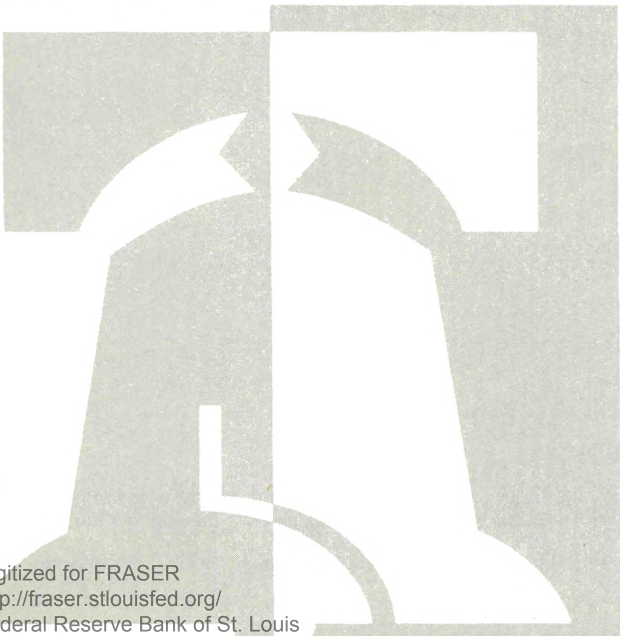
Federal Funds and the Profits Squeeze—a New Awareness at Country Banks

Excising Excises

FEDERAL RESERVE BANK OF PHILADELPHIA

BUSINESS REVIEW



MARCH 1965

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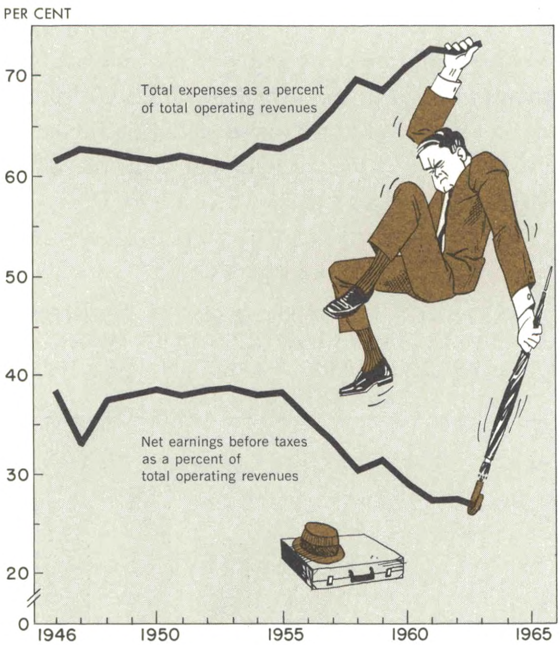
FEDERAL FUNDS AND THE PROFITS SQUEEZE— A NEW AWARENESS AT COUNTRY BANKS

THIRD DISTRICT COUNTRY MEMBER BANKS



The figure in the chart above is a familiar one to country bankers in the Third Federal Reserve District and to many in the nation as a whole. For like their city cousins, country bankers have been faced with two-pronged pressures in recent years, with rapidly rising costs—especially in the interest paid on mounting time deposits—and with generally stable interest rates on loans and investments.

The result has been increasing pressure in a tender spot—the profit margin. As the chart shows, operating expenses have climbed relative to total revenues, forcing a sharp dip in before-tax earnings as a percentage of total revenues. As shown in Chart II, earnings per dollar of total assets and total capital also have leveled off.

But as the cartoon indicates, the country banker hasn't taken the profit pressures lying down. Among other things, he has sought to bolster profit margins by keeping a sharp eye on costs, by increasing the volume of loans relative to deposits, and by holding non-earning assets—cash, excess reserves, and the like—to a minimum. Indeed, minimizing cash assets has become an objective which the country banker has pursued with increasing ardor as profit pressures have mounted.*

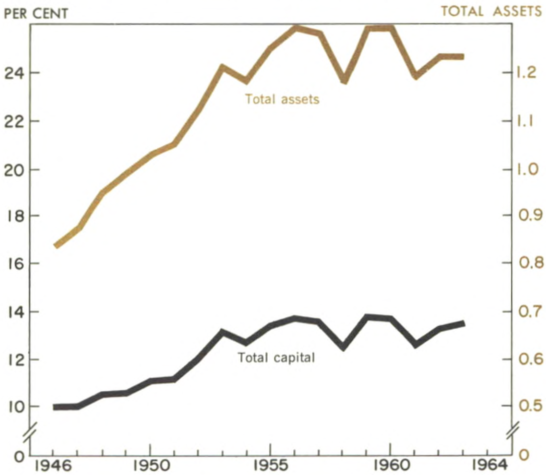
The extent of this increasing attention given to the management of cash assets is illustrated particularly by the swelling number of country banks which have entered the federal funds market in recent years. Yet though much has been said about country-bank activity in federal funds, little has been done to measure the actual dimensions of this participation.

To throw some light on this question, the Federal Reserve Bank of Philadelphia recently conducted a complete census of Third District

* For an analysis of bank efforts to reduce cash assets, see Federal Reserve Bank of Philadelphia, **Business Review**, "What Price Liquidity," September, 1964, p. 3.

CHART II

THIRD DISTRICT COUNTRY MEMBER BANKS
Net earnings before taxes as percentage of:



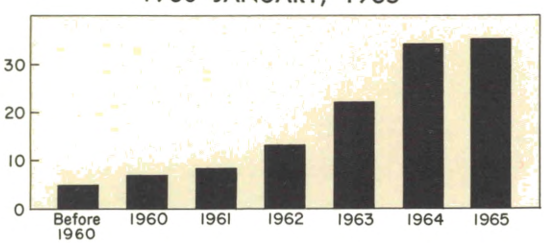
country banks, attempting to find out the number of banks in the federal funds market, size of transactions, and many other facts. What follows is a summary of findings, along with some implications both for the individual banker and for the Federal Reserve System.

How many banks in the market?

Before 1960, less than five out of every 100 Third District country member banks had any experience in the federal funds market. In 1964, one out of every three country banks participated in the market, a substantial increase in participation in only a few years. Indeed, as Chart III shows, the greatest spurt in federal funds activity occurred between 1962 and 1964, when the proportion of country banks which had been active in the funds market jumped from around 13 per cent to 34 per cent.

CHART III

PERCENTAGE OF THIRD DISTRICT COUNTRY MEMBER BANKS WHICH HAVE PARTICIPATED IN THE FEDERAL FUNDS MARKET, 1960–JANUARY, 1965

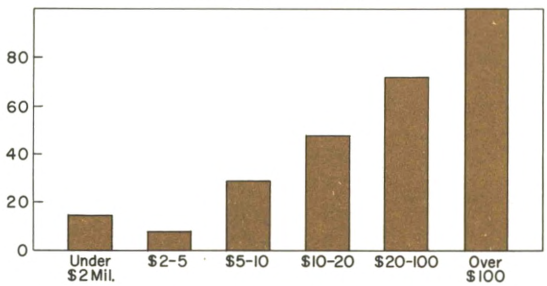


What size banks are most active?

