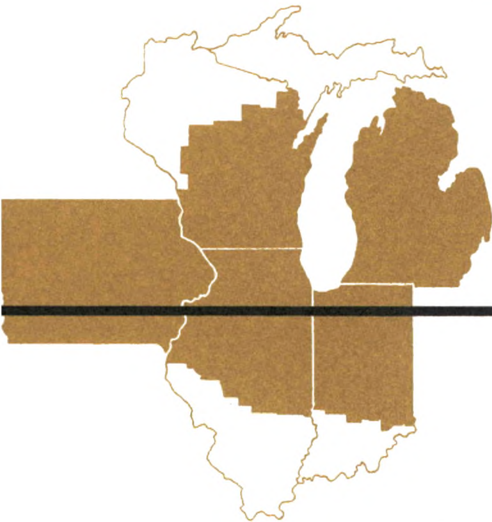
A review by the **Federal Reserve Bank of Chicago**

Business Conditions



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Economic and credit conditions

In place of the regular features, "The trend of business" and "Trends in banking and finance," we present in this issue of Business Conditions *a statement by William McChesney Martin, Jr., Chairman, Board of Governors of the Federal Reserve System, before the Joint Economic Committee of Congress, August 16, 1962.*

Much in the recent flow of statistical information has indicated a definite loss of momentum in the pace of economic expansion. This was particularly true of the June reports. In that month, there were declines in durable goods orders, average hours of work at factories, retail sales and housing starts and only small gains in industrial production, employment and personal income. Altogether, the impression of slowdown seemed well confirmed.

There has been a popular tendency to view the various signs of slowdown as foreshadowing an imminent upper turning point in the economic cycle. Judged from the perspective of cyclical indicators, which in the past have shown a tendency to run ahead of the over-all data, this view has perhaps been reasonable.

I sometimes wonder though if we have not become overly sensitive to cyclical indicators—we read, watch, study and talk about them so much that we may have become like medical students who "acquire" each disease as they read about its symptoms in their textbooks. We ought to remember that, while leading indicators have correctly foretold some recessions, they have also on occasions given portents of recession that did not occur.

In June, our economic data were subject to certain special influences and, if allowance is made for these, the situation does not appear so persuasively discouraging as appeared at first sight. Thus, using up the inventory accumulated in anticipation of a steel strike that did not occur affected not only new orders for steel but also employment and hours of work in the steel industry and unemployment claims in steel centers.

The steel industry is so large that declines in that one industry can at times result in declines in over-all manufacturing orders, employment, hours of work and many other measures of economic activity. Observers who simply count the pluses and minuses among the cyclical indicators run the risk of being overly influenced by the reflections of a decline in one industry, not of cyclical origin, showing up several times in their lists of unfavorable omens. In addition to the steel situation, though of less importance, a strike at some auto plants affected production and sales in June. The adverse effect of this on the June data should not be interpreted as being of cyclical significance.

Nevertheless, the June showing as a whole was not strong. And it certainly made clear that the economy was moving ahead more slowly than the optimistic goals widely discussed at the turn of the year.

Improvement in July

From data now available for July, the economic situation appears improved. The unemployment rate was down slightly, nonagri-

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cultural employment rose somewhat further and labor market data were definitely encouraging in another respect: they showed a fairly large decline in the number of long-time unemployed.

Among other information on July, retail sales rose briskly, with new domestic auto sales and department store sales both making a strong showing. Private construction activity, seasonally adjusted, held its advanced level. The Board's index of industrial production . . . gained almost a full point, advancing to a new record high approximately one-fifth above the 1957 level.

Preliminary indications from production schedules and weekly sales reports suggest that the general improvement of the economy carried forward in early August.

The information on consumers' purchase plans obtained in July by the survey conducted for the Board each quarter by the Census Bureau gave two important indications. First, consumer buying plans had not been adversely affected over-all by the recent stock market decline and the mixed economic tendencies shown for June. Second, . . . the data show some strengthening of consumer purchase plans since early this year, especially for household durable goods.

Consumers are in a good financial position. Their incomes rose further in July to a new record high, and so did their savings. The payments on debt that consumers are obligated to make each month have risen less rapidly than their incomes. Furthermore, defaults on instalment credit have declined sharply over the past 18 months to levels at or close to the lows for recent years.

Business concerns' retained earnings and depreciation allowances in recent months have also been large, in many instances considerably in excess of current needs for replacement and expansion. This form of saving has been used in providing an additional flow of funds into credit markets and into extensions of trade credit as well. Meanwhile, business demand for bank loans has been less vigorous than in this stage of previous upswings. Banks, therefore, have sought other outlets for their funds and have increased other loans and investments, especially their holdings of state and local securities and real estate loans. Demand deposits have changed little so far this year, while time and savings deposits grew very rapidly in the first quarter and then continued to expand substantially but at a lesser rate.

Interest rates

Over the first half of the year, short-term interest rates fluctuated within a narrow range around a 2¾ per cent level. Since late June, the level has been a little higher, with the range on three-month Treasury bills running between 2.80 and 3 per cent. Yields on longer term U. S. Government, state and local government, and corporate issues meanwhile declined through midspring and subsequently moved moderately upward, but they remain below the earlier highs for the year. Throughout the year, mortgage yields have moved downward.

