

# Federal Reserve Bank of San Francisco

January 26, 1973

## Spurring Consumers On

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The nation's consumers practically swept the shelves clean during the recent Christmas season, as they appeared willing to spend not only their substantial 1972 paychecks but large portions of their 1973 incomes as well. Among the factors spurring consumers along in their spending spree was the expectation of very large tax refunds this spring because of overwithholding of 1972 income taxes. In addition, older consumers were able to buy more because of their recently fattened social-security checks, although their younger counterparts will now be paying the bill through an increase in social-security taxes.

### Why The Stimulus?

The repayment of overwithheld income taxes traceable to 1972's withholding schedule could by itself amount to as much as \$8 billion. But this figure is only the top of the iceberg. Total overwithholdings have increased steadily over the past decade, from about \$5 billion in fiscal 1963 to about \$14 billion in fiscal 1972. Indeed, about three-fourths of all individual returns in the latest reported fiscal period reflected overpayments, as against the two-thirds proportion characteristic of earlier years. To some extent, the withholding system is being used as an automatic saving device, allowing individuals to accumulate the means to settle other obligations, such as state income taxes and local property taxes, or to lay funds aside for making future big-ticket purchases.

Gross income-tax refunds in fiscal 1973 could approximate \$22 billion, as against last year's \$14-billion figure. About \$5 to 6 billion of the increase is attributable to 1972-schedule overwithholding, and \$2 to 3 billion attributable to the normal growth of refunds. Allowing the usual six-week delay between filing of return and payment of refund, and given the normal filing pattern, consumer income could be increased—beyond the normal amount of refunds—at an \$8-billion annual rate in the first quarter and at a \$14-billion rate in the second quarter of 1973.

Social-security benefits increased 20 percent in 1972, effective September 1st and payable in October. This boost accounted for over one half of October's \$15-billion increase in personal income (annual rate)—or more than \$2 billion on a quarterly basis. But in 1973, a large proportion of this increase will be offset by a substantial rise in social-security taxes. On January 1, the tax rate increased from 5.20 percent to 5.85 percent for both employers and employees. In addition, the taxable wage base rose from \$9,000 to \$10,800, in accordance with legislation passed by Congress in its pre-adjournalment rush.

### What History Teaches

Substantial tax refunds and higher social-security benefits—with this partial tax offset—thus should have a significant impact on the 1973

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consumer economy. Since what is past is prologue, it might be helpful to consider certain historical episodes where a similar stimulus was administered or where the opposite occurred through a tax increase. The 1964-65 reductions in income and excise taxes represent a case history of a strong stimulus to disposable income, while the 1968 income-tax surcharge represents the opposite case of a restrictive tax boost.

The first phase of the two-phase tax reduction of 1964-65, which amounted to over \$11 billion overall, came at the end of the first quarter of 1964, when the economy was in the midst of a steady expansion. Initially the saving rate rose, as consumers adjusted slowly to the increase in their disposable income. Sales of many durable goods, principally furniture and appliances, also rose in this period, although this may have been due more to the ongoing housing boom rather than to the tax reduction. But within two quarters of the income-tax reduction, consumer spending rose strongly right across the board, with all major components contributing to this advance.

In more recent periods, consumers have shown a similar tendency to react with a lag to changes in disposable income. In the 1968-69 period, consumers responded initially to an income-tax surcharge and a social-security tax hike by maintaining their spending rate and reducing their saving rate. In a later

episode, they reacted to the expiration of the surcharge, to a Federal pay increase, and to retroactive increases in social-security benefits by increasing their expenditures (although at a reduced pace because of the recession) and by increasing their savings. More recently, with the imposition of higher withholding schedules in 1972, consumers again maintained—indeed, increased—their spending while reducing their saving rate. In each case, total consumption spending generally reacted with a one-quarter lag to the shift in disposable income, while durable goods spending reacted with a somewhat longer lag.

