BUSINESS REVIEW

FEDERAL RESERVE BANK OF PHILADELPHIA FEDERAL RESERVE BANK OF PHILADELPHIA

June 1969

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A Balance Sheet For The Value-Added Tax

by Edward G. Boehne

A taxpayers revolt is brewing. That was the warning issued last January by then Secretary of the Treasury Joseph W. Barr. Whether or not a full-scale "revolt" will occur, there are signs of a confrontation shaping up between taxpayers and the "system." Legislators as well as administration officials have seen these signs and have moved to institute some reforms. Although the popular emphasis for tax reform is focused on closing "loopholes" in the personal income tax, proposals for reform of business taxes are being given attention as well. The most far-reaching proposal is to substitute a value-added tax (VAT) for the corporate income tax.

VAT—WHAT IS IT?

Adding value is what the production process is all about. A few handfuls of wheat are of little value to a housewife—but if that wheat is transformed, stage by stage, into a loaf of bread, it has value to her. The value-added tax is, not surprisingly, a tax on the value added during the production process.

An individual firm may calculate the value it adds to a product by subtracting from its net sales the purchases (including acquisitions of capital goods) it makes from other businesses. For example, as seen in the diagram, the baker purchases all the ingredients for a loaf of bread from a miller for a dime. The baker makes the dough, bakes the loaf, and sells the bread to the grocer for 22 cents, thus adding 12 cents of value to each loaf of bread.

What does this added value consist of? In broad terms, it consists of labor inputs, capital inputs, and managerial inputs. So, the 12 cents

BUSINESS REVIEW is produced in the Department of Research. Evan B. Alderfer is Editorial Consultant; Ronald B. Williams is Art Director. The authors will be glad to receive comments on their articles.
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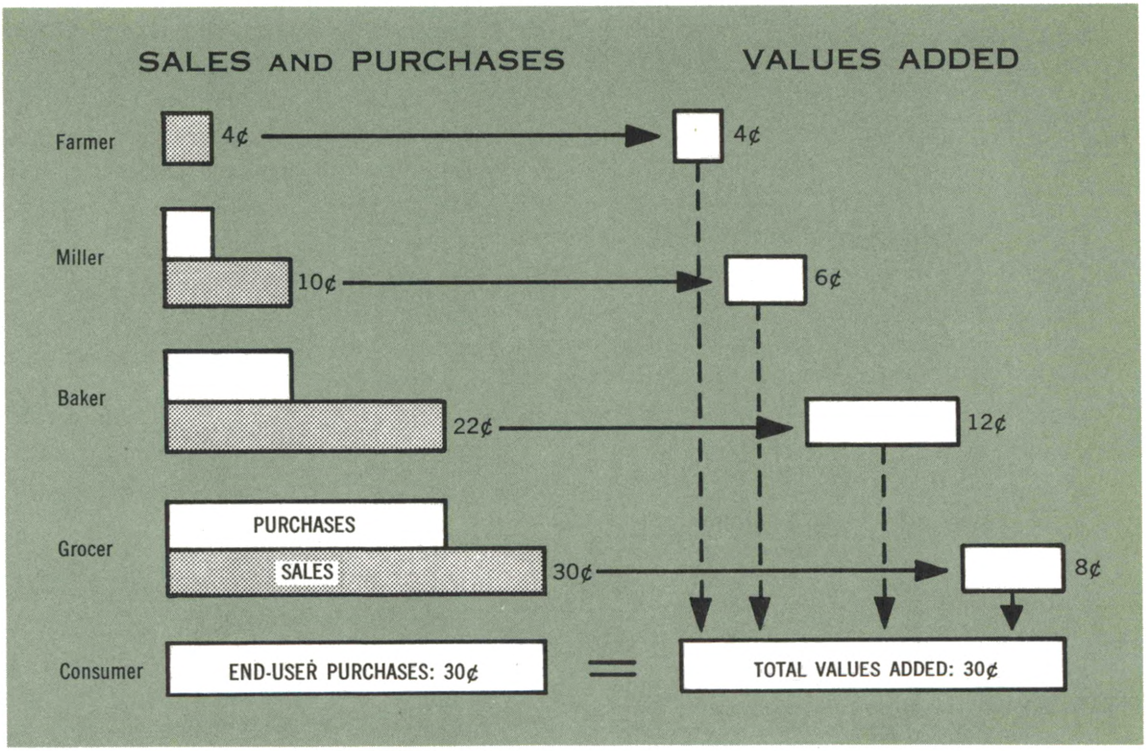


the baker receives for his value added would be used to pay wages and salaries, interest and rents, as well as a profit to the baker.

As far as the baker is concerned, it is on the 12 cents that a VAT is levied. Say the baker bakes 5,000 loaves a day. Ingredients cost him $500 (.10 x 5,000) and his sales revenue is $1,100 (.22 x 5,000). The difference, $600, is the value added by the baker to the bread loaves. If the VAT rate were 1 per cent, the baker's tax would be $6.

From the standpoint of the whole economy, VAT is similar to a multi-stage sales tax. Again looking at the diagram, we find, not surprisingly, that the price the final consumer pays for the loaf of bread is equal to the sum of all the values added at each stage of production from farmer to grocer. Hence, whether a 1 per cent VAT rate is levied on increments to value at each stage of the production process or on the end-user purchase, the amount of revenue collected is the same.[1]

EXPERIENCE WITH VAT

VAT is a fiscal innovation of this century, apparently first recommended to the German

[1] In Europe, notably in France and Germany, VAT supplanted so-called turnover taxes. A turnover tax is a levy on gross sales. The miller in the diagram, for example, would be taxed on his total sales to the baker, not just on the value-added part. With a turnover tax, therefore, there is the incentive to integrate vertically, in other words, to reduce the number of firms by combining productive functions within one company. If the grocer owned the baker, say, the turnover tax per loaf of bread would be reduced. A single-stage sales tax does not have this anti-competitive effect. Rather than adopting a single-stage tax, however, Europeans accepted the VAT compromise—which is multi-staged, like the turnover tax, but whose base adds to that of a single-stage sales tax.

Variations on the VAT Theme

There are two ways to calculate VAT. One, as suggested in the text, is to subtract purchases from other businesses from net sales. The other is to sum factor payments (wages, salaries, rents, interest, and profits). Both the addition and subtraction methods will yield the same tax base for individual firms, as well as for the aggregate of all firms, provided capital purchases are depreciated over time in accordance with their current contribution to production. On the other hand, if capital costs are written off in the period of purchase, as is generally recommended and assumed elsewhere in this article, the tax bases computed by the addition and substraction methods are not equivalent. In social accounting terms, the addition of factor payments sums to national income. The subtraction method, in contrast, yields a tax base which might be called "national consumption." And if Government consumption would be tax-exempt, as is likely, the subtraction method of calculating VAT would yield a tax base equal to personal consumption.

The advantages for businessmen of the subtraction method, with capital costs written off in year of purchase, are clear. A quick write-off increases the rate of return on investment as well as increasing the internal flow of funds in the year of purchase. In the aggregate, of course, investment would be stimulated.

Government at the end of World War I. In the United States, it was proposed first in the early '20's as an amendment to the Revenue Act of 1921, though never enacted. Michigan passed a modified VAT in 1953 in lieu of a corporate income tax, but it was repealed in 1967.

In Europe VAT has been more successful. France introduced it in 1954. The European Common Market, after lengthy study, agreed two years ago to adopt VAT for the entire Community by 1970. Denmark adopted the tax in 1967, followed by Sweden and Austria this year, and Britain apparently is reconsidering its decision not to adopt this type of tax.

