rumored, either through further pairing up or assimilation of components producers.

Many manufacturers of parts and accessories also have suffered substantial reductions in volume and profits this year. In part, this is because the finished car producers are fabricating more components themselves. This has come about as a result of acquisitions of new affiliates or through an attempt to employ capacity which otherwise would be idle. Nevertheless, car producers will continue to be dependent upon a multitude of suppliers of machinery, dies, castings and other items. General Motors' officials have stated that their organization buys from no fewer than 12,500 independent firms.

### Toward 1955

Model changeovers in most cases probably will occur sometime this fall, somewhat earlier than in recent years. At that time the length of plant shutdowns will be largely dependent upon the supply of unsold 1954 models on hand. At the end of June dealer holdings were still fairly large, but amounted to only about four or five weeks' production. The average shutdown is unlikely to exceed that time span.

As usual, prospective car buyers will be interested in the appearance and mechanical features of new models, but they will show perhaps more than usual interest in the price tag. No price changes of significance have been announced so far in 1954, but the introduction of new models will provide the occasion for a critical review of price policy and its role in the competitive race.

New car buyers enjoy lower prices now than two or three years ago. The cuts, however, have come out of the dealers gross margin, not from lower factory list prices. The NADA dealer profit figures suggest that reductions from this source are about at an end. Because of the drastic reduction in used car prices in late 1953, most new car buyers probably were little better off this spring than a year ago. The net cost of a new car to most buyers is determined largely by the value of the car offered as a trade-in.

Looking ahead to 1955 industry officials hope to see more cars produced and sold than in 1954. If this proves to be the case, increased replacement demand will be primarily responsible. Cars sold in 1950, by far the biggest year in history, will then be five years old. By that time also scrappage may be eating into early postwar models for which market values will be approaching the vanishing point.

## HOUSING

### Construction sets fast pace; home building responds to easy credit

Construction activity, contrary to most earlier expectations, continues to set new records. As one of the few major types of business activity to exceed year-ago levels, total construction outlays in the first half were 2 per cent higher than in the same months of 1953. Paced by commercial building, private non-residential construction scored the largest gain—10 per cent. Residential building also was in moderately larger volume than last year, however, and public construction equaled that of early 1953 despite a sharp drop in outlays for public housing and military installations.

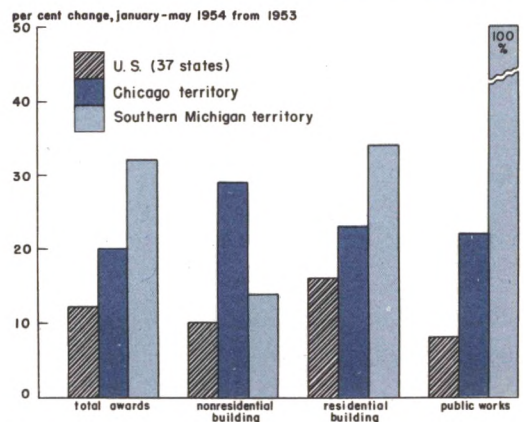
New contract awards, moreover, have continued strong throughout the spring, not only have the gains over 1953 been large, but they have widened as the year progressed. Thirteen per cent ahead of 1953 in the first quarter, the dollar volume of contract awards surpassed last year by 20 per cent in the March-June period. The number of new housing starts also has slightly exceeded last year's 1.1 million rate. Consequently, a high volume of construction expenditure seems assured in the months immediately ahead as work already started moves toward completion. Government estimates of outlays for the year as a whole were even upped recently to exceed 1953's 35 billion dollar record by a small margin.

### Commercial building booming

By far the most striking advance in construction activity this year has taken place in commercial building. Nationally, such outlays during the first half totaled nearly 1 billion dollars—35 per cent more than in the same 1953 period. In the Midwest, commercial projects have shown an even larger year-to-year gain. Contract awards in the Chicago and Southern Michigan territories (roughly the Seventh District) from January through May ran 75 per cent ahead of last year. Although all types of commercial building have been stronger than a year ago, awards for the modernization and construction of stores and restaurants scored the sharpest increase—amounting to nearly two and one-half times the early 1953 volume in this area. Awards for office buildings were one-fifth larger.