### **Overlapping of Adjustments**

Since the several factors affecting consumer spending are not occurring simultaneously, some overlapping of adjustments undoubtedly will occur in 1973. The sequence has already begun with October's increase in social-security benefits. The offsetting factor, the recently effective increase in social-security taxes, will be felt well into the second half of the year because of the workings of a higher taxable wage base. The tax refund due to overwithholding—averaging probably over \$500 in total for the typical return—may be paid out on a roughly 40-60 proportion in the first two quarters of the year. The overwithholding is in effect discretionary, since taxpayers, despite widespread Treasury publicity, have not changed their withholding liabilities, so it will be difficult to judge how their refunds will be

allocated between spending and saving.

Sudden shifts in disposable income of this nature seldom occur alone, but usually in conjunction with other random events. Still, there is no mistaking the fact that consumers respond to a change in disposable income with a lag, adjusting their savings to cushion declines or to absorb increases in income. The adjustment process appears to take place over one to three quarters, until a new equilibrium is established between consumption and savings.

In line with past experience, certain assumptions may be made about the effect in 1973 of these adjustment lags. (These assumptions are subject to wide margins of error with respect to both timing and amount.) For the increase in social-security benefits, we can assume that 80 percent of the increase will be spent as received and the remainder in the following time period. For the tax refund due to overwithholding, we can assume that two-thirds will be spent in the quarter in which received and the remainder split equally between the next two quarters. For the decrease in disposable income due to social-security tax changes, we can assume that the impact will be felt equally over two quarters of adjustment.

#### **Concentrated Stimulus**

In this simplified example, which ignores any multiplier effects, the overall stimulus to consumption should rise from \$1.7 billion in the

final quarter of 1972 to \$2.4 billion in the current quarter and \$3.9 billion in the second quarter of 1973. Thereafter the combined impact will decline significantly, and gradually disappear by year-end. However, any sort of multiplier effect would sustain a strong stimulus to consumer expenditures throughout most or all of 1973.

Most of the increase in social-security benefits might well be used for purchases of nondurable goods and services. The tax refund, being relatively large and essentially windfall in nature, more likely will be spent for durable goods or possibly services. On the other hand, the increase in social-security taxes could reduce the purchase of durables, to the extent that it eats into after-tax income available for instalment-purchase payments.

Other factors besides income are bound to affect the trend of consumer spending in 1973. Auto spending could continue to boom on the basis of a strong level of consumer confidence implicit in a falling unemployment rate, as well as favorable price expectations created by the Price Commission's prolonged hold-down on new-car prices. (Recent and prospective price hikes, of course, could dampen this factor considerably.) Products such as color TV or recreational and sporting goods could continue to do quite well, spurred on by new-product appeal and increased leisure time as well as by expanded income.

**Herbert Runyon**

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**BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT**

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 1/10/73	Change from 1/3/73	Change from year ago	
			Dollar	Percent
Loans adjusted and investments	68,863	— 372	+6,834	+11.02
Loans adjusted—total	50,293	— 320	+6,889	+15.87
Commercial and industrial	17,669	— 179	+1,757	+11.04
Real estate	15,073	+ 28	+2,352	+18.49
Consumer instalment	7,692	+ 11	+1,233	+19.09
U.S. Government securities	7,330	+ 91	+ 167	+ 2.33
Other securities	11,240	— 143	— 222	— 1.94
Deposits (less cash items)—total	67,435	—1,056	+6,495	+10.66
Demand deposits adjusted	21,677	— 207	+1,891	+ 9.56
U.S. Government deposits	722	— 455	+ 91	+14.42
Time deposits—total	43,875	+ 16	+4,336	+10.97
Savings	18,218	— 58	+ 622	+ 3.53
Other time I.P.C.	16,894	0	+2,583	+18.05
State and political subdivisions (Large negotiable CD's)	6,448 6,840	+ 85 + 27	+ 510 +1,715	+ 8.59 +33.46

	Weekly Averages of Daily Figures		
	Week ended 1/10/73	Week ended 1/3/73	Comparable year-ago period
<b>Member Bank Reserve Position</b>			
Excess reserves	— 19	105	— 17
Borrowings	68	129	0
Net free (+) / Net borrowed (—)	— 87	— 24	— 17
<b>Federal Funds—Seven Large Banks</b>			
Interbank Federal funds transactions			
Net purchases (+) / Net sales (—)	+420	+179	+ 885
Transactions: U.S. securities dealers			
Net loans (+) / Net borrowings (—)	+364	+225	+ 255

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