Outside Europe, though, VAT has not fared so well. Canada rejected it on grounds that it was an inferior substitute for a retail sales tax. Japan passed VAT legislation in 1950, although it was never activated and finally repealed in 1954.

VAT VS. CORPORATE INCOME TAX

The economic effects of a tax depend on who bears the final burden, or incidence, of the tax rather than who pays the tax. Unfortunately, determining the incidence of a tax is difficult. The corporate income tax, for example, is levied on profits and paid to the Internal Revenue

Service by corporations. But is the burden of this tax actually borne by corporations and their stockholders, or do corporations raise their prices so that, in effect, incidence is shifted forward to consumers? Similarly, VAT would be levied on value added by business firms and paid by them to the Government. But, again, would the actual burden be shifted forward to the consumer in the form of higher prices (as would be the legislative intent, as in the case of a sales tax) or backwards to profit recipients?

Unfortunately, economic theory does not provide a clear-cut answer to the incidence question because numerous shifting results are possible, depending on one's assumptions. The critical assumptions affecting incidence are the sensitivities of labor and of capital owners to changes in wages and rates of return, sensitivity of consumers to price changes, and competitiveness of the economy. In a highly competitive economy with unemployed resources, for example, it would be more difficult to pass along increased business taxes than it would be if markets were not fully competitive and consumer demand buoyant.[2]

Empirical studies have been no more conclusive than theoretical ones. One approach focused on behavior of rates of return on investment, and concluded that the corporate income tax is shifted forward in the form of higher prices to consumers.[3] But another study, which stressed the relative shares of pre-tax income going to labor and capital, concluded that the corporate tax is not shifted forward and thus is borne by stockholders.[4]
Using still another model based on markup pricing techniques, a more recent study concluded that the corporate income tax generally is not shifted, although some forward shifting does occur in some industries.[5]

So, there is no consensus among economists about the incidence of the corporate income tax; and, although less attention has been paid to the incidence of VAT in the United States, the likelihood of a consensus on this question is remote as well. Yet, the incidence question is crucial in discussing the main issues, like international competitiveness, surrounding a substitution of VAT for the corporate income tax.

International competitiveness. The increasing use of VAT in Europe is largely responsible for its rising popularity as an alternative to the corporate income tax in the United States. Under international trading agreements, sales-type taxes such as VAT are rebated on exports by the producer country and levied against imports by the consuming country.[6] In contrast to this destination principle which is applied to consumption-type taxes, the origin principle is applied to income taxes. This means an income tax is levied by and paid to the producer country. No rebates are allowed on exports

[2] The literature on tax incidence is voluminous. An interested reader, however, may find the following useful as an overview and starting point: John Due, *Government Finance: Economics of the Public Sector,* fourth edition, Richard D. Irvin, Inc., Homewood, Illinois, pp. 222-226, 1968.

[3] M. Krzyzaniak and R. A. Musgrave, *The Shifting of the Corporation Income Tax,* Johns Hopkins Press, Baltimore, 1963.

[4] Challis Hall, Jr., "Direct Shifting and the Taxation of Corporate Profits in Manufacturing, 1919-59," *Proceedings of the American Economic Association,* 1963, pp. 258-271.

[5] R. J. Gordon, "The Incidence of the Corporate Income Tax in U.S. Manufacturing, 1925-62, *American Economic Review,* September 1967, pp. 731-758.

[6] Adjustments in border taxes can be used also as a substitute for altering currency exchange rates. West Germany applied this technique in 1968 in lieu of an upward revaluation of the mark.

Border-tax adjustments for exports and imports are governed by the General Agreement on Tariffs and Trade (GATT).

and no border taxes are added to imports in the case of income taxes. Therefore, it is claimed that countries like the United States, which rely heavily on income taxes, are at a competitive disadvantage compared to nations relying more on sales-type taxes like VAT. Thus, it is argued, substituting VAT for all or part of the corporate income tax would improve the competitive advantage of the United States in world trade.

But would substitution of VAT for the corporate income tax really improve the competitiveness of United States' products? The answer is *yes,* if the burden of the corporate tax is shifted forward in the form of higher prices. The answer is *no,* if the tax is not shifted forward and prices are not higher because of the tax.

As a simple example, think of two corporations—one American, one German—competing against each other in the world market for farm tractors. On average, the profits tax per tractor for the American firm is $20. The VAT is $20 per tractor for the German firm. VAT is not included in the overseas selling price of the German tractor because it is rebated by the German Government when each tractor is exported. The corporate income tax, however, is not rebated; thus, if the American firm attempts to pass on its profits tax in the form of higher prices, it will be at a competitive disadvantage. On the other hand, if the tax is not passed on, the American firm is at no competitive disadvantage because of a higher selling price resulting from taxes.

So, the case for VAT on international grounds rests on the assumption that the corporate income tax causes higher selling prices, and consequently contributes toward making our goods less competitive abroad.

Equity considerations. Would a shift to VAT reduce the over-all progressivity of the federal tax structure?[7] Again, the answer depends on who bears the burden of the corporate income tax and VAT. A switch from a corporate income tax that is shifted backward to a forward-shifted VAT would result in lower-income people bearing a higher percentage of business taxation, for two reasons. First, dividend income accounts for a larger share of higher incomes than it does for lower incomes. Hence, to reduce the tax on income from stocks is to reduce the tax burden of higher-income recipients. Second, a switch to a forward-shifted VAT would place a higher tax burden on consumers because of higher prices generated by VAT. Consumption-type taxes tend to be regressive because lower-income families spend a larger share of their incomes than do high-income families. Therefore, VAT increases the tax burden of lower-income families.

But, if the corporate income tax is shifted forward already in the form of higher prices to consumers, then a switch to a forward-shifted VAT would have little effect on the over-all burden of federal taxation. Likewise, there would be little effect on equity if both VAT and the corporate income tax did not produce higher prices to consumers. The unlikely case of a corporate income tax which is shifted forward being supplanted by a backward-shifted VAT actually would reduce the burden of business taxation on poorer people.

Intergovernmental aspects. Although separation of revenue sources is not strictly adhered to in the United States, in general each level of

[7] A tax structure is progressive when the average tax rate increases as income rises. In contrast, a tax structure is regressive when the average tax rate decreases as income rises. A tax structure is proportional when the average tax rate is the same for all income levels.

Government zeros in on a particular source of revenue. The Federal Government relies heavily on income taxes, states on consumption or sales taxes, and localities on property taxes. Even with higher sales and property tax rates, however, there is a widening gap between expenditure responsibility and taxing ability at the state and local levels. At a time when attention is focused on channeling federal tax dollars to states and localities to help close this gap, is it consistent to supplant an income tax with a sales-type tax at the federal level?

The crucial issue again is who really pays the corporation income tax and who would pay VAT. To drop a corporate income tax whose burden is borne by stockholders for a VAT which boosts prices would undermine the revenue-raising capabilities of states by placing yet another tax on already strained sources. On the other hand, if the corporate income tax presently is shifted forward to consumers, substitution of VAT would do little more than give official sanction to a sales-type business tax at the federal level.

Alleviating domestic distortions. Taxation reduces the ability of individuals and businesses to purchase goods and services and thereby transfers productive resources to the public sector. In addition, taxation also may affect the patterns of private production and consumption. For example, a tax on tea but not on coffee would cause some tea drinkers to substitute coffee in order to avoid the tea tax. Similarly, a tax on labor but not on capital would cause producers to substitute capital for labor wherever possible. Almost without exception, all taxes have some distorting effects on the private economy, but some have more than others. Except when specific social objectives are being sought (for example, encouraging charitable contributions), a cardinal tenet of tax policy is to minimize these distorting effects by making taxes as neutral as possible.