The decline that has taken place in long-term interest rates has reflected in large part the increased availability of funds in long-term sectors of the market, as the rapid increase in time and savings deposits at commercial banks was accompanied by continued large inflows of funds to mutual savings banks and savings and loan associations. Demand for long-term funds in recent months has been generally moderate.

Balance of international payments

My comments would be incomplete if I neglected to mention the persistent problem

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of restoring balance in our international accounts. The problem of domestic expansion is interrelated with our international problems and all of them must be thought about at the same time.

The United States has been making progress in reducing its over-all deficit in international transactions. The deficit came down from nearly 4 billion dollars in 1960 to about 2½ billion last year, and to an annual rate of just under 1½ billion dollars in the first half of 1962. Even so, we have no grounds for complacency. We must move further towards international balance next year, and we must also achieve and maintain equilibrium in the accounts in future years.

United States foreign trade has developed in an encouraging way this year. Total exports have been rising, with exports to Western European countries especially strong. While imports also have risen, they have not spurted ahead as they did in the preceding period of cyclical expansion and so have remained lower in relation to the gross national product. Both our export and our import performances would indicate that we have been competing effectively in international trade, and international price trends support this interpretation. The level of wholesale prices has been stable in this country for some time, while prices in industrial countries abroad have risen.

The merchandise trade surplus, at an annual rate of 5 billion dollars in the first half of 1962, is large but not large enough to match our large net payments for aid, for military expenditures and for net private United States lending and investment abroad. And it would probably be unrealistic to expect the whole of the remaining adjustment to come through yet further expansion of the trade surplus. That is why the Government has been working, both from the procurement side and through negotiations with our allies abroad, to reduce the balance-of-payments burden of our foreign aid and military programs. That is why we have had to pay close attention to the possible effects that monetary and credit policies may have on international movements of capital.

Problem for monetary policy?

Taken together, domestic economic and balance-of-payments developments have posed a problem for monetary policy, but in my judgment that problem has not yet constituted as clear cut a dilemma as some observers suggest. While it has been necessary to formulate policy in the light both of the credit needs of the domestic economy and the potential effects on international capital movements, up to the present time it has not been a matter of choosing between domestic and international goals.

With the rare exception of an internal liquidity crisis, such as that experienced in the early 1930's, it is never helpful to sound recovery or economic expansion to flood credit markets with redundant funds. When resources are not fully employed, credit should be readily available to meet the legitimate needs of commerce, industry and agriculture —as it is now—but no constructive purpose is served by expanding the credit stream to the point where it overflows its banks. So far, we have been able to pursue policies which have not interfered with the ready availability of credit in the domestic markets at rates generally about even with those prevailing in early 1961, and in some critical areas substantially lower.

Fortunately, we have been free from inflation and the expectation of imminent inflation. This has made possible a more liberal policy with respect to reserve availability, a greater growth in bank credit and less upward

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movement of interest rates than in any other recovery and expansion in recent history. In the last 12 months alone, we have added almost a billion dollars to bank reserves, bank credit has expanded by 17 billion dollars and high-grade long-term corporate bonds and state and municipal securities are about ¼ of 1 percentage point below their year-ago levels.

At the same time, we have generally maintained short-term rate relationships with other major financial markets such as to avoid encouraging outflows of short-term funds. The fact that we have done and are continuing to do this, as we strive to improve our basic balance-of-payments situation, is bound to strengthen confidence in the dollar at home and abroad. In my judgment, this enhanced confidence is essential if we are to solve our balance-of-payments problem and promote domestic prosperity.

Financing Budget deficits

This leads me to the matter of deficit financing. It now seems most likely that we shall experience some deficit in our Budget for fiscal 1963. That deficit would, of course, be increased if taxes are reduced during the current fiscal year.

I have stated quite explicitly my belief that such deficits as we may experience, whether they are due to a shortfall of receipts under the existing tax structure, an increase in expenditures or a reduction in tax rates, should be met by borrowing from the real savings of businesses and individuals, not through the creation of money through the banking system.

This does not mean that we will experience less easy conditions in credit markets. What happens will depend on many things—most importantly on the rate of activity in the economy: credit conditions may be tighter, or easier, or the same.

It is also helpful to recognize that in the American banking system there is an important distinction between total bank credit *expansion* and that portion of it which can be traced to the *creation* of money and credit. The loans and investments of commercial banks in the United States can grow in two ways: one, through people placing more savings in banks in the form of time and savings deposits; or two, through the creation of demand deposits. Hence, bank credit can expand substantially without any significant money creation, as it has done in some periods. Alternatively, growth in bank assets can be—as at times it has been—associated almost entirely with money creation.

Analysis of these processes would be simpler if we had an institutional structure in this country in which the money creation function was entirely separate from what is called the savings intermediary function—the collection of small savings and their investment for the benefit of depositors, of shareholders and of policyholders—but that is not the case. To the extent that individuals place their savings with banks and that banks, in turn, invest these savings in Government securities, the deficit which led to the issuance of the securities is being financed by real savings just as surely as if the individuals had purchased savings bonds in the first instance.