As might be expected, the bigger country banks, which generally have a larger and more specialized staff, are most active in the market. All country banks in the over $100 million deposit class, for example, borrowed and lent funds in 1964, as did 70 per cent of banks in the $20–$100 million class (as shown in Chart IV).

CHART IV

PERCENTAGE OF THIRD DISTRICT COUNTRY MEMBER BANKS PARTICIPATING IN THE FEDERAL FUNDS MARKET IN 1964, BY DEPOSIT SIZE

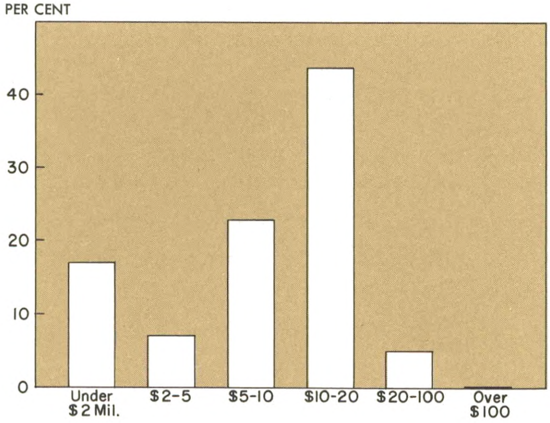


Still, the smaller country bankers were by no means idle. A surprising 48 per cent of banks in the $10–$20 million size class were in the market and even the smallest banks, under $2 million in deposits, participated at a rate reaching almost 14 per cent of their number.

The increasing significance of smaller country banks is illustrated also by the rapid growth in number participating in the market. As Chart

CHART V

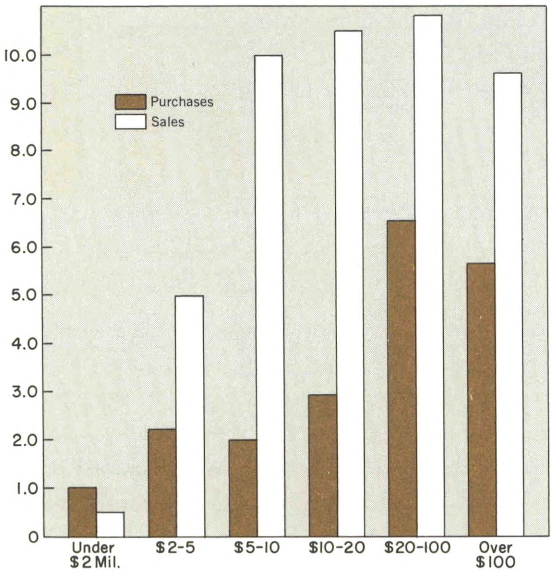
PERCENTAGE CHANGE IN PARTICIPATION RATE BY DEPOSIT SIZE, THIRD DISTRICT COUNTRY MEMBER BANKS 1962–1964



V shows, the portion of banks in the $10–$20 million deposit class which participate in the federal funds market grew by 44 per cent between 1962 and 1964 and a rapid increase in participation rates was also scored by banks in the $5–$10 million deposit class.

CHART VI

AVERAGE NUMBER OF FEDERAL FUNDS TRANSACTIONS PER MONTH IN 1964 BY DEPOSIT SIZE, THIRD DISTRICT COUNTRY MEMBER BANKS

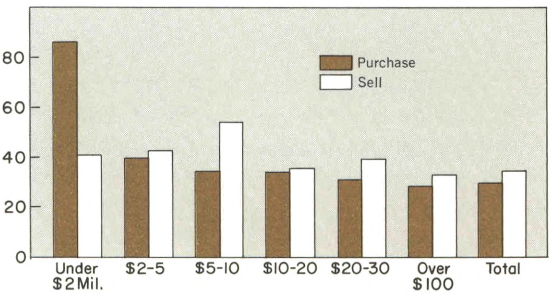


How often are banks in the market?

During 1964, the typical country banker borrowed federal funds, on average, almost four times a month and lent funds over nine times. The bigger the bank, moreover, the more often was the average banker in the market. As Chart VI shows, a banker in the under $2 million class borrowed funds about one time every month and lent less than one time on average. His neighbor in the $20–$100 million deposit class, on the other hand, borrowed almost seven times each month and lent nearly 11 times.

CHART VII

AVERAGE SIZE OF FEDERAL FUNDS TRANSACTIONS AS A PERCENTAGE OF AVERAGE CAPITAL AND SURPLUS, BY DEPOSIT SIZE, THIRD DISTRICT COUNTRY MEMBER BANKS



How much in dollar amount?

In dollar terms, the typical country banker borrowed federal funds amounting to about 30 per cent of his capital and surplus, on average, and lent funds which ran about 35 per cent of capital and surplus.

Unlike the situation with respect to frequency, however, the smaller banks tended to borrow and lend funds in greater amounts relative to capital

FEDERAL FUNDS: AN ANATOMY

What is a federal funds transaction?

When one bank lends to another bank funds it holds on deposit with a Federal Reserve Bank, it has consummated a "typical" federal funds transaction. The qualifier "typical" must be added because other organizations (such as Government securities dealers) borrow and lend federal funds and because under a recent ruling of the Board of Governors of the Federal Reserve System* a bank may lend funds directly to a correspondent, funds which it holds on deposit with that or another correspondent, and consider the transaction a loan of federal funds.

Obviously, then, the term "federal funds" is an evolving one. The recent Federal Reserve Board ruling has simplified the bookkeeping involved in the borrowing and lending of federal funds and has helped stimulate vigorous regional markets in federal funds. It is with this "new wrinkle" in federal funds—the rapidly growing regional markets—that this article is primarily concerned.

Why do banks borrow and lend federal funds?

Banks are in business to earn a profit, hence they lend and invest the funds their depositors leave with them after they have provided for cash needs, required reserves, and the like. Often, however, banks find that they have temporary excesses in funds—more than needed to meet cash and reserve requirements. Other banks have temporary deficiencies—less funds than needed to meet their immediate needs. If the surplus and deficit banks can get together and agree upon terms for a loan of excess funds, then the surplus banks earn a profit on funds that might otherwise be held as idle cash and the deficit banks obtain the funds they need to meet demands upon them.

What are the details of the new type of federal funds transaction?

"Fed funds," answers the manager of the federal funds department.

The place is the X City Bank. It is 2:10 in the afternoon and this is one of several calls from country correspondents which typically will come in between 9:20 a.m. and 2:30 p.m.

"Hello, Joe," says a voice at the other end of the line, "this is Crawford at Y Country Bank. I have 200 to lend for a day, what's the rate?"

"Can take 200 at 4 per cent. All right?"

"Done. Charge my account."

"Righto. Talk to you tomorrow."

"Thanks, Joe."

Click.