In large part, the boom in commercial construction reflects the need for new shopping facilities in rapidly growing suburban and outlying areas. New shopping center projects are now underway in most District metropolitan centers. Increasingly vigorous competition at the retail level also has encouraged modernization and improvement schemes for existing

### All types of contract awards well above last year in dollar volume



SOURCE: F. W. Dodge Corporation



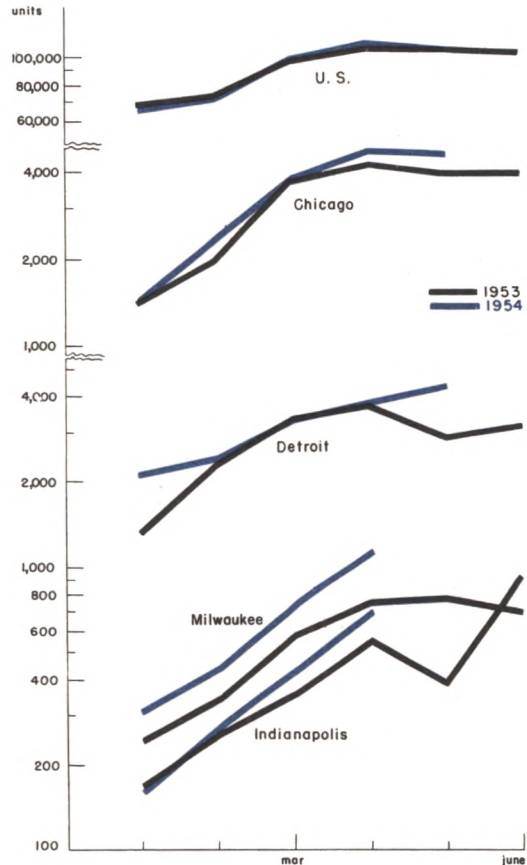
buildings. In addition, construction curbs placed upon commercial projects during the Korean war and accompanying defense build-up in 1951 and 1952 probably delayed until recently many building programs then under consideration.

Industrial building, on the other hand, was in many cases encouraged during this earlier period, and in recent months has fallen well below last year's record volume. Nationally, outlays so far this year are down about one-eighth and new contract awards are off one-fourth. Awards in this area have declined less sharply due mainly to larger auto plant expenditures in Michigan. Completions of industrial projects for which accelerated amortization certificates were issued, as well as generally lower rates of output, appear responsible for the reduced level of industrial building. Since ample plant capacity to meet current and immediately prospective demands now exists in most lines of activity, there is little reason to expect any pickup in such building in the near future.

Construction of most kinds of public facilities has increased substantially this year. Outlays during the first half were 14 per cent higher than in 1953 for educational buildings, 20 per cent larger for highways and 15 per cent greater for sewer and water installations. New awards for such purposes also have continued to run well ahead of last year's volume. In the Seventh District, contract awards for school buildings are up 50 per cent, although the volume of hospital, religious and other private institutional projects is a little lower than last year. Awards for public projects such as highways, bridges, and water and sewer facilities are also half again as large as last year, due in part to the letting of contracts for the Mackinac bridge last spring.

Construction of public facilities generally has not kept pace with home building, population growth and the postwar improvement in the standard of living. Thus a tremendous backlog of need for such facilities exists (see pages 11-12). Moreover, funds are readily obtainable in the capital markets for most public

## Private housing starts above 1953 in major District centers



projects, and borrowing costs are well below those of a year ago. Consequently, public construction is likely to equal or exceed present levels for some time to come.

### Home building strong in Midwest

Private housing starts have continued considerably stronger through the spring than had been generally anticipated. For the first six months, such starts numbered 564,000 nationally, about 2 per cent more than in the same months of 1953. The dollar volume of work completed was slightly higher than a year ago. But in most major District centers,

home-building activity has been substantially above last year's level. From January through May, year-to-year gains in the number of private building permits issued amounted to 21 per cent in the Chicago area and 17 per cent in the Detroit area. In the first four months, such permit issuances were up 37 per cent in Milwaukee and 12 per cent in the Indianapolis area.

