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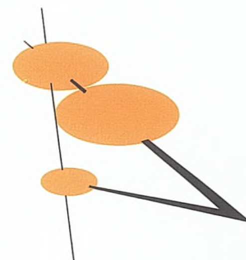
In this issue

Rising Consumption—and Taxes

Healthier Markets

High Tide for Foreign Cars?



September 1970

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Rising Consumption—and Taxes

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Healthier Markets

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High Tide for Foreign Cars?

... Detroit will be making a major effort this fall to stem the rising tide of imports of German, Japanese, and other foreign cars.

Editor: William Burke

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Rising Consumption — and Taxes

Smokers, drinkers, and heavy spenders of every description, no matter what their guilt feelings may be in other respects, should be happy to know that their efforts have eased the tax collector's burden considerably in recent years. In 1969, for example, Federal excises on liquor, tobacco and other products approached $16 billion, while state-and-local sales taxes on a long list of commodities exceeded $25 billion. Taxes of this type thus accounted for about one-fifth of all tax revenue raised from the public last year.

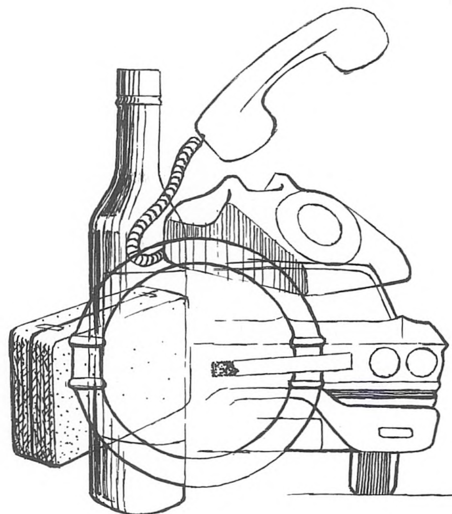
Excise and sales taxes are essentially the same type of tax—a tax on consumption or expenditure—as opposed (say) to a tax on receipt of income. Excise taxes apply to selected goods or services or to a group of related commodities, such as tobacco products, while sales taxes are imposed on all or a very broad range of commodities. In its usual form, sales taxes are levied on all commodities except certain specifically exempted household necessities.

Tax collectors' funds

Consumption taxes have provided about one-eighth of all Federal tax collections in recent years. These taxes consist solely of selective excises; the Federal Government is one of the few major national governments which has never employed a general-sales tax, although its use has been discussed on many occasions in recent history.

While excises at one time contributed heavily to the Federal tax coffers—one-half of total receipts during the Depression era, for example—they have accounted for a declining portion of the tax take over the past several decades. Congress has reduced excise taxes on several occasions since World War II, and in 1965, it repealed most of the remaining ones under the Federal Excise Tax Reduction Act, a comprehensive overhaul of the Federal excise-tax structure. (More recently, however, it has postponed some scheduled reductions, because of its insatiable hunt for tax revenues during the Vietnam war period.) Today, the only major Federal excises still standing are those on alcohol, tobacco, telephone service, motor fuel, motor vehicles, tires, and airplane travel.

At the state level, in contrast, excise and sales taxes have for many years provided a major bulwark for the revenue system. Irresistibly attracted by this form of taxation, the states now rely on consumption taxes for



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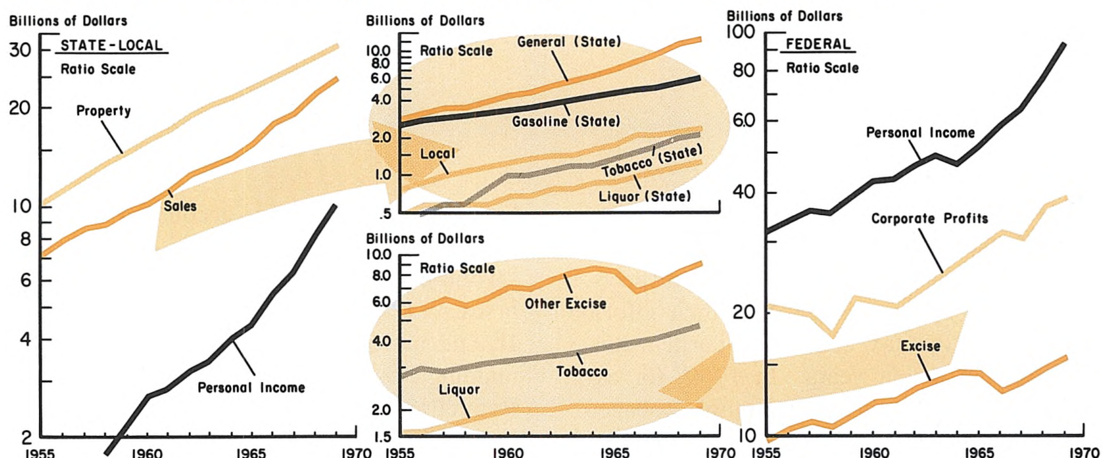
Tax agencies collect billions in state-local sales taxes and Federal excises—but these taxes grow less rapidly than personal-income taxes



three-fifths of all tax receipts. General-sales taxes comprise roughly half of the total take, and selective excises (largely motor fuel, alcohol, and tobacco) account for most of the rest. All fifty states currently impose some form of excise tax, and all but five of the states have adopted a general-sales tax.