The conversation above resulted in a loan of $200,000 in federal funds by the Y Country Bank to its correspondent, the X City Bank. The Y Country Bank will earn about $22 for its effort, which is the approximate return on $200,000 lent for one day at 4 per cent.

But the transaction doesn't stop here. Word of the loan must go to many people in the X City Bank. Let's follow the repercussions of the transaction as it spreads in widening circles throughout the many departments of the X City Bank, for several people must cooperate if the fed funds transaction is to be consummated effectively.

The transaction begins as the federal funds manager, still talking on the phone, fills out the following form.

* For details of this ruling see **Federal Reserve Bulletin,** August, 1964, and P. 1000.

THE X CITY BANK

Date March 30

We promise to pay $ 200,000 on March 31 for Federal Funds borrowed from you for 1 day(s) at 4 per cent per annum.

RECEIPT OF FUNDS IS ACKNOWLEDGED

☐ By your wire transfer through Federal Reserve System
☑ By charging your account with us

INTEREST PAYMENT

☑ We credit your account with us ☐ We enclose our cashier's check $ 22.00 Interest
☐ You are authorized to charge our account with you

In repayment of loan we will return funds through the same channel as received, as indicated above, unless we receive other instructions from you.

☑ Secured

Y Country Bank
Flaresville, Pa.
MR. Crawford

Joseph K. Kreig
Authorized Signature

He hands this form to his secretary who uses the information to type a multiple-part form, different leaves of which go to different parts of the bank and to the country correspondent.

The first leaf goes to the country correspondent to confirm the transaction. The next three leaves go to the City Bank's accounting department with instructions for proper bookkeeping entries: to record receipt of the federal funds, to pay the funds back the following day, and to pay the proper amount of interest to the Country Bank.

Another leaf of the multiple-leaf form goes to the City Bank's filing department to be kept as a permanent record of the transaction. A leaf also goes to the City Bank's money and wire transfer department as a memorandum. The last two leaves go to the custody department. If the transaction is so drawn, the custody department will earmark Government securities of the City Bank as collateral for the City Bank's borrowing of federal funds. This may be for the entire amount of the transaction or only for part. The collateral exempts the Country Bank from laws specifying that loans to one borrower may be only a certain fraction of capital and surplus.

and surplus. This tendency can be seen in Chart VII, though it is evident that *borrowings* bear a more consistent relation to size than *loans*.

Which side of the market?

One might suspect that country bankers, who traditionally have kept a greater cushion of excess reserves than their city cousins, would more often be lenders than borrowers of federal funds. And indeed, both the frequency and magnitude of federal funds *loans* by District country bankers are greater than of *borrowing*.

It is interesting to note, however, that a large number of District country bankers operate on both sides of the market; almost half of participating country banks both borrow and lend funds while 22 per cent borrow funds only and 29 per cent lend funds only, as shown in Table 1.

TABLE 1

THIRD DISTRICT COUNTRY MEMBER BANKS WHICH PARTICIPATE IN THE FEDERAL FUNDS MARKET

Side of market	Percentage of participating banks
Borrow federal funds only	22
Lend federal funds only	29
Both borrow and lend federal funds	49
Total	100

TABLE 2

THIRD DISTRICT COUNTRY MEMBER BANKS WHICH PARTICIPATE IN THE FEDERAL FUNDS MARKET

Deposit size (millions)	Borrow federal funds only as a percentage of banks which only borrow and only lend	Lend federal funds only as a percentage of banks which only borrow and only lend
Under $2	67	33
$2–5	78	22
$5–10	65	35
$10–20	29	71
$20–100	8	92
$100 and over	0	100

Moreover, Table 2 shows that those banks which operate only on one side of the market (only borrow or only lend) tend to be clustered into two groups: smaller banks which, rather unexpectedly, most often are on the borrow-only side of the market, and larger banks, which are most often on the lend-only side.

Through whom are funds borrowed and lent?

By far the large majority of country bankers use the services of their city correspondent to execute federal funds transactions, as shown in Table 3. This choice reflects, among other things, the intensification of city-bank efforts in recent years to inform their country correspondents about the federal funds market. It also reflects the willingness of the city banks to accommodate country-bank needs in relatively small dollar amounts. Whereas federal funds transactions once were denominated in millions of dollars, a country bank needing $100,000 in funds may now obtain accommodation from city banks.

TABLE 3

THIRD DISTRICT COUNTRY MEMBER BANKS WHICH PARTICIPATE IN THE FEDERAL FUNDS MARKET

Percentage placing transaction through:	Borrow*	Lend*
Correspondent	97	99
Federal funds broker	7	5
Other bank	1	2

* Does not add to 100 per cent because some banks execute transactions through more than one class of intermediary.

If the need arose

A final question asked District country bankers in the survey of federal funds activity was this: "Even if you do not borrow federal funds now, would you do so in the future in response to temporary reserve deficiencies?"

A surprisingly large proportion said that indeed they would borrow federal funds if needed. Thirty-three per cent of banks which had never been in the market at all—either on the borrow or lend side—said they would borrow funds if the need arose, and almost 80 per cent of the banks that have lent but never borrowed funds would come into the market on the borrow side if the need arose. Table 4 summarizes the replies by size of bank.

TABLE 4

THIRD DISTRICT COUNTRY MEMBER BANKS

Deposit Size (millions $)	Not in the market but would borrow if needed	Sell only but would borrow if needed
Under $2	36	100
$2–5	31	100
$5–10	32	75
$10–20	41	83
$20–100	21	67
$100 and over	*	100
All country banks	33	79

* All participate.

Some implications for the banks

Like other firms in other industries, banks are in business to make a profit. In today's increasingly competitive markets, banks—also like other firms—find it necessary to innovate, to search out new procedures for controlling costs and to find new sources of funds and uses for those funds if profit margins are to be maintained.

On the other hand, banks are unlike other businesses in at least one respect. A large portion of their liabilities—the checking account deposits of their customers—are payable on demand. Banks must stand ready both to convert deposits into currency and to meet the claims of other banks on a moment's notice.

Herein lies both the challenge and the art of banking. To make a profit, banks must employ funds in loans and investments. To meet the demands of depositors, banks must hold some funds in cash and other assets must be readily convertible into cash with little or no loss or delay. This is the art of banking and the art has changed little in basic, underlying concept from the days of the early Italian bankers, through the great age of European merchant banking to the present. Now, as in the past, the quest for profit must be tempered by the need for liquidity and the exercise of sound judgment.

The federal funds market provides a useful vehicle both to increase profits and to enhance liquidity. Funds temporarily in excess of needs may be lent for very short periods—overnight or for two or three days with little more than a phone call. Temporary deficiencies may be met by borrowing federal funds.

The market thus allows both individual banks and the banking system to economize on cash, to keep less in the form of cash and near-cash assets, and to increase the more profitable outlets for funds—loans and investments.

But like most innovations in banking, the borrowing and lending of federal funds is no panacea, no automatic machine where the press of a button brings forth an instant balance between the need for profit and the requirements of liquidity.