This upsurge in home building has occurred in the face of generally lower levels of employment and factory earnings in most District centers. Although the present and prospective job situation clearly is an important factor in the demand for housing, it is not the only one. The quantity and quality of housing already available in a community, and the availability and terms of mortgage credit may in some cases be more important considerations.

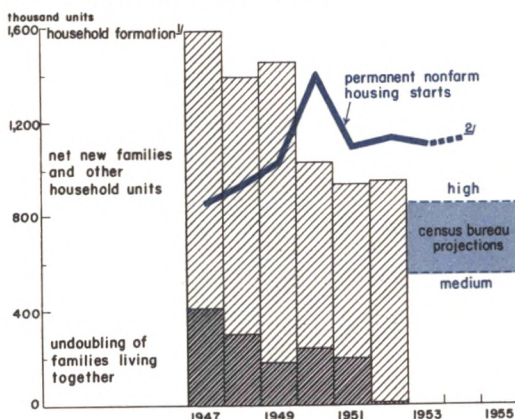
In some places, such as Detroit, Racine and Rockford, building permits have equaled or exceeded early 1953 despite substantial employment declines. On the other hand, housing activity has been moderately lower in a few centers such as Des Moines and Lansing, even though employment has been well maintained. The sharp curtailment in jobs in South Bend and Kenosha, however, has been reflected in substantially lower levels of building.

Home-building activity has received considerable impetus from the much easier mortgage market which has developed since last fall. Financial institutions have ample supplies of investible funds as a result of monetary actions providing additional bank reserves, repayments on outstanding loans and a record inflow of savings so far this year. At the same time, the volume of funds going into some other investment outlets—business loans, consumer credit, corporate security issues—has slackened, with the result that interest rates generally have dropped well below a year ago. Consequently, lenders have turned increasingly to mortgages as an outlet for funds.

### More veterans' loans

Under these circumstances, VA guaranteed home mortgage loans have again gained favor

## New housing starts top net household formations



<sup>1</sup> Changes are for april to april of following year

<sup>2</sup> Annual rate in first five months

with lenders, especially in view of the higher interest rate established for such loans in May 1953. In the first six months, the number of private housing starts carrying VA loan financing was more than two-thirds larger than in the same period of 1953, while housing starts subject to FHA and conventional mortgage loans declined in importance. Moreover, competition for VA mortgages has brought a substantial relaxation in terms, with such loans commonly available on a 30 year maturity and involving down payments of 5 to 10 per cent and, in some areas, no down payment at all except closing costs. Terms on conventional mortgages also appear to have eased, but to a lesser extent, and interest rates commonly have slipped  $\frac{1}{4}$  to  $\frac{1}{2}$  of 1 per cent as compared with last year.

The Housing Act of 1954, now up for final vote in Congress, would relax terms on FHA insured home mortgages in several respects. First, maturities on new houses would be extended to 30 years, as compared with 25 years currently on houses valued above \$7,000. Second, down payment requirements would be lowered appreciably on new houses priced above \$11,000. Typical minimum down payments would be 10 per cent on a \$12,000

house, 13 per cent on a \$15,000 house, and 15 per cent on a \$18,000 house, as compared with 20 per cent currently. Third, the maximum loan limit for FHA single-family mortgages would be increased from \$16,000 to \$20,000. Finally, down payments would be lowered and mortgage maturities generally lengthened for loans on existing homes.

### Saturation of markets?

A longer-run problem which appears to have been developing over the past several years is the possibility that the demand for further additions to the housing stock will be curtailed in many communities. Since early 1950, permanent housing starts have exceeded net annual additions to the number of households in the nation by a substantial margin (see chart). Household formations have dropped from a postwar high of 1.6 million in the year ended April 1948 to 950 thousand in the year ended April 1953. Moreover, such additions to the number of households are expected to drop at least moderately lower for some years to come. Partly accounting for the current and prospective decline is a reduction in marriages reflecting lower birth rates during the 1930's. In addition, undoubling of married couples living with other families has about been exhausted as a source of new demand for housing accommodations.

The margin between housing starts and household formations has averaged around 125,000 in recent years. It is clear that this gap has been substantially larger than destruction and demolition of existing structures, and that vacancies have been increasing gradually in consequence. Unless surplus dwellings can be disposed of, larger vacancies eventually will bring cuts in apartment rentals and prices of existing houses, thus tending to detract from new housing demand.