Both the corporation income tax and VAT violate this principle of neutrality and therefore alter private decision-making. But VAT is guilty of fewer violations and hence generally stands above the corporate tax no matter the direction of incidence-shifting. A few examples follow which compare the effects of the corporate income tax and VAT on business decision-making. In these examples, it is assumed that VAT raises prices for consumers.

(1) The corporate income tax hinders efficiency by taxing profitable firms more than unprofitable ones. A shift to VAT would redistribute business taxation from firms with a high ratio of profits to value added to firms with a low ratio of profits to value added. If VAT replaced a corporate income tax which is not shifted forward, a dollar saved because of increased efficiency would generate an additional dollar of profit without additional tax liability. Similarly, a dollar lost because of inefficiency would decrease profits by a dollar with no corresponding decrease in tax liability. On the other hand, if the profits tax is shifted forward to consumers, VAT would allow efficient firms to pass along the entire savings in the form of price reductions to consumers instead of just the after-tax savings which is now the case. In effect, VAT in comparison with a profits tax rewards efficiency and penalizes inefficiency.

(2) Expenditures related to servicing debt capital are deductible under the corporate income tax; whereas, of course, payments

to stockholders are not. VAT, in contrast, does not discriminate between equity and debt capital, thus leaving the method of financing free of distorting tax effects.

(3) VAT most likely would have a wider coverage than the corporate income tax in terms of business organization. Unincorporated businesses, typically in farming and professional services, would bear a larger share of business taxation with VAT. Hence, the decision as to the type of business entity would be less affected by tax considerations.

(4) A shift to VAT also would stimulate investment because capital expenditures would be deductible in the year of purchase rather than depreciated over time as they are with corporate income tax. Immediate tax write-off of capital costs increases both the rate of return on investment as well as business savings. Although in periods of protracted unemployment, more automation may not be socially desirable, over the longer haul it would bolster economic growth.

THE NET WORTH OF VAT

A rational discussion of substituting VAT for all or part of the corporate income tax involves the question of who actually bears the burden of these two taxes. Economic theory is generous with conclusions, depending on one's assumptions about various supply and demand factors. Empirical studies, particularly on the incidence of the corporate income tax, also provide conflicting results. So, we conclude that VAT would be beneficial for international competitiveness if the corporate income tax is shifted forward to consumers in the form of higher prices but not helpful if the corporate tax burden is borne by profit recipients. When we look at equity considerations, poor groups in society probably could not be helped directly by VAT, but they could be hurt if VAT supplanted a corporate income tax that is shifted backward. Likewise, adoption of VAT would place additional stress on the consumption tax base of states only if the existing corporate tax were shifted backward.

When we look at the comparative effects of the corporate tax and VAT on business decision-making, VAT is clearly the more neutral. VAT would not discriminate against equity financing; it would encourage, not penalize efficiency; and it would not influence the type of business organization. VAT would stimulate investment—and thus would not be neutral in this regard, but non-neutrality in this instance is defensible. Hence, VAT comes out on top in the important area of business decision-making.

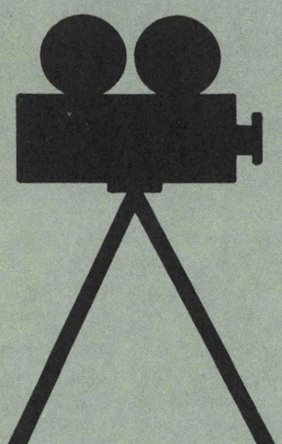
But what of the uncertainties hanging over international, equity, and intergovernmental aspects of substituting VAT for the corporate income tax? A reasonable view, although still conjectural, is that the corporate income tax as well as VAT are shifted both ways—partially forward in the form of higher prices to consumers and partially backward to stockholders in the form of lower profits. The division and speed of the shifts are determined by economic characteristics of specific industries and firms, and by the state of the general economy.

If one accepts this view, then in addition to its advantage for business decision-making VAT makes sense for improving the competitiveness of United States exports. Further, the impact on equity of switching to VAT appears minimal, as does the impact on the tax-raising abilities of state and local governments. In short, VAT appears to be a strong challenger to the corporate income tax.

A nagging thought remains, however. VAT

is levied like a multi-stage sales tax, but the economic effects appear much like those of a single-stage sales tax. This multi-stage characteristic makes sense in Europe because of the long history of turnover taxes. Perhaps VAT has the markings of compromise in the United States as well between those who want an obvious business tax and those opposed to a retail sales tax at the federal level. But we ought to be careful in fiscal reform that we do not become so enamored with the wrappings of tax proposals that we fail to examine carefully the contents of the package. Otherwise we may be stuck with an inferior substitute.

NOW AVAILABLE: FILM STRIP ON TRUTH IN LENDING



A film strip on Regulation Z, Truth in Lending, for showing to groups of creditors has been developed by the Board of Governors of the Federal Reserve System.

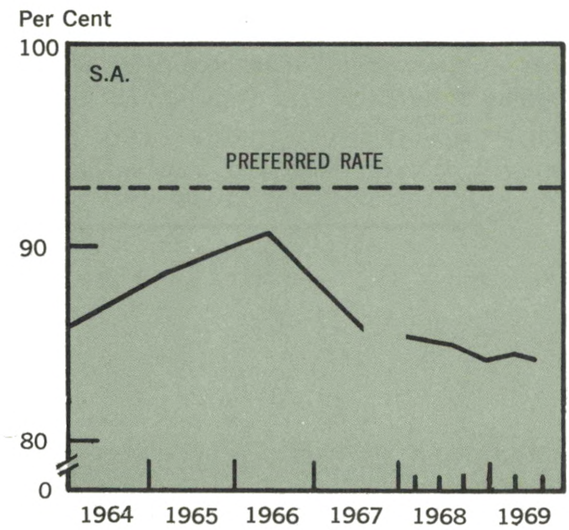
The 20-minute presentation is designed for use with a Dukane projector which uses 35mm film and plays a 33 RPM record synchronized to the film. Copies of the film strip can be purchased from the Board of Governors of the Federal Reserve System, Washington, D. C. 20551, for $10.00. It is also available to creditors in the Third Federal Reserve District without cost except for return postage.

If you are a creditor in the Third District, you may direct requests for loan of the film to Truth in Lending, Federal Reserve Bank of Philadelphia, Philadelphia, Pennsylvania 19101. Such requests should provide for several alternate presentation dates.