The sizable expansion in country bank participation in the federal funds market raises some interesting questions. Perhaps most important, since most banks entered the market after 1960, a period of generally easy money conditions, what might happen if money should become tight?

Should the current expansion in economic activity accelerate to a point where inflationary pressures threaten, and should monetary policy shift to a posture of less ease, then country banks may find wholly new conditions in the federal funds market—conditions which they may not now anticipate.

With limited experience in the market, some banks may expect federal funds to be available even in the event of tighter money. This expectation may not in fact be realized. The result: a necessary return to more traditional techniques of adjusting cash positions, a return for which the prudent banker will be prepared.

By the same token, an important question exists for larger correspondents which are the major lenders and borrowers of funds from country banks. How will the larger correspondents react when the needs of country banks conflict with their own money position? As the availability of funds from country banks diminishes and as larger banks are called upon to supply funds, their own cash positions may well be strained.

Indeed, to illustrate the extent of the possible pinch, the survey of federal funds activity showed that many banks not even *borrowing* funds would do so if the need arose. As already noted, 33 per cent of banks which have never been in the market indicated a willingness to borrow funds if needed, as did almost 80 per cent of banks which had lent but never borrowed funds.

Implications for Federal Reserve policy

If experience in the Third District is indicative of an evolving national trend, developments in the federal funds market have important implications for Federal Reserve policy. The large increase in country-bank participation in the funds market and the declining cushion of cash reserves held by country banks means that a move toward restraint would tend to result in a quicker and more pervasive tightening. In other words, a given unit of restraint would tend to produce a greater tightening effect now than in the past, and the Fed would certainly want to take this into consideration both in formulating and in implementing its monetary policy.

The question also arises of administration of the Fed's discount window. Regulation A prescribes that ". . . credit is generally extended on a short-term basis to a member bank in order to enable it to adjust its asset position when necessary because of developments such as a sudden withdrawal of deposits or seasonal requirements for credit beyond those which can reasonably be met by use of the bank's own resources."

Clearly, Regulation A precludes continued accommodation at the discount window in cases where over-loaned or over-invested positions result in frequent cash needs.

In determining the appropriateness of borrowing, the Federal Reserve Banks will also want to look at flows of funds between city banks and their country correspondents. The extent to which city banks are lenders of federal funds to country correspondents, for example, will be a factor in determining the appropriateness of city-bank borrowing.

In conclusion

The new environment in which banks today are operating was appraised with particular thoughtfulness by J. L. Robertson, a member of the Board of Governors of the Federal Reserve System, at a recent meeting of the Ohio Bankers Association.*

Governor Robertson discussed a broad spectrum of developments in banking, especially recent efforts by banks to open new sources of funds—certificates of deposit, capital notes and debentures, as well as federal funds. He indicated some of the advantages of the new areas of competition for funds as well as some possible difficulties. Following is a particularly interesting quote from Governor Robertson's speech.

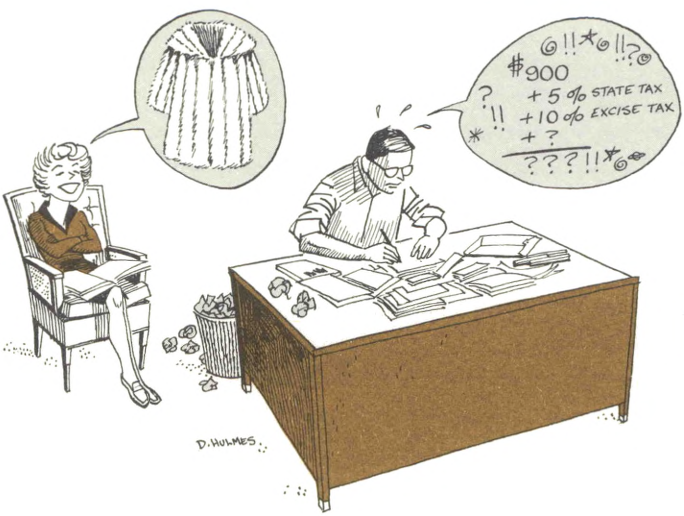
Some of the consequences of this change [*in sources and uses of funds*] *can be seen, and others can be guessed at. For one thing, sophisticated management skills are clearly of increasing importance in this new banking market. Tapping the new sources of funds is not child's play. To the extent that these funds represent borrowing from the market what used to be borrowed from correspondents and the Federal Reserve, the borrower may find the market, in times of need, to be much colder and far less understanding. While banks can now gain funds from a greater variety of sources* (*and incidentally be emancipated from sole dependence on local area sources*), *by and large these new funds are much "hotter"—more volatile—than the old deposit flows. In this field the personal customer rela-*

* "The Changing World of Banking," remarks of J. L. Robertson, member of the Board of Governors of the Federal Reserve System, before the midwinter meeting of the Ohio Bankers Association, Columbus, Ohio, February 12, 1965.

tionship is not as important today as the quoted rate—as both the customer and the bank become aware of alternatives.

Banks have always been borrowers—that is how they get their resources—but the latest developments are something new. They are new because more banks are now aggressively seeking short-term, price-sensitive money. This increasing emphasis on short-term funds from the market may actually increase the exposure of individual banks to sudden adverse drains—particularly since policy changes by the Federal Reserve that once influenced mainly your portfolios now also powerfully influence the relative cost and stability of your liabilities. As a result, in adversity many banks may be more dependent than ever on correspondent relations and ultimately on the lender of last resort—the Federal Reserve System. The discount window will, of course, always be there to protect communities and to meet the emergency needs of banks. But it would not be wise to count on its being there to save bankers from the consequences of going overboard *in borrowing short and lending long. Furthermore, supervisory authorities should not count too heavily on the use of the discount window to paper over their mistakes and deficiencies.*

The essence of Governor Robertson's remarks seems to be this. The federal funds market, as well as other new sources of funds, must be approached with caution and with judgment if maximum benefits are to be derived. Now, as in the past, indiscriminate action is likely to result in haphazard, even dangerous operating results. For unlike modern cake mixes and coffees, there is no instant wisdom.



excise: a hateful tax levied upon commodities, and adjudged not by the common judges of property, but wretches hired by those to whom excise is paid
—Samuel Johnson

EXCISING EXCISES

Excise taxation has never been especially popular in this country. The first such American levy, on liquor, spurred western Pennsylvania farmers to stage a rebellion; militiamen were needed to quell this demonstration of taxpayer unhappiness. That was in 1794. In 1965, taxpayers with grievances resort to more civilized methods of protest such as appearing at House Committee hearings and sending lobbyists to Washington. Despite the change in tactics, the

EXCISES ARE LEVIED ON A WIDE RANGE OF GOODS

The classifications used here are those in the Treasury Bulletin

ALCOHOL TAXES
- Distilled spirits
- Wines
- Beer

RETAILERS' EXCISE TAXES
- Furs
- Jewelry, etc.
- Luggage, etc.
- Toilet preparations