Moreover, a certain amount of money creation to meet the legitimate needs of a growing economy is a necessary and normal function of the banking system, and it is expected reserves will be provided for expansion to meet such needs. Some part of the normal growth in banks' assets which accompanies this money supply expansion must, as a simple matter of banking prudence, take the form of additions to the secondary reserves of the banking system, which consist largely of Government securities. Additions to banks' holdings of Government securities due to additional flows

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of savings through this particular intermediary or to normal growth in the money supply do not represent the financing of Government deficits with bank-created or "printing press" money. Such additions are not inflationary and do not pose any threat to the soundness of the dollar.

Wartime financing inflationary

What would be damaging to the strength of the dollar would be the deliberate expansion of the credit base, above and beyond the needs of the economy, in order to provide a ready market for the Government's borrowing. This was done in the United States during World War II and in other countries both at that time and during the economic chaos that followed. It is still being done in some unfortunate countries today. The results have invariably been bad and have ranged from damaging, as they were here, to nearly disastrous, as they have been in some other countries. The process of withdrawal and correction is always painful and difficult.

The only sure safeguard against the financing of deficits through bank credit creation lies in careful control over the process by which bank credit and money are created. As I have said, the Federal Reserve is determined to provide, on the one hand, the reserves needed to support the necessary and healthy expansion of bank credit and money required to meet the needs of a growing economy, and on the other, not to again become entangled in the vicious circle of financing Government deficits with bank credit created solely for that purpose.

Further growth seen

In closing, let me summarize as specifically as I can my view with respect to the economic situation today.

All in all, the performance of the economy has been disappointing in that it thus far has failed to reach the goals set for it by some and predicted for it by others. Yet the economy has withstood some rather severe shocks—last fall an auto strike, this year a major steel inventory adjustment and the sharpest stock market break since the 1930's—and still it has moved forward. On the one side, it has not achieved the levels of manpower or physical resource utilization we would all like to see; on the other, the latest data do not, in our judgment, confirm that we have reached or passed a turning point in the cycle at this time. The most likely possibility in the period immediately ahead seems to be for a continuation of mixed movements in the more sensitive indicators and some further growth in the broad aggregate measures of economic activities.

Now a final word, about monetary policy and credit conditions. The one factor over which the Federal Reserve has anything like complete control is the volume of reserves available to the banking system. In my judgment we have supplied—and are now supplying—all the reserves the banking system requires to meet the American economy's needs for credit today and to foster its further economic progress.

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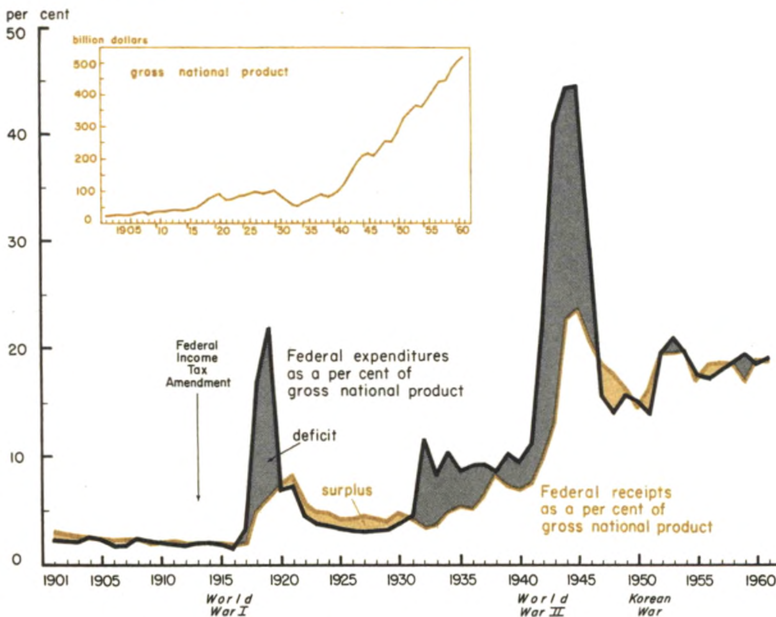
The tax cut debate

Almost every year since World War II there have been demands for cuts in Federal income tax rates. Advocacy of "tax relief" has been most prominent in times such as the present when there has been widespread dissatisfaction with the level of employment and production. Now, as in the past, the proponents of tax reduction are meeting vigorous opposition from those who consider that such action should be taken only when Budget surpluses are realized or in prospect, when business activity is declining or when Government spending is being reduced.

Supporters of a tax cut insist that such action would provide the best means of stimulating spending on consumer and investment goods and that such a step is desirable now. However, they differ as to the types of tax reduction proposed. Some place primary emphasis on cutting corporate and upper-income rates, while others favor reducing lower- and middle-income rates.

Federal receipts and expenditures have been a fairly stable proportion of gross national product since 1956



Note: Gross national product is on calendar year basis. Federal receipts and expenditures are for fiscal years and are on a budgetary basis prior to 1935 and on cash basis thereafter.