Optimism and Inflation Spur Business Investment

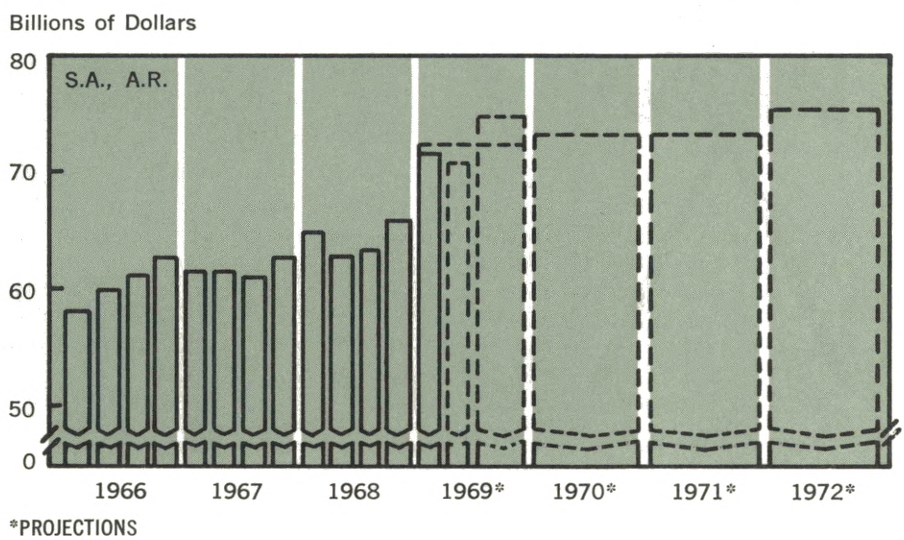
by Marlene G. Doak

CAPACITY UTILIZATION IN MANUFACTURING



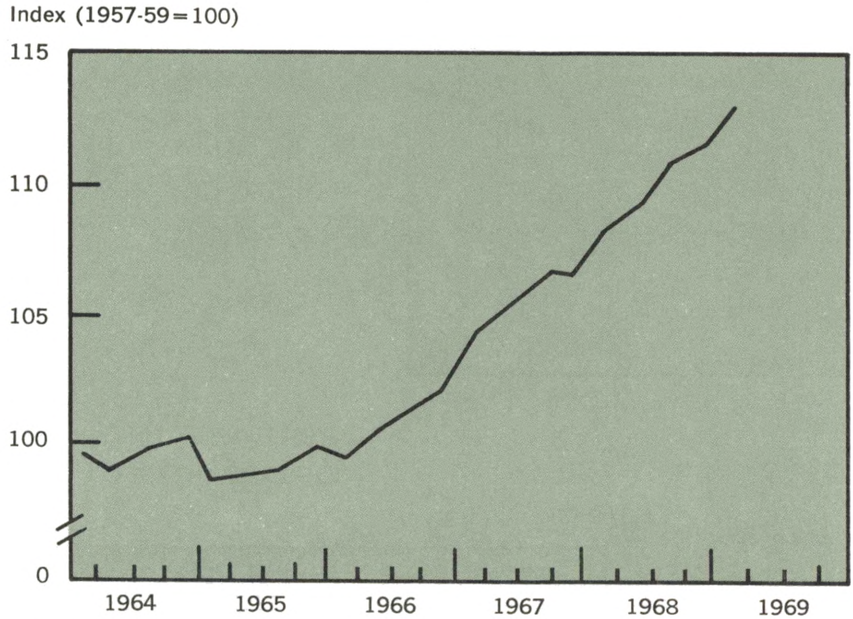
Although capacity utilization has been trending downward, . . .

PLANT AND EQUIPMENT EXPENDITURES



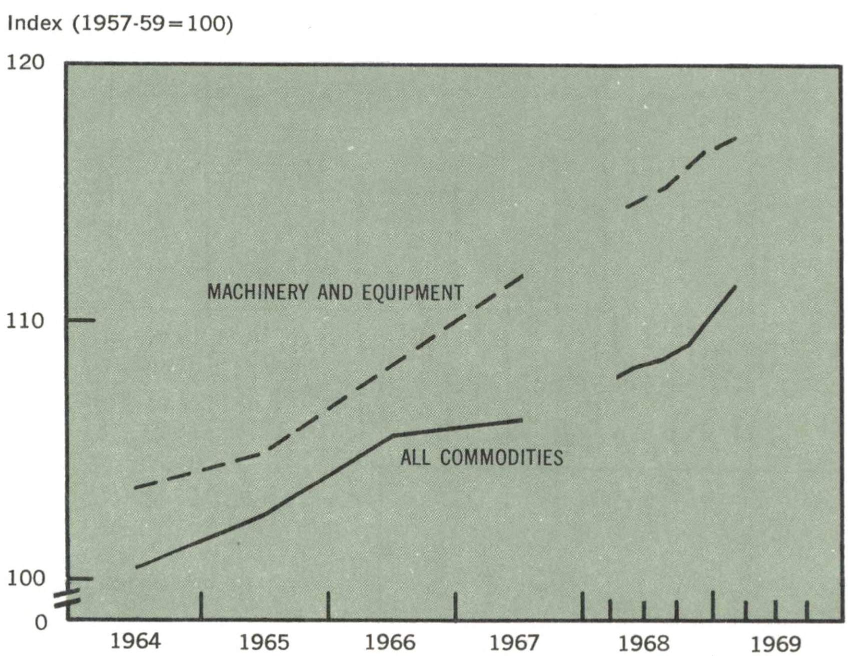
businessmen plan higher capital outlays.

LABOR COST PER UNIT OF OUTPUT



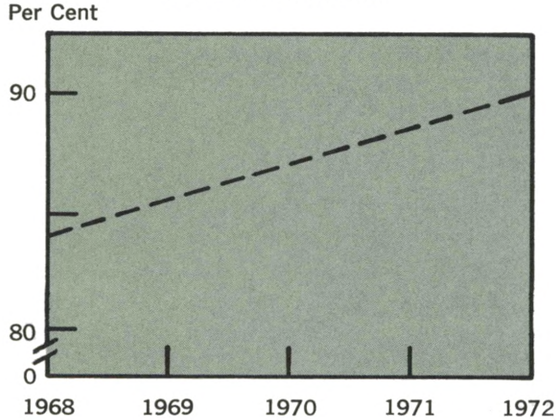
In part, businessmen are attempting to offset rising costs with more efficient plant and equipment . . .

WHOLESALE PRICES



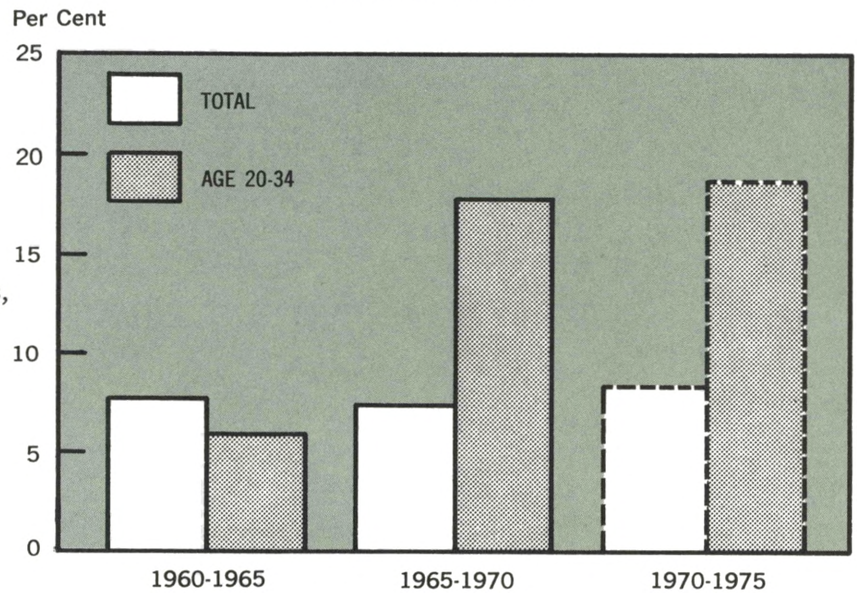
and they are trying to avoid expected future price hikes by buying now.

PROJECTED PLANT UTILIZATION



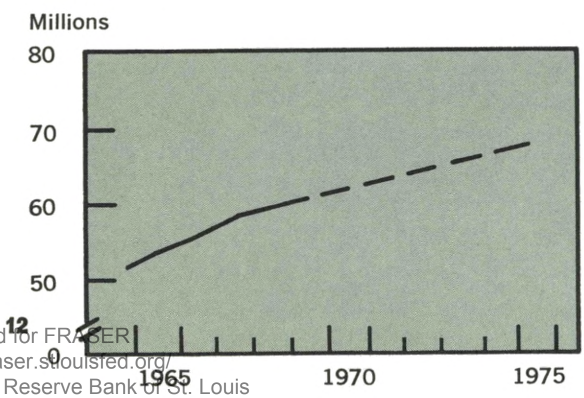
But, in addition, businessmen are optimistic about spending, particularly consumer spending, in the early '70s because . . .