MANUFACTURERS' EXCISE TAXES
- Gasoline
- Lubricating oils, etc.
- Tires, tubes, and tread rubber
- Passenger automobiles, chassis, bodies, etc.
- Trucks and buses, chassis, bodies, etc.
- Parts and accessories for automobiles, trucks, etc.
- Radio and TV sets, phonographs, components, etc.
- Refrigerators, freezers, air conditioners, etc.
- Electric, gas, and oil appliances
- Pistols and revolvers
- Phonograph records
- Musical instruments
- Sporting goods, (other than fishing rods, creels, etc.)
- Fishing rods, creels, etc.
- Business and store machines
- Cameras, lenses, film, and projectors
- Electric light bulbs and tubes
- Firearms (other than pistols and revolvers), shells and cartridges
- Mechanical pencils, pens, and lighters
- Matches

TOBACCO TAXES
- Cigars
- Cigarettes
- Other

DOCUMENTARY AND CERTAIN OTHER STAMP TAXES
- Documentary stamp taxes
- Playing cards
- Silver bullion sales or transfers

MISCELLANEOUS EXCISE TAXES
- Admissions to theaters, concerts, etc.
- Admissions to cabarets, roof gardens, etc.
- Club dues and initiation fees
- Toll telephone service, telegraph, cable, radio, etc., wire mileage service, wire and equipment service
- General telephone service
- Transportation of persons
- Use of safe deposit boxes
- Sugar
- Diesel and special motor fuels
- Narcotics and marihuana including occupational taxes
- Coin-operated amusement devices
- Coin-operated gaming devices
- Bowling alleys, pool tables, etc.
- Wagering occupational tax
- Wagers
- Use tax on highway motor vehicles weighing over 26,000 pounds
- Adulterated and process or renovated butter, filled cheese, and imported oleomargarine
- Firearms transfer and occupational taxes
- Interest equalization

goals remain the same—abolition of the offending duties.

The Federal excise-tax structure today is extraordinarily complex, frequently frustrating, and, in some cases, seemingly irrational. Taxes are levied on such diverse goods as alcohol and automobiles, matches and mechanical pencils. Rates range from 5 per cent to more than 100 per cent of a commodity's value. In fiscal 1964, the excise tax on alcohol produced $3.6 billion in revenue; the levy on various butter, cheese, and oleomargarine products yielded $3,000.

This year the Administration plans to ask Congress to reduce excise taxes. In his budget message President Johnson said it was time to "revise and adjust" excises, and asked for a reduction of about $1.75 billion, effective July 1. He further noted that:

. . . Some of the present excises are costly and inefficient to administer. Some impose onerous recordkeeping burdens on small business. Some distort consumer choices as among different kinds of goods. . . . I believe it is vital that we correct the most pressing of these deficiencies this year. . . . In addition to improving the tax system, the recommended changes will increase purchasing power and stimulate further growth in the economy.

Although the President laid emphasis on the reform aspects of his proposed reductions, their impact on the economy is also important. Questions have been raised about the economy's ability to continue strong in the second half of this year and through 1966; any reduction in excise taxes should provide at least modest stimulus to further expansion.

Preparatory to this year's legislative consideration, the House Committee on Ways and Means held hearings last summer on the Federal Excise Tax Structure. Spread over three months, the hearings produced more than 1,400 pages of testimony, panel discussion, and papers. The Committee heard a panel of excise-tax experts and then listened to industry spokesmen present their cases. The consensus was that some excises should be cut; which and by how much were not agreed upon.

In its examination of the forthcoming Administration requests, Congress will look at both the potential economic effects of a given reduction, and the technical and administrative difficulties associated with particular levies. These are the primary considerations to be examined here.

Excises—what and how much?

An excise is defined by Webster as "an internal tax levied on the manufacture, sale, or consumption of a commodity within a country." Federal excise levies are sometimes termed selective sales taxes, in contrast to a general sales tax which may be levied against all products sold, with specific legislative exemptions such as food and clothing.

Within the framework of Federal finance, excise duties play an important role. In fiscal 1964, Federal excise-tax collections produced $14.0 billion for the Federal Government, approximately 12 per cent of total budget receipts from the public; in fiscal '65, excises are again expected to produce about 12 per cent of budget receipts. As a proportion of total receipts, excise collections have been stable over the past six years, averaging about 12.3 per cent annually.

Who pays?

Federal excises are collected at both the wholesale and retail levels as manufacturers' excise levies and retail taxes, respectively. The major dollar volume of Federal excise collections comes from producers in the form of manufacturers' excises on automobiles, gasoline, tobacco, and alcohol. Retail excises are collected from the final seller, who in turn collects all or part of the tax from the consumer. These taxes are levied on such items as jewelry, furs, and luggage.

But to know where a tax is collected by the Internal Revenue Service is not necessarily to know who actually bears the burden of the tax. Lawmakers, economists, and social researchers have long studied this question of tax incidence. Does a manufacturer, for example, pay the 10 per cent manufacturers' excise tax on a particular good, in whole or in part, or does he shift it forward to the consumer in the form of higher prices? Or shift it backward onto his workers and suppliers in the form of lower wages and prices?

Determination of a tax's incidence is not always easy, but it is essential. Only if we know who actually bears the burden of the tax can we attempt to calculate the effects of adjusting the levy. For not all taxpayers react the same way when they find themselves with additional cash.

What stimulus from an excise tax cut?

The stimulus a particular reduction will give the economy depends on many factors: absolute dollar amount of reduction, pattern of demand for the product on which the tax is levied, and incidence of the levy, among others.

In the following table, major excise levies have been listed in order of revenue produced in fiscal 1964. Everything else remaining the same, repeal of the alcohol excises would probably give the economy the biggest lift because it would leave most additional revenue in the private sector of the economy. Abolition of the

TABLE 1

RECEIPTS FROM SELECTED EXCISE TAXES — FISCAL 1964
(in thousands of dollars)

Category	Revenue	Percentage of total excise collections
Alcohol	$3,577,499	25.6
Gasoline	2,618,370	18.8
Tobacco	2,052,545	14.7
Passenger automobiles, chassis, bodies, etc.	1,745,969	12.5
General telephone service	530,588	3.8
Retailers' taxes*	475,013	3.4
Tires, tubes, and tread rubber	411,483	2.9
Toll telephone service, telegraph, cable, radio, etc. wire mileage service, wire and equipment service	379,608	2.7
Trucks and buses, chassis, bodies, etc.	350,945	2.5
Parts and accessories for automobiles, trucks, etc.	228,762	1.6
Radios and telephone sets, phonographs, components, etc.	197,595	1.4
Documentary and certain other stamp taxes	171,614	1.2
Diesel and special motor fuels	128,079	0.9
Transportation of persons	106,062	0.8
Use tax on highway motor vehicles weighing over 26,000 pounds	100,199	0.7
Sugar	95,411	0.7
Electric, gas and oil appliances	77,576	0.6
Lubricating oil, etc.	76,316	0.5
Club dues and initiation fees	75,120	0.5
Business and store machines	71,867	0.5
Refrigerators, freezers, air conditioning, etc.	62,799	0.5
Admissions to theaters, concerts, etc.	47,053	0.3
Electric light bulbs and tubes	41,511	0.3
Admissions to cabarets, roof gardens, etc.	41,026	0.3
Cameras, lenses, film and projectors	29,580	0.2
Phonograph records	25,098	0.2
All other	232,544	1.7
Total	$13,950,232	100.0**

* Includes tax on furs, jewelry, luggage, toilet preparations, etc.
** Items do not add to total because of rounding.
Source: **Treasury Bulletin**, December, 1964.

tax on phonograph records would give the economy less of a boost.