On the other hand, the widespread desire of families to better their housing standards is apparent. Mortgages are available on easy down payment and monthly payment terms, and so long as borrowers and lenders feel that job and income prospects warrant taking on

such debts, home ownership can continue to expand. In this event, the market for new housing might continue relatively strong even though substantial vacancy ratios develop in rental housing.

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## PUBLIC FINANCE

### State and local government expenditure

Expenditure by the states and their local political subdivisions continues as one of the few components of total spending on goods and services to show sustained growth. The state and local units, unlike their big brother in Washington, are reputed to follow fiscal "rules of the game" familiar to individuals and businesses, trimming their outlay when business slackens. The recent recession, however, has had no observable effect on their outgo. The expectation that this will continue to be true is widely expressed.

Explaining this rise are several factors, some by now familiar. One of these is the presence of a backlog of capital needs, estimated to total as much as 100 billion dollars. Largely the legacy of two decades of neglect of physical plant, of enforced inability to replace, to enlarge and to relocate investment in the facilities furnished by the state and local governments, this deficiency has sparked a rapid growth in public construction activity since the relaxation of war and postwar shortages and controls. From a level of a billion a year back in 1946, construction spending (financed by state and local funds only) had risen to the 6½ billion mark by the first quarter of this year. The pace of new construction has been rapid, but it is hard to determine how much, if any, real headway has been made in working off the arrearage, simply because of the parallel emergence of new demands.

Another factor behind the growth in state-

local spending has been the effort to bring current services abreast of present-day standards of living—to provide the services purchased through public expenditure that go with services and products purchased privately in a community experiencing steady growth in per capita income. Much of the impetus behind toll road building, for example, has arisen from the desire to provide the kind of highway that will unleash the potential of the modern automobile.

Technological evolution has an impact in other ways, also. A generation ago it was not uncommon for municipalities to dump their raw sewage into nearby streams. The alternatives, if known, were too costly to be practical. The modern community, however, will treat its sewage by radically new processes that permit the recovery of valuable by-products and that render effluent harmless and inoffensive. The innovation is adopted both because the new techniques now have been perfected and because today's taxpayers would regard the older practice as inconsistent with present standards of public health and community welfare.

Public services and facilities consistent with a private mode of living long since left behind cannot survive indefinitely. The one-third rise

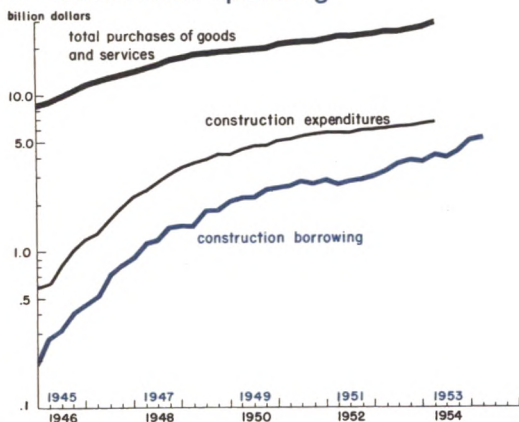
in real income per head that has taken place since 1940 inevitably has provoked dissatisfaction with governmental standards and techniques suited to prewar days. Today's community is better off by far than it was a generation ago; accordingly, it will expect more and better public services just as it expects more and better services of a privately-supplied nature.

Finally, the fact that the means have been at hand for the financing of a swelling volume of state-local investment is to be reckoned among the causal factors. Balances accumulated during the war have been important, until recently at least. Meanwhile the credit markets have supplied state and local units with an unprecedented flood of borrowed funds.

The sharp upswing registered recently in state and local borrowing for capital purposes suggests that construction spending during the coming year will rise. On the accompanying chart the lag between borrowing and the expenditure of borrowed funds for construction purposes is brought out by the use of separate scales; borrowings in 1952, for example, are plotted with expenditures in 1953. The rise in state-local borrowings during the last several quarters has been sharp. If past relationships continue to hold, this could be taken to presage a similar growth in construction activity.