INCREASE IN POPULATION



more people, especially big-spending young adults,

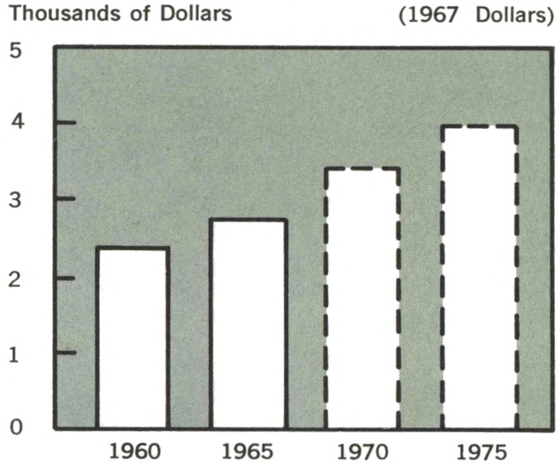
TOTAL HOUSEHOLDS



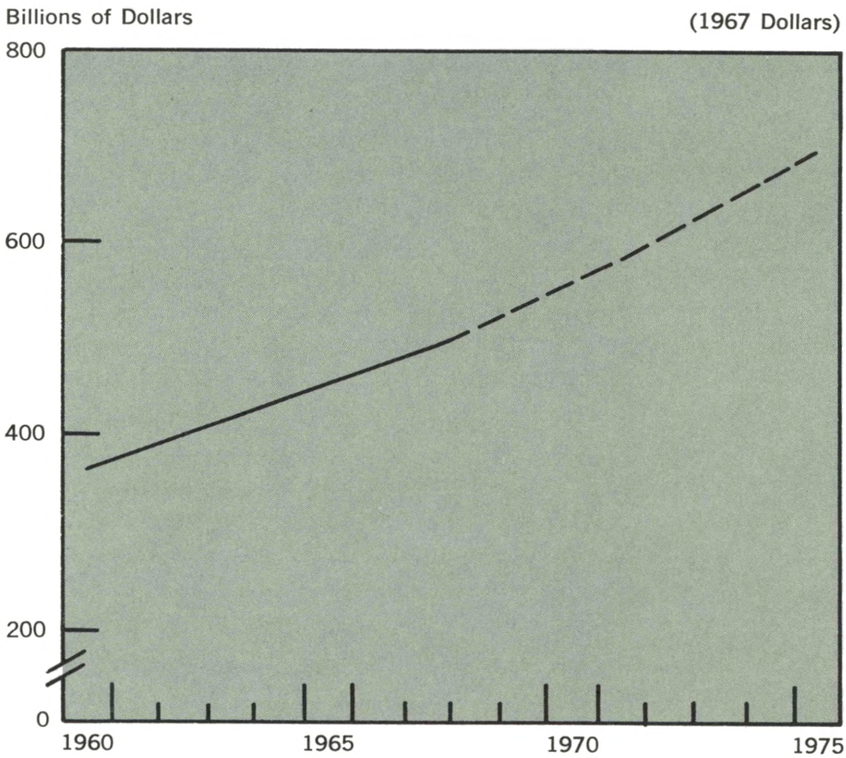
forming new households, . . . and

PER CAPITA PERSONAL INCOME

rising incomes . . .



PERSONAL CONSUMPTION EXPENDITURES



mean more consumer sales.

Sources:
U.S. Department of Commerce
National Planning Association
McGraw-Hill

Plain—But Fancy

by George C. Haag*

It's summertime and the tourists are swarming. And several million of them will be heading for Lancaster County, Pennsylvania, where, in some respects, time has stood still for a century.

Since early colonial times Lancaster County has enjoyed the reputation of being one of the top agricultural counties in the United States. And deservedly so. Field crops are lustier, milk creamier, tobacco leaves heavier, and meat "beefier" when exposed to the elements of the county and the artistry of its farmers. Now, the "Plain People" who till the soil in the county have caught the fancy of folks from metropolitan areas. Visitors are fascinated by the blend of history, tradition, and folklore. They marvel at a society that has refused to keep pace with progress and the technology that surrounds it. Tourists enjoy the contrasts of farmers' markets and supermarkets side by side, automobiles sharing the roads with horses and buggies, and lush farmlands bordering new industrial plants.

Estimates place the 1968 tourist count between 3,000,000 and 3,500,000. This year all indicators point to a 10 per cent increase.

Every effort is made to accommodate this influx of travelers. There are approximately 2,500 first-rate motel units in the Lancaster area and about 500 new units are expected to be added by next year. Even so, only the uninitiated would venture to find lodgings during the summer months without early reservations. Chances are they would find "no vacancy" signs just about anywhere they might apply.

What's the reason all roads lead to Lancaster these summers? Well, for one thing the Pennsylvania Dutch Tourist Bureau, a division of the Lancaster Chamber of Commerce, has done a superb job in letting people know what the

*Public Information Officer

county has to offer. Slick magazines such as *National Geographic, Holiday,* and others, have devoted spreads to the "Deutsch" and vacationers consider visiting the county an "in" thing to do.

Then, too, here is found one of the pure folklores in the United States, with its colloquialisms and customs handed down over generations. Billed as an American heritage to be preserved and cherished, the county is the stage, the "Plain People" the players. Some feature attractions are the Pennsylvania Farm Museum, the Strasburg Railroad, the Amish House and Farm, Dutch Wonderland, and Pennsylvania Dutch Days, a 10-day frolic usually held in late August—early September.

But the real attraction is the "Plain People." Known by their peculiar garb and stubborn refusal to yield to progress, these folk have resisted three centuries of mechanical progress and have survived the resulting conflicts with modern civilization. The Amish, in particular, have detached themselves from the world. They seemingly have found a way of life satisfactory to themselves and call it "wonderful good."

A tourist's day might include a leisurely morning drive through the countryside viewing livestock in the fields and passing corn and tobacco growing so close to the road you are tempted to reach out and touch it to see if it's real. Perhaps a visit to an old Amish farm might be included in your itinerary and certainly a stop at one of the many gift shops that dot the area would be a must. True, the current fad for anything Pennsylvania Dutch is being exploited, but what does it matter? How can one resist the lure of an old milk can that can be sanded down and brightly painted for use as an ash tray, umbrella stand or what have you—or a genuine wheel from an old Amish carriage?

For the more serious collectors, regular auctions are held at several locations. Many sales are conducted right at the farm sites. Whether these are a shrewd ruse employed by the Dutch to dispose of undesirable items or evidence of hardship is difficult to ascertain. Tales are told that many of the younger, up-to-date "Plain People" are not so successful as their plodding, old fashioned forebears.

There is some evidence that the horse and buggy is being replaced—though grudgingly. Young Mennonites have swung over to the new-fangled gas buggy and in some instances a new class of hot-rodders is developing. But, the true Amishman can still be found behind his horse and the sight of these narrow wheeled carriages and the sound of the horse's clopping hooves always somehow tingle the emotions.

That is, of course, if you aren't stuck behind the contraption for an interminable stretch of road.

Later an excellent dinner is obtainable at almost any restaurant you might choose. Light eaters are at a disadvantage, however. The Pennsylvania Dutch have a habit of sitting about a foot from the table and eating their way in. Area chefs are aware of this and prepare accordingly.