Another consideration bearing on the stimulus of a tax cut is the extent to which a cut in price will increase the quantity of goods demanded. Economists call this *price elasticity of demand*, or elasticity. If a reduction in price stimulates a considerable increase in the quantity of goods demanded, the demand is said to be more elastic than if the same price reduction produces a smaller increase in the quantity demanded.

It is very difficult to make meaningful *quantitative* judgments about the elasticity for a particular commodity. Economists must, therefore, usually content themselves with making general *qualitative* judgments about the elasticity for various goods, as the following examples show.

Demand for cigarettes seems relatively inelastic, whereas demand for color television sets may be elastic over a broad range of prices. In other words, it is doubtful if increasing the tax on cigarettes, with a corresponding rise in retail price, would discourage a great deal of smoking. In general, demand tends to be inelastic for those goods on which consumers spend small percentages of their incomes, such as cigarettes, salt, and pencils. It seems probable, however, that abolition of the 10 per cent levy on color television sets, were the reduction passed on to the consumer, would encourage purchases of color televisions by persons who will not buy sets at the present higher prices. Again, however, such judgments are necessarily subjective.

A third consideration is the levy's incidence, that is, who bears the burden of the tax and hence who would benefit from a reduction in the tax. If taxes borne by low-income individuals are reduced, then money would be left in the pockets of people more likely to spend new funds.[1] A reduction benefiting higher-income groups would perhaps mean less of an absolute increase in spending because high-income individuals tend to save a larger percentage of their income than low-income persons. By the same token, reduction of a tax previously borne by corporations, the proceeds from which were used to build cash balances, would be less stimulative than if the funds released went to corporations which paid them out in dividends, spent them on new plant and equipment, or reduced prices.

Repeal of certain taxes is not the only possibility. Congress may choose to reduce certain rates, raise some, or impose taxes on goods not already taxed by the Federal Government. There has been discussion outside the administration, for example, of lowering some manufacturers' excises to 7 or 5 per cent from 10 per cent, particularly the levy on automobiles. The table following shows how much revenue would be released by a one percentage point reduction in the tax rates on selected commodities. Under certain conditions, the table shows, a tax cut of 1 per cent of the automobile levy, for example, would release more revenue than a 5 per cent cut of the tax on radios and television sets. This kind of calculation permits comparisons among different reduction packages with regard to their potential effects on the nation's economy.

Taking the above-mentioned factors into consideration, we can make some statements as to what cuts might, theoretically, give more and less stimulus. More stimulus might come from elimination or reduction of a tax which released large absolute dollar amounts into the hands of consumers with a high propensity to consume wide ranges of products. An example of this might be elimination of the Federal excise on automobiles, which yielded $1.75 billion in revenue in the past fiscal year.[2] Automobile manufacturers point to the large amount of money that would be released and say that any reduction in this 10 per cent manufacturers' excise levy will benefit consumers.

Less stimulation would probably come from abolition of a low-yield tax, the released revenue from which would go to individuals or businesses with a low propensity to consume. One example of such a reduction might be abolition of the levy on club dues which affects mainly higher-income groups. Persons with high incomes tend to spend a lower percentage of their income than low-income individuals. Another

TABLE 2

REVENUE RELEASED PER PERCENTAGE POINT REDUCTION IN TAX*

(in thousands of dollars)

Automobiles (10 per cent)	$174,597
Gasoline (4c per gallon)	72,732
General telephone service (10 per cent)	53,059
Retail excises (10 per cent)	47,501
Toll telephone service, telegraph, cable, radio, etc. (10 per cent)	37,961
Trucks and buses, chassis, bodies, etc. (10 per cent)	35,095
Parts and accessories for automobiles, trucks, etc. (8 per cent)	28,595
Air transportation of persons (5 per cent)	21,212
Radio and television sets, phonographs, components, etc. (10 per cent)	19,760
Electric, gas, and oil appliances (5 per cent)	15,515
Refrigerators, freezers, air conditioners, etc. (5 per cent)	12,560
Business and store machines (10 per cent)	7,187
Electric light bulbs and tubes (10 per cent)	4,151

* Derived from data in **Treasury Bulletin:** December, 1964.

[1] Past experience has shown that the average American consumer tends to spend about 92 per cent of his income.

[2] Although the Administration has not mentioned this levy as a target for reduction, considerable pressure is being brought to bear on Congressmen to reduce or abolish this tax. Automobile makers talk about a 9-million-car year if the tax is abolished.

example might be abolition of the manufacturers' excise tax on matches, which yields only $4 million. Demand for matches tends to be very inelastic over a wide range of prices.

Stimulus to the economy, however, will be only one factor Congress will consider in the coming weeks. In some cases non-revenue factors may be more important in determining the fate of a levy. Let us look at some of these considerations and the taxes on which they bear.

Non-revenue considerations

In his budget message the President emphasized the reform aspects of his proposals. In particular, he mentioned those excises "costly and inefficient to administer," those which "impose onerous recordkeeping burdens on small business," and those which "distort consumer choices as among different kinds of goods." Some of the levies which might fall in one or another of these categories are discussed below.

One levy costly to collect is the tax on cabaret admissions. This tax presents problems because it must be collected from a large number of taxpayers, and in relatively small dollar amounts from each. One estimate puts collection costs of this levy at several times those of most other excises. Other levies costly to collect are the retail excises on furs, jewelry, toiletries, and luggage. These, also, are collected from thousands of individual taxpayers, who in turn collect the tax from millions of customers.

Compliance is difficult for storekeepers, particularly drug store owners. The House Ways and Means Committee heard testimony that payment of these taxes is difficult because so many items are involved. At the retail level, usually, collection from customers is only as good as the clerk behind the counter. One result is that audits of taxpayer returns frequently show excise collections below what sales data would indicate. This causes friction between revenue agents and retailers who are trying to comply with the law.

Bookkeeping difficulties have not been the bane of small businessmen alone. A major oil company, for example, points out that payment of the manufacturers' excise levy on lubricating and cutting oils is complicated by the existence of "hundreds of interpretations" of the law.

The President also referred to levies which "distort" consumer selections. Of course *any* tax distorts consumer choice to some extent. Some taxes, however, are probably more immediately guilty than others. An example of such a tax, its opponents claim, is the 10 per cent tax on cameras and photographic equipment. Camera manufacturers and distributors complain that the levy discriminates economically against camera "bugs" because it taxes one form of recreation and not others. Phonograph-record makers complain that the excise duty on their products discriminates against them because books and magnetic tape, for example, are not taxed.