But there is reason to believe that the period by which borrowing leads actual spending may be lengthening out. Increasing emphasis has been placed upon very large construction undertakings—such as expressways, toll roads, bridges, and the like—in recent state-local capital investment programming. Such projects necessarily get under way more slowly and take longer to complete than the smaller-scale jobs such as schools and water supply and sewage disposal systems. Today's borrowing, therefore, may actually spread a stream of construction spending over a two- or three-year future period. In any case, the record volume of borrowings during the past few quarters undoubtedly has provided the basis for high-level state and local construction activity in the rest of 1954 and early 1955, and, probably, some time beyond.

### State-local capital borrowing outpaces expansion in construction spending



## **A busy tax year—rates cut, tax laws revamped**

**I**t may seem strange, but controversy is usually more bitter when Congress has a chance to cut taxes than when it is faced with the unpleasant necessity of boosting them. The reason is that tax increases are enacted only when their urgency is clear to everyone, as in wartime or in other national emergencies. In such circumstances, most people accept, no doubt gloomily, the need for higher taxes without doing too much jockeying for personal advantage. However, when tax reductions are in the works, there is no sense of urgency to prevent taxpayers of all sizes and shapes from doing their utmost to impress the Congressional committees which write the tax bills with the unfairness of their own particular tax burdens.

And so it has been in recent months, as Congress has written, debated and passed two tax bills, one to lower excise taxes and the other to grant selective tax relief in the course of overhauling the entire Federal tax structure. A complicating fact has been that the tax bills have been enacted in the shadow of fears that the dip in economic activity will persist or even worsen. These fears have stirred up demands for more tax reduction than the Treasury thinks wise and have stimulated arguments over which forms of tax relief are most conducive to improvement in business conditions. Complicating things even more has been the fact that this discussion and controversy has occurred in an election year.

### **The excise bill**

Although the tax reform legislation had the benefit of months of spadework by Treasury and Congressional experts last year and of Administration endorsement, the bill reducing excises was on the President's desk before the reform bill had progressed even halfway through Congress. This was because excise

taxes were reduced by amending another tax bill, one which had to be rushed through before April 1.

The 1951 Revenue Act, passed when the Korean war was still raging and our defense build-up was in its early phases, raised the rates of the excises and personal and corporate income taxes. These increases, however, were to expire this year—the personal tax increases on January 1 and the others on April 1. The former did in fact expire, but extension of the higher rates of the corporate tax and the excises for at least another year was a high-priority element of the President's program.

By the time the Administration's excise tax extension bill reached the House, large majorities of both parties had endorsed some variant of an earlier proposal to limit to 10 per cent all excise rates excepting those on alcohol and tobacco. Accordingly, this limit was adopted. The only arguments in the House, and in the Senate a little later, were over amendments cutting certain excises somewhat more, particularly those on admissions, automobiles and home appliances. The final bill, as signed by the President, maintained for another year the high 1951 rates on liquor, tobacco, automobiles, gasoline and a few other things, while cutting to 10 per cent the previous 20 per cent rate on furs, jewelry, luggage, cosmetics, cameras and films, light bulbs and admissions, and the 15 per cent rate on passenger fares, local phone service, telegrams and sporting goods. It also halved the 10 per cent rate on most home appliances and exempted from the admissions tax tickets costing 50 cents or less. Most of the over 10 per cent rates dated far back, to 1943 and 1944, at which time they were imposed in some cases mainly to restrict consumption of the taxed items.

The excise extensions figure to save the Treasury 1.1 billion dollars in a full year, while the cuts will cost 999 million, so the Treasury is just a little bit ahead.

### **The reform bill**

Actually, tax reform is a continuous process, for even when the primary intention of Con-

gress and the Administration is to make major changes in revenue yields, structural reforms creep into the body of a general revenue bill. This year, however, there was to be no general revenue bill: the announced intent of the Administration and the tax-writing committees of Congress was to revise and reform the tax system, not to make big rate changes. When the bill reached the debating stage, the fight over increasing personal income tax exemptions from the existing 600 dollar level obscured the reform aspects of the legislation, at least in the press. And rightly so, for there was a matter of anywhere from 2.4 to 8 billion dollars involved, affecting millions of personal income taxpayers. The actual proposal debated in both Senate and House was one to increase the exemption to 700 dollars, with certain restrictions to minimize the value of this to higher bracket taxpayers. This would have cost the Treasury about 2.4 billion dollars. It was narrowly defeated in both Houses, and a number of variants of this general tax reduction device were similarly rejected. As it stands, the new law offers no over-all tax reduction.