Against cuts

In addition to the arguments noted above, many individuals object to a "quickie tax cut" now because it might indefinitely postpone a general reform of the tax structure, which they believe essential if investment and economic growth are to be stimulated. And some contend that other steps—easier credit or increased Government expenditures—should take precedence over a tax cut.

Not everyone agrees that a tax cut would be an effective incentive to consumer or busi-

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ness spending. Some insist that the additional income left with individuals and business firms as a result of tax cuts would not be spent but would be saved or used to repay debt. Others oppose tax reduction because they believe Federal deficits are inflationary and tend to undermine business confidence. They point out that the Federal Government ran a 6 billion dollar deficit in the fiscal year which ended June 30 and that a similar deficit is a possibility in the current year.

Some emphasize international factors and suggest that the prospect of a tax cut accompanied by a large Federal deficit might weaken confidence in the dollar and accelerate the outflow of gold from this country.

For cuts

In answer to these views, advocates of an immediate tax cut have insisted that a substantial proportion of the increase in "take-home pay" resulting from tax reduction would be spent as would an increase resulting from a rise in wages and salaries or some other source. They argue, moreover, that sums used by some to repay debt or to increase savings would boost the supply of funds available to would-be borrowers through financial institutions. It is also asserted that inflation is no longer a clear and present danger and, in the long run, the stimulatory effects of a tax cut will raise incomes and increase tax revenues.

The significance of a Federal Budget deficit for our present balance of international payments is judged by those favoring tax cuts to be remote since the nation has sizable amounts of unused labor and plant facilities which would tend to restrain price increases.

Two Congressional committees—the House Ways and Means Committee and the Joint Economic Committee—held hearings in late July and early August on the desirability of a tax cut. Spokesmen for business, finance, labor and agriculture as well as academic economists testified and expressed views covering the spectrum of opinion outlined above. The committees have proposed no general action on taxes for this session.

The President announced, meanwhile, that he would propose a broad tax revision which would have the effect of reducing total Federal revenues beginning January 1, 1963. However, details have not been made public yet. He reiterated also that a tax cut would be proposed later this year if he decides "it is needed." Recently, the Administration revised depreciation guidelines in a manner which permits business firms to write off many types of equipment at rates 30-40 per cent faster than in the past. This change is expected to reduce business taxes by about 1.5 billion dollars per year. In addition, the President continues to urge Congress to approve the 7 per cent tax credit on newly purchased business equipment—estimated to reduce taxes by about 1.3 billion dollars annually.

Tax reductions of the past

Proposals to reduce taxes commonly carry estimated "price tags"—the amount of revenue "loss" to be expected in the first year under the new schedules. Since lower tax rates permit individuals and business firms to spend and invest a larger share of their earnings, there is a "multiplier effect" upon total income as additional funds flow through successive hands. This higher income, therefore, will partly offset the effects of the lower rates on total tax revenues. Given time for the economy to grow, lower tax rates can produce a larger aggregate revenue than was collected formerly as past experience has indicated.

The United States first imposed an income tax in 1861 to help finance the Civil War. It was repealed in 1872 and subsequently re-

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enacted in 1894 but was declared unconstitutional by the Supreme Court that same year. The Sixteenth Amendment, approved in 1913, removed the legal obstacle and rates of 1-7 per cent were levied on personal incomes and 1 per cent on corporate profits. These rates were increased very sharply during World War I until the bracket rates on individual income in 1918 ranged from 6 to 77 per cent and the corporate rate was 12 per cent, plus an excess profits tax. Ever since, the income tax has provided over half of all Federal revenues.

Since 1913 there have been only ten substantial cuts in income tax rates. Six of these occurred during the Twenties and four between the end of World War II and 1954.

A series of tax cuts during the Twenties eliminated taxes on personal incomes under $4,000 and lowered the highest bracket rate to 25 per cent. Despite reductions in tax rates, Federal revenues tended to rise as incomes increased. The Treasury reported surpluses in each of the 11 years from 1920 through 1930, which permitted a reduction in the Federal debt from 25.5 billion to 16.2 billion dollars.

There was no attempt to stimulate activity through tax cuts during the depressed decade of the Thirties. On the contrary, tax rates were increased to help pay for new spending programs. In addition, social security payroll taxes were imposed during this period and for many years the receipts of these trust funds substantially exceeded payments.

During World War II tax rates were increased to record high levels to aid in financing defense expenditures. The rate on taxable income under $2,000 was increased from 4 per cent in 1940 to 23 per cent in 1944, and the rate on income in excess of $200,000 was raised from 66 to 94 per cent. For corporations the maximum rate was raised from 31 to 40 per cent and an excess profits tax of 95 per cent was imposed.

In 1945 tax rates were cut to offset the effects of an expected sharp decline in Government expenditures. Each bracket of the individual income tax was reduced by 3 percentage points, and personal tax liability as calculated under the schedule was reduced by 5 per cent. The maximum corporate rate was lowered to 38 per cent and the excess profits tax was eliminated.