The retail excise on fur goods was attacked by fur-garment makers on the grounds that it taxed their products but not perhaps equally luxurious garments which had no fur on them. Makers of women's handbags are unhappy about a tax on what they consider a necessity. "The tax [on handbags] is discriminatory. The pockets of the fair sex are taxed; those of the male are tax free. This is contrary to the American concept of basic fairness."[3] Excise levies apply to men's wallets, but not usually to trouser pockets.

[3] Burton S. Wirtschafter, Director, National Authority for the Ladies Handbag Industry, in U.S. Congress, House, Committee on Ways and Means, **Federal Excise Tax Structure,** 88th Congress, 2d session, 1964, p. 240.

Business excise taxes

Another group of levies under heavy fire consists of taxes on equipment and supplies used by businesses. Some tax authorities argue that business equipment and supplies should not be subject to excise taxation because goods used in production are not "consumed" in the same way that hair spray, for example, is consumed by a housewife. Rather, they argue, goods currently taxed such as light bulbs, business machines, lubricating oils, and the like, are used by businesses in the production of other goods; and the taxes, opponents say, place an unfair burden on firms using these goods. Insofar as the tax burden is sometimes passed on to the final consumer, of course, manufacturers do not really shoulder the tax load, and in these cases the above argument would be less persuasive.

If Congress, however, concurs with the opponents of business excises, the 10 per cent tax on business and store machines might be reduced or repealed. Similarly, the tax on electric light bulbs—of which businesses are big users—might be abolished, as might the 10 per cent levy on general telephone use and long-distance calls. Telephone taxes have been criticized on the grounds that (a) large numbers of telephone calls are made by business firms as an essential part of daily commercial operations, and (b) the tax is no longer needed to perform its initial function of discouraging telephone use in a time of war.[4]

Appearing before the Ways and Means Committee, Professor John F. Due of the University of Illinois gave "top priority for repeal" to, among other items, the tax on lubricating and cutting oils. He pointed out that the portion of the tax collected from business concerns is objectionable because businesses should not be subjected to excise taxation on goods they use, essentially for the reasons discussed above. Moreover, he argued, the portion of the tax falling on non-business users is undesirable because those taxpayers are satisfactorily taxed by the gasoline levy.

"Undesirable" consumption discouragers and low-yield taxes

Other levies have been attacked for tending to discourage activities generally considered desirable. In this group are frequently included taxes on musical instruments and on theater and concert admissions. Yielding about $20 million annually, the levy on musical instruments has been criticized because it may tend to discourage musical instruction in some families.[5] Admissions taxes have been criticized for discouraging attendance at cultural events. At least in the case of the Broadway theater, the tax falls on an industry that has operated in the red for several years. David Merrick, the Broadway producer, testified that "elimination of the crippling admission tax would be a most effective immediate measure in moving toward the revitalization of the living theater. It would be a concrete demonstration of recognition of the importance which we place on cultural achievement."[6]

There are several excise taxes which have received attention as possible candidates for elimination on the grounds that they produce

[4] Opponents of a reduction or elimination of the telephone levies cite two key reasons why the 10 per cent tax should not be adjusted this year. First, they note, domestic telephone companies are prospering, and do not "need" tax relief at this time. Second, the telephone levies might be good ones to retain until the economy shows signs of slowing down because abolition of the taxes would then pump almost $1 billion into the stream of economic activity.

[5] Professor Due noted in his presentation before the Committee that musical instruments are used by many persons to earn a living, and the tax is in part a business excise tax and, therefore, undesirable.

[6] On behalf of National Association of the Legitimate Theatre, Inc., and the League of New York Theatres, Inc., in U.S. Congress, **op. cit.**, p. 1185.

insignificant revenue, and so are not worth the cost of collection because of the inconvenience which collection causes. Among such taxes are those on matches (yielding about $4 million annually), mechanical pencils, fountain pens, ball-point pens, and lighters ($9 million), playing cards ($9 million), and safe-deposit-box rentals ($7 million). Their combined yields of about $29 million annually constitute about .02 per cent of estimated budget receipts in the coming fiscal year, and .21 per cent of estimated excise receipts in the same period.

Unlikely candidates

There are several taxes that have not been mentioned often as targets for reduction or elimination. Indeed, some of them may actually be raised. These levies fall into three classes: sumptuary, user, and regulatory.

Sumptuary taxes are levied in part to discourage consumption of goods which some persons consider undesirable. Tobacco and alcohol excises have long been grouped in this category. In addition to serving a sumptuary purpose, these two levies produced $5.6 billion in revenue last year. There are two economic arguments in favor of these taxes. First, because of the relatively inelastic demand for these goods, a tax on them probably does not distort production and consumption patterns as much as a tax on a good for which demand might be more elastic. Second, some maintain, there is a real social cost to the use of tobacco and alcohol which is not fully reflected in the selling price; this cost is said to be the manhours lost to alcoholism and other illnesses.

User fees were singled out by the President in his budget message. "Fairness to all taxpayers demands that those who enjoy special benefits should bear a greater share of the costs," he said. In revenue terms the most important user fee is the 4 cents per gallon tax on gasoline, receipts from which go mainly into the Highway Trust Fund. Other levies benefiting the Fund include those on tires, tubes, rubber, and vehicles over 26,000 pounds. As the President further noted in his budget message, the estimated cost of completing the Interstate Highway System has increased by $5.8 billion. Accordingly, he said, he will include in his proposals "specific recommendations for increasing certain highway user charges."

Another user fee unlikely to be eliminated is the 5 per cent tax on domestic airline tickets. Proceeds of this tax are used to offset in some measure the funds the Federal Government has spent to assist commercial air transportation in this country.

Several taxes have regulatory functions as their *raison d'etre*. Payment of these levies by taxpayers provides the Government with a record of transactions in certain goods. The levies in this classification have not been widely mentioned as targets for reduction or elimination and include those on narcotics, marihuana, firearms, documents, adulterated and processed butter and filled cheese. The revenue produced by most of these duties is low, with the exception of the stamp tax on documents which contributed $163 million to the Treasury in fiscal 1964.

Outlook

The excise tax structure in this country remains complicated despite legislative efforts since the Korean War to make the code more nearly uniform with respect to rates and other requirements. Hundreds of different items are taxed at different rates and for different reasons. In its deliberations Congress will have in mind many factors affecting each tax—some fiscal, some technical and administrative, some political.