Night life? Well there isn't too much to do after dark. But then who cares? The average urban dweller by this time is happy to waddle to his trundle bed and dream sweet dreams if he hasn't overtaxed his capacity to digest the chicken and dumplings and shoofly pie.

How do the "Plain People" take to all this exposure? Some have expressed concern that they have suffered an invasion of privacy because of the booming tourist trade in the county. No one can dispute the contention that the way of life in Lancaster County has felt the impact of the tourist influx. Only a visit to the county during July or August could give credence to reports on tourist activity that might be unbelievable otherwise. The mix of the old and new has proven irresistible to urban dwellers. New York license plates outnumber corn stalks during the summer months in Lancaster County. After all, how much farther away from Manhattan can you get?

To some extent the complacency of the "Plain Folk" has been jarred. Some carriages display "Please don't blow horn" signs. Bumper-to-bumper traffic on what had previously been seldom-used Routes 23 and 340 in the heart of the Dutch country is a constant reminder that "getting away from it all" is becoming increasingly difficult.

But the "Plain People" have entered into the spirit of the thing. Many Mennonites have opened portions of their homes to tourists. Prices for items sold by the natives have risen sharply. "Plain People" assist in planning and conducting tours.

All of this leads one to believe that the "Plain Folk" are not averse to making a dollar—and the opportunity has increased greatly since the county became a tourist haven. "Green" can be readily recognized by the countians and it doesn't have to be in the fields.

ALL THIS AND INDUSTRY TOO

Perhaps the fact that the county has become an outstanding industrial center is not so well known. The past decade has brought a 20% increase in population—and it has been absorbed smoothly. Some two-score new plants employing 6,000 workers have joined the industrial community during this time. In all there are approximately 22,000 more non-farm jobs available in Lancaster County today than in 1958. This represents an increase of 24.2 per cent as compared to Pennsylvania's overall growth of 11.2 per cent for the period.

The old standby firms have, of course, strongly contributed to this growth. No sooner is one expansion program completed than another is begun. A comparison of employment in leading area manufacturing firms using 1963-1968 figures would show:

FIRM	EMPLOYMENT 1963	1968
Armstrong Cork Company	3,700	6,000
Gunnell Corporation	1,000	1,500
Hamilton Watch Company	1,800	2,900
New Holland Machine Company	1,600	2,600
Radio Corporation of America	3,300	5,700

Industry's growth has pressured the labor market. Unemployment seldom exceeds 2 per

cent of the county labor supply and there are more job opportunities than job seekers. There is a real need for semi-skilled workers in most local plants. Workers from less fortunate areas continue to pour into the county to fill job openings. The county population, rising steadily, has already passed the 300,000 mark and shows no signs of slowing.

Even so, two segments of the population present a problem. Farmland is scarce and young Amishmen are finding it necessary to depart from the habits of generations to find other work. The type of work "plain people" may do is limited by their beliefs. A partial solution has been found by bringing trailer builders into the county. Making trailers entails much woodwork, a form of labor compatible with the Amish faith.

Not so easily solved is unemployment among the nonwhite portion of the work force. This group, while representing only 3 per cent of the population makes up about 40 per cent of unemployment totals. A vigorous training program seems sorely needed to qualify these people for jobs.

. . . . . .

"There is no place,
Just like this place,
Anywhere near this place:
So this must be the place."

The above, found on an old wall plaque in a tiny restaurant just off the Farmers Market in downtown Lancaster seems to appropriately describe Lancaster County. Its unique blend of the old and new has no counterpart in the Third District—perhaps none anywhere in the United States. And the unusual combination of agriculture, industry and tourism—all flourishing—has contributed greatly to the economic stability for which the area is famous.

What Truth in Lending Is All About*

by Hugh Chairnoff

After many years of debate, the consumer credit customer was given his day in Congress in May, 1968. Beginning July 1 of this year, hereafter to be known as Z-day, he can have his day in court as well. Congress has declared that as of July 1 there shall be a new era in the relationship between creditors and their customers.

It would be less than honest of me if I did not state at the outset that I think the idea behind Truth in Lending has been long overdue. Though my educational level may be considered above average, it did not prepare me for the traumatic experience I encountered each time I wanted to borrow money or buy something on credit. The complexities involved conspire to produce the uneasy feeling that ignorance indeed is bliss.

To me, however, the most telling blow against the consumer credit marketplace has been struck by creditors themselves. My colleagues and I have spoken already to more than 11,000 creditors this year. Yet, we have found that the real experts are too few and far between. Consumer credit has become so specialized that it just isn't possible for one person to understand adequately more than a few of the myriad ways that credit currently is extended.

I must hasten to add that I am not an opponent of diversity. But when diversity is too great a source of confusion—of poor decision-making—its value certainly is subject to question.

WHAT IS TRUTH IN LENDING?

Truth in Lending is an unfortunate title for the legislation which brought about the new era in consumer credit. The fact of the matter is that the truth has been there in black and white—if you could read the small print and if

* A speech given at the Delaware Bankers Association convention in Wilmington, Delaware, May 8, 1969.

you could make sense of the legal and technical jargon. And that is the point of Truth in Lending: tell the customer what is happening in language he can understand, not in language only creditors and their lawyers can understand. Clearly, tell him what he is getting and how much it costs. Clearly, tell him what his rights, privileges, and obligations are. Clearly, tell him what your rights are if he fails to live up to his obligations.

Formally, Truth in Lending is Title I of the Consumer Credit Protection Act of 1968. Other titles of the Act deal with extortionate credit transactions, wage garnishment, and establishment of the National Commission on Consumer Finance.

Congress authorized the Board of Governors of the Federal Reserve System to promulgate a regulation implementing the objectives and refine the requirements of the Truth in Lending Act. Need for a regulation derived from the virtual impossibility of conceiving a law that would cover every type of credit practice extant. Even the regulation, known as Regulation Z, has been unable to do this. Doublespaced, Regulation Z runs for 59 pages, excluding some appendixes, and we still have had to issue 27 interpretations so far in order to clarify practices not effectively dealt with in the Regulation. It's ironical that a regulation has to be an encyclopedia in order to cover all of the variations of a simple transaction such as borrowing money or buying merchandise on credit.

THE IDEA OF TRUTH IN LENDING

Basically, Truth in Lending is a disclosure law. It does not tell the creditor how he must conduct his business or the rates he may charge. It requires only that the creditor tell his customers what he is doing in language the customer hopefully can understand.

But Truth in Lending also grants a credit customer two new rights as well. A customer will have the right to sue his creditor for failure to comply with the requirements of Truth in Lending and Regulation Z. A customer also will have the right to rescind a credit transaction within three days if the customer's principal residence is used as collateral for the loan or credit sale.

In the short time available to me, let me concentrate on the transactions covered by Truth in Lending and the nature of the two basic disclosures each creditor must make to every customer covered by the law.

CREDITORS COVERED

Anyone or any organization who in the ordinary course of business regularly provides any one of the following services is subject to the requirements of Truth in Lending and Regulation Z:

1. Extends consumer credit.
2. Arranges for the extension of consumer credit.
3. Offers to extend credit or arrange for the extension of consumer credit.

You easily can see that commercial banks are not in this thing by themselves. Acknowledged competitors such as credit unions, finance companies, savings and loans, life insurance companies, and mortgage bankers are subject to this Act as well.

So are retailers who regularly provide credit services to their customers. And some people and organizations you ordinarily would not think of as creditors also are subject to Truth in Lending. For example, the real estate broker who regularly brings a buyer to any lender for a mortgage may be arranging for the extension of credit. Hence, he may be a creditor under Truth in Lending.