Congress in 1947 passed further tax reductions that were vetoed. A modified bill was enacted over the President's veto in 1948. It allowed husbands and wives to "split" their income thereby placing many families in lower tax brackets and removing others from the tax rolls. Personal exemptions were increased from $500 to $600, and other changes were made which reduced revenues. The act was estimated to reduce Federal revenues about 5 billion dollars on a full year basis.

In retrospect, it appears that the tax reduction of 1948 played an important role in moderating the downswing in business activity which began late in that year. The desirability of stimulating the economy through tax cuts had been argued in support of the bill, although there was no indication that a recession was imminent when it was enacted.

The Korean War brought increases in personal income tax rates of 2-7 percentage points and a corporate excess profits tax was imposed again. Also the maximum corporate rate was raised from 38 to 52 per cent, where it has remained.

Federal expenditures reached a peak annual rate of 79.4 billion dollars in the second quarter of 1953, toward the end of the Korean War. Within a year, spending cuts had reduced this total by more than 10 billion dollars at an annual rate. This reduction coincided with the business recession of 1953-54.

Demands for tax cuts in 1953 were resisted by the Administration, but at the start of 1954

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the corporate excess profits tax and the increases in rates on personal incomes enacted during the Korean War were allowed to expire. The revenue loss resulting from these changes was estimated at about 4.7 billion dollars on a full year basis. In addition, the Revenue Act of 1954, signed by the President in March, reduced excise taxes, liberalized the treatment of depreciation and made other changes which, in total, were estimated to reduce revenues by about 2.4 billion dollars during the first year. These tax reductions, totaling 7.1 billion dollars, were credited by the Council of Economic Advisers in 1955 with having helped to moderate and reverse the 1953-54 recession.

Some Congressmen and economists contended that either an additional tax cut or a substantial rise in Government expenditures would be required to bring full recovery from the 1954 recession. Nevertheless, without either of these the subsequent business upswing proved to be vigorous, with demands pressing upon available capacity during most of the period from late 1955 to early 1957. Tax cuts were advocated also when the business upswing paused momentarily in the spring of 1956 and again during the recession of 1957-58, but no proposals were adopted.

The economy rebounded in 1958 without a tax cut but fiscal policy was strongly expansionary. The Federal deficit totaled 13 billion dollars in fiscal 1959 as the drop in income lowered revenues while expenditures rose substantially. The expansion that began in 1958, however, proved to be the shortest of the postwar period.

The "overburden" of the income tax

There is general agreement that the growth rate of the American economy since 1957 has been considerably slower than in earlier postwar years. Some economists, including Arthur F. Burns, former chairman of the President's Council of Economic Advisers, and Walter W. Heller, the present chairman, have concluded that the present income tax structure is too restrictive and that it has retarded economic growth.

Neither Burns nor Heller subscribes to the view that a Federal deficit is desirable in and of itself. They suggest that while a broad restructuring of the tax system, emphasizing investment incentives, would tend to increase the deficit temporarily, it would—in Heller's words—prove to be "a downpayment on future surpluses" because of the stimulus it would give to private activity.

The tax rates on individual incomes, bracket by bracket, are virtually as high today as at the peak of World War II when it was essential to boost Federal revenues to restrain inflation. The corporate rate is substantially higher than it was at the wartime peak, exclusive of the excess profits tax.

Of course, many changes have tended to moderate the impact of these comparatively high rates. Provisions for income splitting, increased exemptions, more liberal treatment of deductions and the right to report certain income as capital gains taxable at not more than 25 per cent have worked to reduce the "effective rates" of the income tax.

About two-thirds of all Federal revenues come from individual and corporate income taxes. Collections tend to move up or down, more than proportionately, with changes in total personal income and business profits. The "automatic" fluctuations in income tax revenues have long been an effective "balance wheel" for the private economy. The tax structure is one of the "built-in stabilizers" that help to smooth out cyclical movements in activity. In recent years, economists such as Burns and Heller have concluded, however, that the tax structure may be too re-

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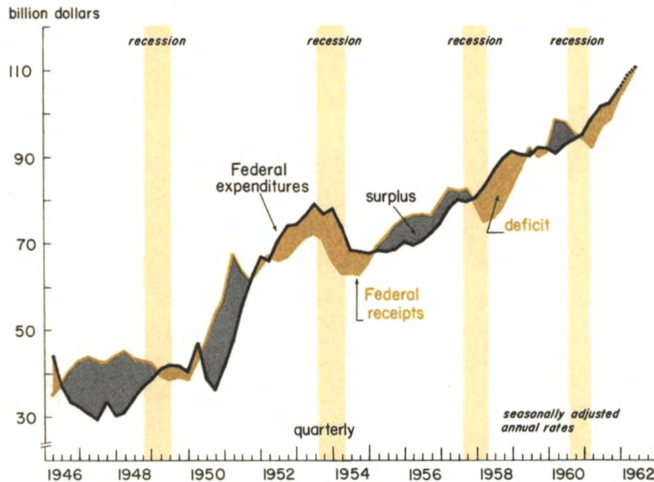
During postwar recessions, Federal expenditures have risen while receipts have declined resulting in deficits



Note: Federal receipts and expenditures are on national income basis.

strictive at times, that it has tended to terminate periods of expansion prematurely. They point to the rapid rise in revenues during the upswings in activity following the 1957-58 and 1960-61 recessions as playing an important role in preventing a return to "full employment."