At present the outlook for excise tax reduction and reform this year seems bright. The Administration does face two major problems in requesting such a reduction, however. First, Congress will be, and is already, under pressure to exceed the requested $1.75 billion package. Secretary of the Treasury Dillon has stated that a $2 billion cut probably would not be inflationary, but that a reduction of $3 billion might well be. Concern over incipient inflationary pressures may be one reason the Presidential request was smaller than generally had been anticipated. Secondly, the list of proposed items must be presented to the House Ways and Means Committee, and acted on by that body and the entire House, within a relatively short time, or many fear a general buyers' "strike" against goods whose taxes might be reduced or abolished. Already there are reports that some consumers are awaiting the outcome of the House deliberations before making major expenditures on goods whose taxes might be affected. One widely discussed possible solution may be a system of rebates to persons who purchase affected goods before a reduced price goes into effect. This might prove effective at the manufacturers' level and on big-ticket items, such as automobiles, but retailers seem skeptical about application of such a system for small items on which the tax is but a few cents or a few dollars.

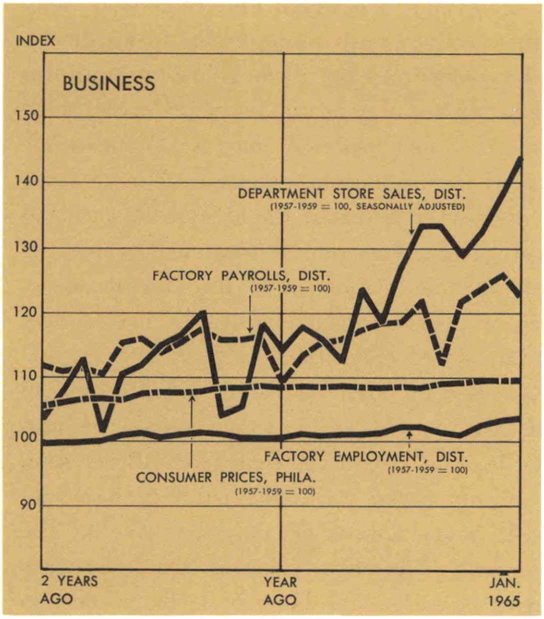
Not everyone, however, is in favor of cutting excises without some compensating adjustments. The President, as noted above, has indicated that some excises may be raised. The Chamber of Commerce of the United States reiterated its position last summer: "For many years the national chamber has urged the Congress to eliminate selective excise taxes—except in wartime—and to substitute for them a low-rate uniform excise tax on all goods and services except medicine, rent, and food consumed 'off premises.' "[7] One of the arguments against a national sales, or excise, tax is that it would squeeze state and local governments out of what has evolved as their taxable domain. For this reason alone, such a proposal would probably meet heavy Congressional opposition.

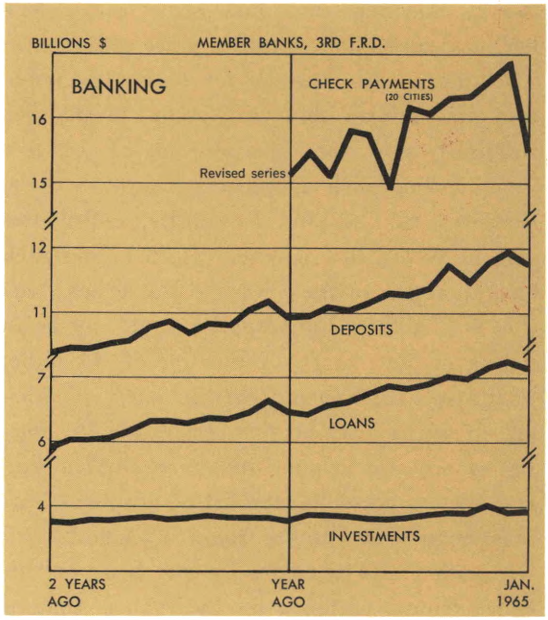
Another proposal has been that rather than eliminate certain excises, they should be lowered to, say, 7 or 5 per cent, from 10 per cent. In certain cases, the Administration has indicated, some reductions may be sought. The President made clear, however, that a primary reason he seeks cuts this year is that collection and compliance problems in some areas are inordinately difficult. Reduction rather than elimination probably would not solve these problems.

Whatever the final package that emerges from the House deliberations, the key fact is that for the first time the Administration, Congress, manufacturers, consumers, and economists have demonstrated considerable unanimity of opinion and are prepared to act on this consensus. How much stimulus the final cut will give the economy and to what extent increased state levies will offset any stimulative effects of a Federal cut remain unknown. But at least it seems virtually certain that a modest reform of the Federal excise tax structure will take place this year. This will be viewed favorably by many interest groups, not least by consumers.

[7] Joel Barlow, chairman, committee on taxation, Chamber of Commerce of the United States, **Ibid.**, p. 124.

FOR THE RECORD...





SUMMARY

	Third Federal Reserve District		United States	
	Per cent change		Per cent change	
	Jan. 1965 from		Jan. 1965 from	
	mo. ago	year ago	mo. ago	year ago
MANUFACTURING				
Production	....	....	0	+ 8
Electric power consumed	− 1	+ 9	....	....
Man-hours, total*	− 2	+10	....	....
Employment, total	− 0	+ 3	....	....
Wage income*	− 2	+12	....	....
CONSTRUCTION**	−10	− 4	−13	− 7
COAL PRODUCTION	+16	+ 1	− 1	+ 2
TRADE***				
Department store sales	−59	+11	....	....
Department store stocks	....	....	....	....
BANKING (All member banks)				
Deposits	0	+ 8	− 3	+ 9
Loans	0	+10	− 2	+13
Investments	+ 2	+ 4	− 1	+ 3
U.S. Govt. securities	+ 2	− 1	− 2	− 2
Other	+ 3	+13	+ 1	+13
Check payments***	− 8	+ 2	− 3	+ 4
PRICES				
Wholesale	....	....	0	0
Consumer	0‡	+ 1‡	0	+ 1

*Production workers only.
**Value of contracts.
***Adjusted for seasonal variation.

‡Philadelphia

LOCAL CHANGES

	Factory*				Department Store†		Check† Payments	
	Employ-ment		Payrolls		Sales			
	Per cent change Jan. 1965 from		Per cent change Jan. 1965 from		Per cent change Jan. 1965 from		Per cent change Jan. 1965 from	
	mo. ago	year ago	mo. ago	year ago	mo. ago	year ago	mo. ago	year ago
Lehigh Valley	+ 3	+ 6	+ 5	+21	....	....	− 7	+ 5
Harrisburg	+ 1	+ 4	0	+19	....	....	− 3	+ 9
Lancaster	− 1	+ 4	− 2	+16	−58	+10	− 8	+13
Philadelphia	− 1	+ 2	− 3	+10	−59	+11	−10	+ 2
Reading	0	+ 2	0	+11	−56	+16	−16	0
Scranton	− 1	+ 1	0	+ 9	−65	+11	− 6	+ 8
Trenton	0	+ 1	0	+ 2	−60	− 1	+ 6	−14
Wilkes-Barre	+ 1	+ 6	+ 1	+18	−64	+12	+ 3	+10
Wilmington	0	+ 6	− 7	+11	−61	+15	− 5	+ 5
York	− 2	+11	− 1	+25	−61	+21	−11	+ 4

*Not restricted to corporate limits of cities but covers areas of one or more counties.
†Adjusted for seasonal variation.