There are few things in the tax revision bill proper to make it as big a change for the better as its more vocal sponsors claimed, nor as big a change for the worse as its more vocal opponents feared. Most of the 800-odd pages of the new law just restate existing law; this is because the bill was first and foremost a general technical overhaul of the Internal Revenue Code. Rewriting of complex laws—and the complexity of the Internal Revenue Code is legendary—is needed periodically and the tax laws had not gone through this for some time. Congress constantly changes the laws to keep up with revenue needs, with court interpretations of the laws and with changing ideas about tax policy. As the laws are changed, the Code becomes even more complicated. Moreover, revenue acts often are passed so hastily that their language leads to unforeseen and unwanted results when the laws are applied.

Besides rewriting the Code, the purposes of the bill were to correct certain marked inequities in the taxation of personal income and

to create what was held to be a sorely-needed more favorable climate for business growth and expansion. Despite the fact that popular ideas differ about which changes will best correct inequities and stimulate business, the only change to get much attention from any except the experts and those directly affected, concerned the provision for partial tax relief for dividend income, and even this argument was tame compared to some past tax debates.

### **The dividend credit**

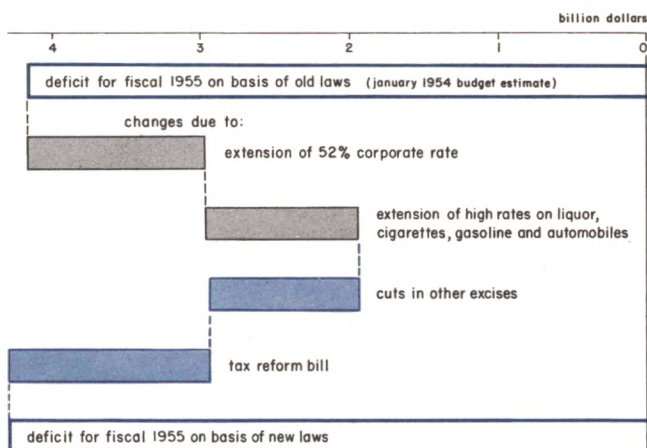
The corporation income tax has a somewhat strange position in our tax system. It was originally conceived as a distinct levy on corporate profits rather than, as is the case in some other countries, a way to obtain revenue from intermediaries from whom taxes can easily be collected. But corporations as such ordinarily do not bear the tax in the last analysis. It may be passed on to consumers in the form of higher prices, it may reduce dividends paid to stockholders, it may reduce stock prices by reducing corporations' retained earnings and hence their assets, or it may have any combination of these effects. Because of uncertainty over who bears the burden of the tax and because it is so hard legally to distinguish costs from profits (which are supposed to be the proper basis of the tax), no one is really happy with the corporation income tax. Revenue requirements being what they are, we are probably stuck with it, however, and with a source of perpetual controversy.

A major complaint has been that, to the extent the tax is ultimately borne by dividend recipients who pay personal income taxes on the dividends, they are being unfairly subjected to double taxation. Although we tax many things twice or even three or more times, this instance of double taxation is said to be particularly bad because it diminishes funds otherwise available for investment in business and thus limits business growth. And so the bill relieves dividends of part of their personal tax load.

The House version would permit dividend recipients to deduct a specified percentage of

## The Treasury will be

about as well off after this year's tax legislation as it would have been without it. The excise bill, which extended some taxes and cut others, will cost about 100 million dollars. The reform bill extends the 52 per cent corporate rate for one year more; the revenue from this will not quite offset the costs of the various reliefs it grants.



dividends from their personal tax bills and dividends in small amounts in any one year would have no personal income tax at all. Senate action restricted the provision to the exemption from tax of dividends amounting to less than 50 dollars per year. As this issue of *Business Conditions* goes to press, the difference between the two methods of treating dividend income remains unresolved. The House-Senate conference committee has accepted the principle of the House version, but action on the conference report still is ahead. Whichever of the two plans is finally adopted, it is a foregone conclusion that some measure of dividend relief will be provided.