During the first quarter of 1958—the recession low—Federal tax receipts were at a seasonally adjusted annual rate of 75.4 billion dollars, counting corporate taxes on an accrual basis, and the Treasury was running a deficit at an 8.1 billion dollar annual rate. By the first quarter of 1960, just before the onset of recession, revenues had jumped 31 per cent to a 99 billion annual rate, without an increase in income or excise tax rates, and the Treasury surplus was 8.1 billion dollars on an annual rate basis. Expenditures had risen 9 per cent between these periods. On balance there was a shift of 16 billion dollars in the Government's deficit-surplus position in a span of only two years. While the Government had been paying out considerably more to the public than it was taking in during the first quarter of 1958, it was withdrawing a substantial volume of funds net from the private sector in the first quarter of 1960.

A similar development was evident between the first quarter of 1961 and the second quarter of 1962. During this period Federal receipts rose from a rate of 93 billion dollars to 107 billion, or 15 per cent, while expenditures increased 7 per cent. The result was a shift in the Federal accounts, from a deficit of 7 billion dollars, at an annual rate, to an approximate balance between income and outgo. A reduction in income tax rates would reduce the "balance wheel" effects but not eliminate them.

But the major objective of those seeking tax reduction is the stimulation of economic growth, not merely to smooth cyclical fluctuations in business activity. Economic growth, of course, requires increased investment in new plants, equipment and research. Whether this can be accomplished more effectively by reducing taxes on business and high-bracket personal incomes, which provide most of the funds for this type of spending, or by cutting taxes in the lower- and middle-income brackets so as to provide maximum stimulation to consumption is a debatable question. The arguments in the months ahead, therefore, are likely to shift from "whether" to cut taxes to "where" the cuts should be made.

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Sugar—an example of "supply management" in agriculture

Varying types of production controls have been applied to the major crops in the United States in most years since the early Thirties. However, these controls have not been as comprehensive as those proposed in many quarters currently under the general label of "supply management."

The concept of "supply management" has gradually assumed prominence in farm policy discussions bearing on agricultural surpluses as the cost of agricultural price support programs has risen. Last year the Administration sought authority for greater control of production and marketing of most agricultural commodities, and this year Congress turned down a similar proposal for wheat and feed grains by a very close vote.

One commodity—sugar—has been subject to fairly complete supply control for nearly three decades. While it is not a typical American crop, since large quantities are imported annually and it has no close substitute in most uses, a review of the experience of the domestic sugar industry illustrates the way in which a "supply management" program is applied to one commodity.

The prime requisite of "supply management" involves placing an effective ceiling on the total quantity of the commodity which can be produced or marketed. The word, effective, must be emphasized.

Current agricultural legislation provides for restrictions on production in the form of controlling the number of acres grown or the quantities which may be marketed for specific uses under Federal marketing orders (milk for fluid use and some fruits and vegetables for fresh market). But these controls are not fully effective. Acreage controls on wheat, cotton and feed grains, for example, have failed to prevent accumulation of Government-owned stocks or increases in support program costs. In the case of tobacco, acreage controls have been restrictive enough to hold production in line with consumption in most years. Acreage controls alone, however, lack a key element of "supply management," namely, effective control of the total quantity which can be marketed.

The mechanics of sugar controls

Probably no commodity in international trade is more subject to government control than sugar. Only about 10 per cent of the total annual world production of nearly 60 million tons is sold on the world market without the aid of government regulation, such as preferential tariffs, quotas or other controls. For example, in the United States since passage of the Sugar Act in 1934, the sources of raw sugar, location of processing facilities and prices received by producers and paid by consumers have been largely determined by the Government. It limits the total quantity of sugar marketed, allocates quotas to major producing areas, assigns maximum acreages to individual farmers and determines the amounts individual processors may market.

The Secretary of Agriculture can exercise wide discretion in carrying out these functions and has the power to levy fines and penalties as well as withhold subsidy payments to any

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who do not comply with the regulations.

In December of each year, after a series of public hearings, the Secretary announces the amount of sugar which will be "needed" to fill total United States "requirements" the following year. He must take into account consumption in the previous year, existing inventories, growth of population and other factors. Also, he must consider the price at which this quantity of sugar can be marketed so as to maintain "prices which will not be excessive to consumers and which will fairly and equitably maintain and protect the welfare of the domestic sugar industry."

Once the total quota has been established, a share is assigned each domestic and foreign area supplying sugar to the United States market. The Secretary then establishes "marketing allotments" for individual processors "to assure an orderly and adequate flow of sugar" and "to prevent disorderly marketing"—for the purpose of maintaining stable prices. Sugar importers, processors and refiners are required to maintain records and file reports with the USDA. Any company exceeding its quota is subject to penalties.

The domestic share of the sugar quota is divided among individual farms in "proportionate shares," based on past production history. Compliance with these acreage allotments is voluntary but producers who exceed their "proportionate shares" forfeit rights to Government "conditional payments"—an important part of total income from sugar production.