The same thing applies to auto dealers. They are covered whether they extend credit directly or only arrange for the extension of credit from a bank or other financial institution. What about colleges and universities that arrange for education loans for students? Or what about your local tax collector, who offers a discount for early payment? They all seem to be creditors under Truth in Lending. It would seem that legislative edict has increased your competition significantly. What a nice way to promote competition.

TRANSACTIONS COVERED

Not every credit transaction is covered by Truth in Lending. To be subject to the requirements of the Act and Regulation Z, the transaction must possess three characteristics.

1. The credit customer is a natural person rather than an organization such as a corporation, partnership, estate, or trust.
2. The credit is to be used for personal, family, household, or agricultural purposes.
3. The creditor may impose a finance charge or the obligation is repayable in more than four installments.

Every transaction which satisfies each of these criteria is a Truth in Lending transaction.

For bankers, it is important to note that Truth in Lending loans are not made solely in the installment loan department. Truth in Lending loans also are made in the mortgage loan department and savings department as well as in the commercial loan department. That's right, the majority of your single payment loans in the commercial loan department probably are subject to the requirements of Truth in Lending.

Bankers' agricultural lending activities also may be subject to the requirements. Loans to individual farmers whether for personal purposes or for equipment, supplies, and buildings are covered by Truth in Lending because it is very difficult to distinguish between purely agricultural purposes and household purposes in the case of an individual farmer. Feed and grain dealers as well as equipment dealers also are covered inasmuch as they extend credit to individual farmers.

A few credit transactions are exempt. For example, so long as the transaction is not secured by an interest in real property, only credit transactions up to $25,000 are covered by Truth in Lending. If any real property is used as collateral for a loan or credit, the transaction is subject to Truth in Lending regardless of the amount of credit extended.

Loans or credit to a governmental agency are exempt from the provisions of Truth in Lending. So are utility bills rendered by local gas and electric utilities. And when the credit customer is a corporation, partnership, or other type of organization, the transaction is not subject to the requirements.

COST OF CREDIT—TRUTH IN LENDING STYLE

The first obstacle the creditor encounters in attempting to satisfy the law is the computation of the cost of credit. There are two aspects of this problem. First, is the dollar cost of credit. Second is the annual percentage cost of credit.

Finance Charge. The cost of credit is quite different from the requirements contained in most state laws. Indeed, the cost of credit under Federal law represents a significant departure from the concepts that traditionally have been applied in state legislation. Departure begins with the assumption that the cost of credit is determined from the credit customer's point of view rather than from that of the creditor.

As a general rule, the cost of credit—referred to as the "finance charge"—is the sum of all charges incurred by the customer. In fact, it makes no difference whatever that somebody else paid the charges on behalf of the customer or that somebody other than the creditor received payment. So long as a charge is incident to or a condition of the credit transaction, it is part of the finance charge.

Thus, unlike state law, there is no distinction between an add-on or discount system of charges and the time price differential. Further, loan fees, investigation fees, even points on a mortgage transaction when paid by the seller are part of the finance charge irrespective of state law.

To complicate matters further, some charges may or may not be included in the finance charge depending on how the creditor handles the situation. For example, if the creditor tells the customer that credit life insurance is not required, then any charge for voluntary coverage can be excluded from the finance charge.

On the other hand, if a creditor requires physical damage and liability insurance, he may still exclude the cost from the finance charge so long as he tells the customer that the insurance can be acquired from anyone the customer chooses. In no event, however, can insurance to protect the creditor against a customer's default be excluded from the finance charge. So, premiums for Federal Housing Administration insurance must be included in the finance charge. No longer will we talk about 7½ per cent FHA mortgages. We'll start talking about 8 per cent FHA's and work our way up as the seller pays points to entice the lender.

There is one consolation in real property transactions. Here, the usual costs of settlement are not included in the finance charge provided they are bona fide, reasonable in amount, and not for the purpose of circumvention or evasion.

For transactions that qualify under Truth in Lending, one of the most important things creditors must tell the customer is the total dollar cost of obtaining credit. And creditors must call that cost of credit the "finance charge."

Annual Percentage Rate. Once the total dollar cost of credit has been determined, the creditor must convert this dollar cost to an annual percentage cost. Again, we are confronted with a significant departure from practices permitted under most state laws.

Creditors cannot use the add-on or discount percentage, or use the constant-ratio method to find this percentage cost. The method specified by the law is the actuarial method—the method used in the mortgage-lending industry. The actuarial method involves a redistribution of the dollar finance charge in accordance with the series of declining unpaid balances under an installment contract. So, if state law permits you to charge on the basis of the original balance, the actuarial method will mathematically relate that dollar finance charge to the series of declining unpaid balances.

But before you say that it appears to be an easy task, let me remind you that the rate applied to the original balance will not be the rate that will produce the same finance charge when applied to the series of declining unpaid balances. The rate will be almost twice as high.

There are a number of ways you can find the annual percentage rate—most of them require a Ph.D in mathematics. But there is one simple way: the use of tables. Such tables have been made available by the Federal Reserve as well as private publishers. In most cases the calculation of the rate can be made within a matter of seconds.

The rate calculated—to be called the "annual percentage rate"—is an approximation of the true percentage cost of borrowing, at least for most installment loan or credit contracts. But if a creditor offers a revolving credit or credit card arrangement, determination of the annual percentage rate is quite different.

For these types of credit arrangements determination of the annual percentage rate will be made periodically, when the customer is billed. Any relationship between the annual percentage rate and the true percentage cost of borrowing is probably coincidental. The advantage of the calculation under credit card or revolving credit plans is that it is quite simple in most cases, and easily handled by our monster computers.

So, the second important piece of information creditors will provide to credit customers after July 1 is an approximation of the true cost of borrowing. It is called the "annual percentage rate."

The balance of the requirements of Truth in Lending and Regulation Z mainly are concerned with standardized language, timing of disclosure, rules for advertising, and the right to cancel a transaction. The details of these elements of Truth in Lending are much too voluminous to consider within the time allotted. And the fact of the matter is that these elements are merely subsidiary to the real guts of Truth in Lending —the finance charge and annual percentage rate.

THE PURPOSE OF IT ALL

Now that I have deluged you with the dimensions of reform, perhaps it is time to pause to consider a bit further the purpose of it all.

The single major objective of Truth in Lending is to make consumers wiser users of and better shoppers for credit. To succeed, it is vital that consumers become aware of what it really costs to borrow money or make purchases on credit. Further, it is vital that these costs should be stated in a uniform manner among all competitors in the marketplace.

Those of us who have been living with Truth in Lending know that its success will not be immediate. However, it would be unfair to criticize Truth in Lending because it won't make much difference in the near future. After all, how long did it take bankers to recognize the opportunities of consumer lending, or to learn the intricacies of the Federal funds market, or to sell negotiable certificates of deposit? There always seems to be a lag between the opportunity for improvement and action to realize improvement.

Truth in Lending is asking us, particularly creditors, to make an investment in the future. Unlike Social Security where we give ourselves increased benefits and pass along the cost to future generations, we are absorbing the cost of a major change in how we communicate to credit users in order that future generations will become wiser users of credit.

It is a story based on an economic theory hundreds of years old. Simply stated, the more information one has when he or she enters the marketplace, the better he or she will fare. The market will become more competitive in terms of the relationship between price and services rendered.

The beneficiaries. What creditors are likely to be the major beneficiaries of Truth in Lending? I think probably it will be commercial banks. On balance, bank rates tend to be at the lower end of the scale. After all, it is difficult to accept the fact that only superior marketing has paved the way for the significant increase in banks' share of the consumer credit market during the post-World War II era.