There have been objections to this change on the grounds that the corporation income tax is largely paid by consumers through higher prices so there is really no double taxation at all, and that in any case this particular device is not a very effective or desirable way to encourage new and growing businesses. The Committee for Economic Development, for example, in a statement early in the year, held that the corporation income tax itself is so unfortunate that reductions in the corporate tax rate (a bad tax is always a lot more obnoxious at high rates than at low ones) ought to have priority over relief for dividend income, and thus the 5 per cent rate reduction scheduled for April 1 should be allowed to

take place. Actually, the objection with the most popular appeal was an emotional one—that this change confers tax relief on the well-to-do and that, within the limited scope for tax reduction, lower income groups ought to benefit first.

### Depreciation allowances

Another major complaint against the corporate income tax has been that under the old laws deductions permitted for the cost of long-lived items like plant and machinery have been so restrictive that corporations have been paying taxes on costs, not profits, and are discouraged from investing enough in new capital assets to keep industry flexible and dynamic and to keep the makers of producers' goods fully employed. The Treasury has maintained elaborate tables which estimate the useful lives of all kinds of plant and equipment and has not permitted taxpayers to deduct more during each year of the estimated life of a capital asset than a fixed percentage share of the asset's cost.

The new provisions give businesses more leeway to deduct a large part of the costs of investment goods in the early years of their lives and place the burden of proof of the reasonableness of a particular deduction on the Treasury rather than on the taxpayer. Moreover, businesses are to have a choice whether to capitalize or to write off as current expenses

their outlays for research and development, a choice up to now a Treasury prerogative. As long as tax rates remain stable, the Treasury's revenues will not suffer over the long run, since once a taxpayer has deducted the whole cost of a capital asset, whether it takes five or fifteen years to do so, he has exhausted his deduction. But it's a good deal for growing businesses, which will have large depreciation deductions as long as they continue to increase investment.

### Personal deductions

The personal income tax, like the corporate, reaches net rather than gross income and so taxpayers have available a variety of deductions. Some are allowed for certain expenses which obviously reduce ability to pay income taxes, like large medical bills. Others take account of expenses necessary to earn one's living, like union dues or the cost of small tools. The deduction for charitable and educational contributions is to encourage that kind of spending, and the deduction for taxes paid to state and local governments helps protect their tax bases in the face of high Federal tax rates.

The trouble with deductions is that there always are people who can demonstrate that their particular circumstances call for more generous treatment than they are getting. The tax reform legislation this year covered a number of points on which there was pretty general agreement that the old treatment was inadequate. In recognition of the greater costs and complexity of medical care, the ceiling on the medical expense deduction was doubled to \$2,500 per person and \$10,000 per family. Also, taxpayers may now deduct medical costs when they exceed 3 per cent of income, instead of having to wait until they reach the 5 per cent mark. Working mothers are now permitted to deduct their actual expenses for the care of their small children while they are working. Another big change is to allow children as dependents (for the purpose of the personal exemption) regardless of their incomes as long as the parent provides over half their support. Previously, if children earned over 600 dollars

per year as many did in part-time and summer jobs, their parents could not claim them as dependents no matter how much financial help the parents provided.

### Tax reform ideas

Most tax reformers subscribe to the same general goals: the tax system should treat individuals in similar circumstances alike, it should be neutral among competing firms and industries and it should not dampen incentives and ability to take risks, invest and work hard. The trouble is that when these general objectives are translated into specific tax laws, they are not always consistent, especially when revenue needs are such that tax rates must be high. In the past, Congress has chosen to offer certain taxpayers ways to avoid high taxes, sometimes to encourage a particular type of economic activity, sometimes on the ground that because of special circumstances equity requires special treatment. These "loopholes" in turn offend other "canons" of taxation.

So it is with this year's reform bill: it attempts to correct deficiencies in earlier laws and in doing so no doubt creates new defects. It opens new loopholes, closes some old ones, leaves others unchanged. It rewrites the Internal Revenue Code to simplify its language and correct technical errors, but in years to come the errors and complexity introduced this year will employ lots of legal talent. In short, the new bill neither revolutionizes the tax system nor ends debate on it. It's safe to say the tax reformer will be active in the 84th Congress, too.

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