Evolution of sugar controls

The United States first began to levy duties on sugar imports in 1789. Tariff protection, however, has not been limited to United States producers and processors. In 1876 the Hawaiian Islands were granted duty-free access to the American market. Following the Spanish-American War, Puerto Rico, and later the Philippines, gained duty-free access, while imports from Cuba received preferential tariff treatment.

In 1934 Congress passed a sugar act, subjecting all phases of the domestic sugar industry to the comprehensive controls described above. The intent of the 1934 act was to protect existing mainland producers and processors while at the same time guarding "against further expansion of this necessarily expensive industry." Additional quotas necessary to supply increased demand associated with growth of population and other factors were primarily allocated to the low-cost overseas tropical cane areas. Furthermore, annual marketing quotas were held above the amounts recommended by the domestic industry to avoid boosting prices to consumers.

However, as succeeding legislation has been adopted, the implied purpose of the original sugar act—to limit expansion of mainland sugar production beyond levels prevailing at that time—has undergone drastic revision.

The basic domestic beet sugar quota was raised successively from 1.56 million tons in 1934 to 2.65 million tons in the 1962 Sugar Act. Similar treatment has been accorded mainland sugar cane producers who have seen their quotas rise from 260 thousand tons in 1934 to 895 thousand tons in 1962. All told, domestic sugar quotas have been more than doubled from levels specified in the 1934 act.

The 1962 Sugar Act

The 1962 act dealt primarily with the reallocation of Cuba's former 3.2 million ton annual quota. It increased the share of the "basic" sugar quota awarded to United States producers from 53 to 60 per cent; it also gave them 65 per cent of any increase in quotas necessary to supply higher demand, compared with 55 per cent in effect since 1956. Prior

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to 1956 domestic producers were not assured any share of incremental demand growth.

The new act also established a 1.6 million ton "global quota" (quickly reduced to 1.5 million tons by a second bill) available to foreign producers on a first-come, first-served basis. This reduced quota will be held for Cuba's re-entry to the United States market.

One innovation was a provision for variable import fees, in addition to present tariffs, to "recapture" the "sugar quota premium." (This premium represents the difference between the world sugar price and the United States price.) All of the premium on the new "global quota" shipments will be recaptured immediately, while premiums on the permanent quotas held by foreign producers will be reduced at the rate of 10 per cent a year through 1964, at which time the effects of the new import fees as well as the foreign quotas will be reviewed by Congress.

Reallocation of former Cuban sugar quota under 1962 Sugar Act*

		Amount (1,000 tons)
Former Cuban quota		**3,208**
New global quota		1,485
Increases in permanent quotas:		
Domestic beet	539	
Mainland cane	246	
Philippines	70	
Other foreign	1,030	1,885
Decreases in permanent quotas:		
Hawaii	68	
Puerto Rico	92	
Virgin Islands	2	162
Net reallocation		**3,208**

*As amended by the 1962 Honeybee Act.

Benefits of sugar controls

The benefits of the sugar act to holders of quotas can be measured by the excess of the United States quota price over the world price. In most peacetime years, this premium has been quite substantial.

Since 1957, the world price of raw sugar has declined sharply from a high level largely attributable to scare buying during the Suez emergency. Suspension of Cuba's import quota by the United States in 1960 and large European beet sugar crops in recent years have exerted further downward pressures on world prices. By the end of 1961 the world price had dropped below 2.5 cents a pound—a decline of more than 60 per cent from its Suez peak in April 1957. Although the world price had firmed to about 3.4 cents a pound by the end of August of this year, it was still far below the quota price for shipment to the United States.[1]

With the United States quota price for raw sugar averaging about 2.5 cents a pound above the world price during the past year, sugar producers, both domestic and foreign, eligible to supply the United States market received a subsidy of about $50 a ton, or a total of 500 million dollars based on a total domestic requirement of about 10 million tons. In addition, United States farmers received nearly 75 million dollars as "conditional" payments last year.

Although production costs for sugar grown in the United States are substantially higher than in the tropical areas, quota rights appar-

[1]The United States quota price represents the spot price for raw sugar under bulk contract, minus freight, insurance and unloading charges.