Truth in Lending will increase already existing pressure on other types of lenders to consider their present pricing structure in relation to the services they uniquely provide. As a multitude of creditors already have told me, Truth in Lending really will put them on the spot. As consumers become more aware of what is involved in borrowing money or buying on time, many creditors are going to receive embarrassing questions about the price and nature of their services.

CONCLUSION

Truth in Lending is here. The job creditors must do in order to comply with the requirements of the law and Regulation Z will lead many to reconsider their role in the credit marketplace. Now is the time to begin thinking about the opportunities Truth in Lending will open up to you as bankers. Because we cannot see the immediate benefit of Truth in Lending, let us not fool ourselves into thinking that this is not the most significant reform in the marketplace for consumer credit since commercial banks decided they wanted a piece of the action.

WHERE TO GET MORE INFORMATION ON TRUTH IN LENDING

From the list that follows, you will be able to tell which Federal Agency covers your particular business. Any questions you have should be directed to that agency. These agencies are also responsible for enforcing Regulation Z.

National Banks
Comptroller of the Currency
United States Treasury Department
Washington, D.C. 20220

State Member Banks
Federal Rerserve Bank serving the area in which the State member bank is located.

Nonmember Insured Banks
Federal Deposit Insurance Corporation Supervising Examiner for the District in which the nonmember insured bank is located.

Savings Institutions Insured by the FSLIC and Members of the FHLB System (except for Savings Banks insured by FDIC)
The FHLB's Supervising Agent in the Federal Home Loan Bank District in which the institution is located.

Federal Credit Unions
Regional Office of the Bureau of Federal Credit Unions, serving the area in which the Federal Credit Union is located.

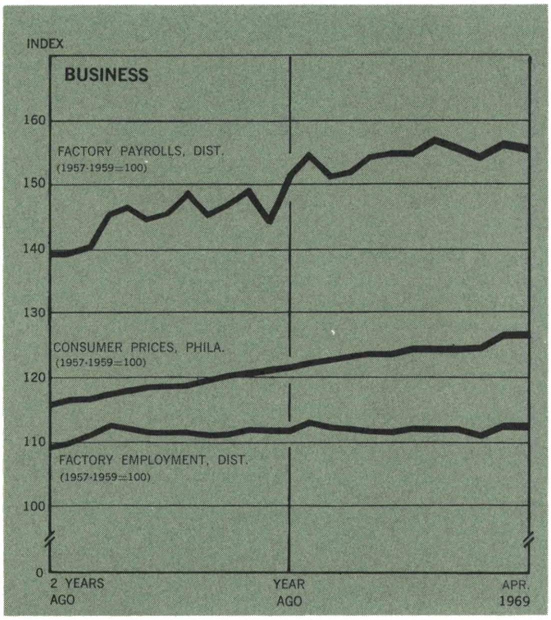
Creditors Subject to Civil Aeronautics Board
Director, Bureau of Enforcement
Civil Aeronautics Board
1825 Connecticut Avenue, N.W.
Washington, D.C. 20428

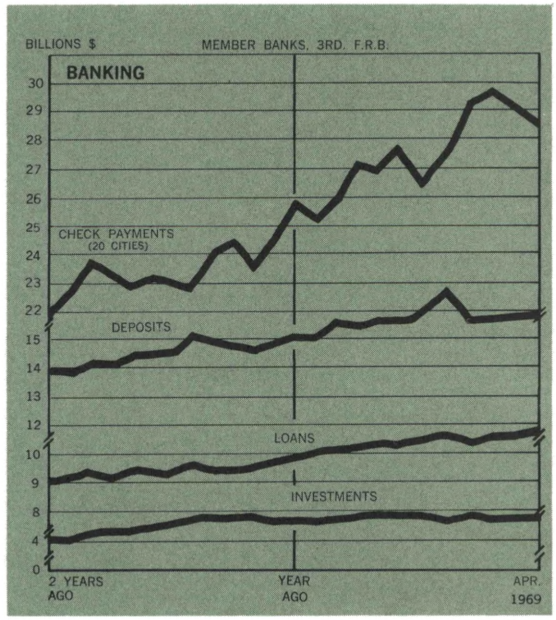
Creditors Subject to Interstate Commerce Commission
Office of Proceedings
Interstate Commerce Commission
Washington, D.C. 20523

Creditors Subject to Packers and Stockyards Act
Nearest Packers and Stockyards Administration area supervisor.

Retail, Department Stores, Consumer Finance Companies, and All Other Creditors
Truth in Lending
Federal Trade Commission
Washington, D.C. 20580

FOR THE RECORD . . .





SUMMARY	Third Federal Reserve District			United States		
	Per cent change			Per cent change		
	April 1969 from		4 mos. 1969 from	April 1969 from		4 mos. 1969 from
	mo. ago	year ago	year ago	mo. ago	year ago	year ago
MANUFACTURING						
Production	....	....	....	0	+ 6	+ 5
Electric power consumed	....	....	....	....	....	....
Man-hours, total*	+ 1	+ 4	+ 1	....	....	....
Employment, total	0	0	0	....	....	....
Wage income*	− 1	+ 9	+ 7	....	....	....
CONSTRUCTION**	0	− 3	+12	+18	+21	+15
COAL PRODUCTION	+ 6	0	+ 1	+ 5	− 3	− 3
BANKING						
(All member banks)						
Deposits	+ 5	+13	+ 9	+ 3	+10	+ 8
Loans	+ 4	+14	+12	+ 2	+13	+13
Investments	0	+ 6	+ 6	0	+ 4	+ 4
U.S. Govt. securities	− 1	− 3	− 4	− 1	− 4	− 5
Other	0	+14	+15	+ 1	+11	+12
Check payments***	− 1†	+17†	+21†	+ 2	+18	+20
PRICES						
Wholesale	....	....	....	0	+ 3	+ 3
Consumer	0‡	+ 5‡	+ 5‡	+ 1	+ 5	+ 5

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

†15 SMSA's
‡Philadelphia

LOCAL CHANGES	Manufacturing				Banking			
	Employment		Payrolls		Check Payments**		Total Deposits***	
Standard Metropolitan Statistical Areas*	Per cent change April 1969 from		Per cent change April 1969 from		Per cent change April 1969 from		Per cent change April 1969 from	
	mo. ago	year ago	mo. ago	year ago	mo. ago	year ago	mo. ago	year ago
Wilmington	− 6	− 6	− 6	+ 2	−10	+16	0	+16
Atlantic City	....	....	....	....	+ 2	+18	+ 1	+10
Trenton	0	+ 3	− 1	+ 9	−38	+20	+11	+18
Altoona	+ 3	+ 4	+ 5	+18	+ 7	− 6	+ 2	+15
Harrisburg	+ 1	− 2	0	+ 5	− 3	+ 9	+ 6	+20
Johnstown	+ 1	− 3	+ 3	− 5	+ 2	+ 5	+ 7	+15
Lancaster	0	+ 2	0	+14	+ 3	+ 9	+ 2	+13
Lehigh Valley	0	0	0	+ 5	+ 1	+11	+ 3	+12
Philadelphia	0	− 2	0	+ 9	+ 4	+18	+ 7	+13
Reading	− 1	+ 3	+ 1	+16	− 2	+21	+ 2	+14
Scranton	0	− 1	+ 2	+ 8	+ 6	+14	+ 1	+ 9
Wilkes-Barre	+ 1	+ 3	− 1	+14	+10	+19	+ 5	+13
York	0	+ 3	0	+16	+ 5	+ 6	+ 3	+13

*Not restricted to corporate limits of cities but covers areas of one or more counties.
**All commercial banks. Adjusted for seasonal variation.
***Member banks only. Last Wednesday of the month.