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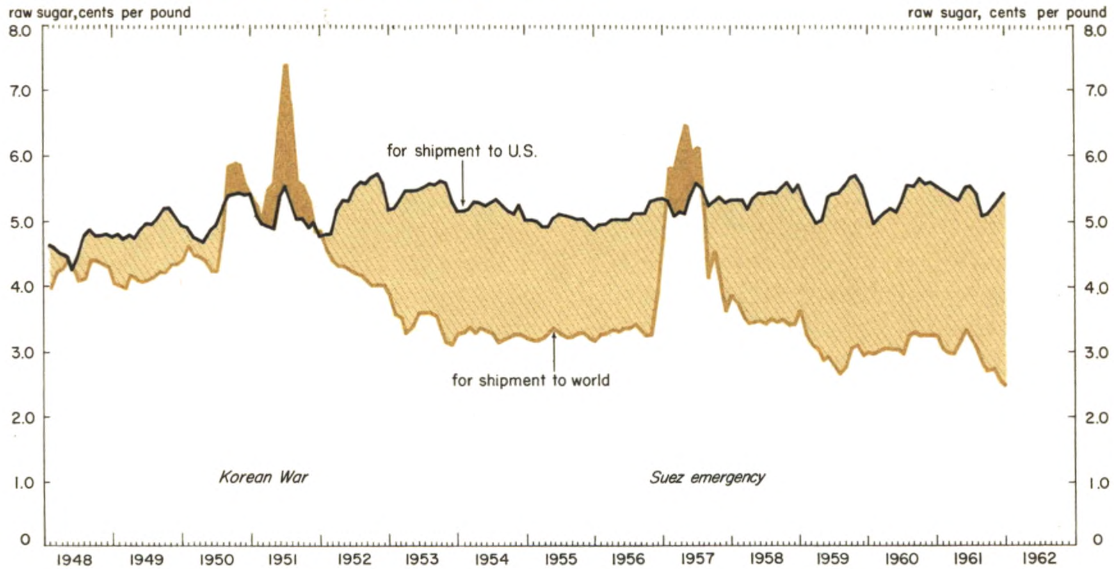
Sugar prices—suppliers of United States market usually receive substantially higher prices for their quotas than for sales in world market



SOURCE: U. S. Congress, *History and Operations of the U. S. Sugar Program*, May 14, 1962.

ently are quite valuable to domestic producers. In 1960, following the suspension of the Cuban sugar quota, all acreage restrictions on American producers were waived. In 1961 domestic sugar acreage increased more than 10 per cent. Prices of Florida land adaptable to the production of sugar cane are reported to have doubled in recent years as additional acreage has been planted and new sugar mills constructed.

For sugar processors and refiners, controls have provided greater price stability and restricted competition from abroad.

Program costs

Most of the cost of the United States sugar program is borne by consumers in the form of higher prices. Taxpayers, of course, pay for subsidies provided producers in the form of "conditional" payments. The United States quota price boosts costs to consumers about 2.5 cents per pound—as measured by the difference between raw sugar prices for shipment to the United States and shipment to the world market. In addition, a tariff of ½ cent a pound is levied on all raw sugar imports, boosting prices to consumers by a similar amount. On top of this, another ½ cent a pound is added by a processing tax on all sugar, regardless of origin. Thus, the "supply management" sugar program boosts prices to consumers by about 3.5 cents a pound.

With per capita annual consumption of sugar (including the sugar bowl, candies, bakery goods, soft drinks, etc.) averaging about 97 pounds, the program costs each consumer directly about $3.25, or about $13.00 for a family of four per year. Although this may

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appear to be a modest sum, since sugar constitutes a relatively small portion of total consumer purchases of food, it represents about one-third of the total annual cost of sugar to the American housewife.

Sugar—retail price, processing and marketing costs and returns to farmers, November 1960

	Beet sugar	Cane sugar
	(cents per pound)	
Price paid by consumer (5-pound bags in Chicago)	11.62	11.62
Sugar manufactures paid:		
Farmers	4.27	4.28
Excise tax	.54	.54
	4.81	4.82
Farmers received:		
From manufacture . . .	4.27	4.28
From Government payments	.86	.68
	5.13	4.96
Cost of manufacture and marketing (excluding excise tax)	6.81	6.80

SOURCE: U. S. Congress, *Special Study on Sugar*, February 14, 1961.

Problems and issues

The effects of the United States sugar policy range far beyond the direct costs of filling the American housewife's sugar bowl. The use of quotas and other controls on sugar has prevented low-cost tropical cane producing areas from competing effectively in the world's largest market. Several of these countries derive the bulk of their foreign exchange earnings from sugar and a few other tropical foods.

During the course of Congressional debate on the 1962 sugar bill, it was argued that the problems confronting these countries—low per capita income and meager foreign exchange reserves—could be combated more effectively through aid programs as opposed to giving them freer access to our domestic sugar market. This approach represents a revealing departure from the accepted free trade doctrine of "more trade, less aid."

Furthermore, most control programs tend to freeze existing production and trade patterns or cause significant lags in adjustment to modern technological developments.

In any society regardless of its political structure the key economic problems to be solved are: how much of each commodity is to be produced; who is to produce it; where is it to be produced; at what price is the commodity to be sold; and finally, how are the returns to be distributed among the various claimants—land, labor, capital. Under "supply management" these decisions are largely removed from the competitive forces of the market place, which tend to shift production to the low-cost producers. Lacking the discipline of the highly impersonal forces of competitive markets, it is possible to continue production indefinitely—and even expand production—in high-cost areas at the expense of the low-cost areas. The higher costs are reflected in consumer prices and subsidies. The *real* cost, however, is the smaller total production of goods and services and the slower economic growth than would be achieved if resources were used efficiently.

As one observer recently noted, when commenting on the sugar-control system: "Quotas and direct restrictions, with their shifts in the rules of the game and their windfall gains and losses, place a premium on winning political favors rather than on performing economic services."

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