State sales- and excise-tax revenue has grown substantially in recent years, increasing by over 60 percent in the past half-decade, in contrast to the relatively modest gain in Federal excises. While, in the aggregate, the relative importance of consumer taxes in the states' tax structure has remained virtually unchanged in recent years, yields from general-sales taxes have risen twice as rapidly as yields from specific levies.

Revenue from general-sales taxes has risen so rapidly because of frequent rate increases and extensions of coverage, as well as the addition of new states to the sales-tax family. Twenty-nine states enacted at least one rate increase between 1965 and 1969. (Pennsylvania now heads the list with a 6-percent sales-tax rate, although California would have matched that figure under a tax bill that was narrowly defeated in the state legislature in late August.) Eight states adopted a general-sales tax during this period, while only three states adopted a new excise tax. Moreover, a 24-percent growth in retail-sales volume since 1965 contributed heavily to the recent climb in sales-tax revenue.

At the local level, consumption taxes have played only a negligible role, accounting for only one out of every sixteen tax dollars in recent years. Localities, incidentally, place nearly twice as much reliance on general-sales taxes as on selective levies.

Traditional funds

Long-standing traditions help explain the differences in tax structure exhibited by the different types of taxing authorities. The Federal Government looks to individual and corporate income taxes as its major sources of revenue; in 1969, these sources brought in $92 billion and $39 billion, respectively, as against $16 billion in excise taxes. The state governments rely primarily on sales taxation; this source brought in $23 billion, as against only $8 billion in personal income taxes. Local jurisdictions make the most intensive use of real property taxes; this source accounted for $31 billion last year, as against only $2½ billion in local sales taxes.

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The negligible role of sales taxes in the local tax structure reflects the lack of enabling legislation for such taxes. As legal offsprings of the states, local governments are limited to the taxing powers granted them by their parents—and less than half the states presently authorize sales taxes for local use. In addition, local jurisdictions are often restrained from imposing a new sales tax (or raising an existing one) because of the fear that this will place them at a competitive disadvantage vis-a-vis neighboring localities. Every locality, after all, has a natural concern that a rise in its taxes may drive shoppers to a neighboring town.

For all but perhaps the largest cities, the cost of the tax-collection effort may be so great as to wipe out a substantial portion of the expected revenue. In an attempt to alleviate this problem, however, many states have empowered their local jurisdictions to levy sales taxes patterned after the state's own sales tax—and collected at the same time as the state's own tax. Typically, the local rate is added to the state rate, and after collection by the state, the allocated share of revenue is credited to the locality. In this way, the localities are able to take advantage of the efficiency of state-tax administrative procedures, and to benefit thereby from reduced collection costs. Meanwhile, the availability of sales or excise taxes on a uniform basis to all local governments within a state probably tends to limit intercommunity tax competition.

Direct vs. indirect

All consumption taxes, of whatever particular classification, have traditionally been categorized as *indirect* rather than direct taxes. (Property taxes join consumption taxes in the indirect category, while individual- or corporate-income taxes or estate and gift taxes fall in the direct category.) This distinction, however, has become somewhat neglected in recent years because of the lack of unambiguous standards of classification.

According to the standard criteria, direct taxes are thought to fall on the taxpayer (whether an individual or a business) in such a way that the burden cannot be shifted to anyone else, whereas indirect taxes are believed to be included in the price of a commodity or service and hence shifted forward to the consumer. But tax experts' knowledge of the shiftability of taxes is sometimes uncomfortably vague. For example, there are undoubtedly instances when the corporate-income tax is at least partially shifted to the consumer.

Secondly, indirect taxes are presumed to tax consumption or expenditure while direct taxes apply to income. But this classification is not all-inclusive. A tax on capital, for example, is neither an expenditure nor an income tax.

Thirdly, some experts contend, a taxpayer is fully aware of a direct tax but not of an indirect one, which is purportedly hidden in the price. But this is less true today than it was years ago, when it was much less common for sales taxes to be quoted separately and then added onto the price. Consumers today are probably quite aware of the dollars spent on sales and excise taxes—and if they aren't the Internal Revenue Service provides them with estimates of their state tax payments (for Federal-tax deduction purposes) with its annual income-tax packet.

Forms of taxes

Consumption taxes may be categorized in several different ways. They may be classified with respect to the manner in which the tax is computed: the rate may be based on the dollar value of the commodity, as in the ad valorem rate used for general retail-sales taxes, or it may be based on the physical unit of sale, as in the specific rate used for

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alcohol or gasoline taxes. But these taxes may also be categorized with regard to the particular stage in the production process at which the levy is imposed—whether at the retail, wholesale, or manufacturers' level.

Selective excises are often viewed in terms of some general purpose desired by the original legislators. Thus, the so-called *sumptuary* taxes — primarily alcohol and tobacco taxes — exist not only to raise revenue but presumably also to discourage or penalize consumption of socially "undesirable" commodities. The sumptuary role of taxation is justified on the grounds that consumption of such goods as alcohol and tobacco should be restricted below the levels that would otherwise prevail in the absence of the tax penalty. Advocates argue that sumptuary-tax revenue helps offset the additional costs that society must bear because of the undue consumption of these allegedly harmful commodities—for example, the costs of treating alcoholics in

Beyond 1965

The year 1965 was a landmark in the history of the Federal excise-tax system. Most excises then in effect had been initially imposed as "temporary" revenue-raising measures at the time of the Depression, or World War II, or the Korean War, but had then been retained "temporarily" for years or even decades. The Excise Tax Reduction Act of 1965 was designed to repeal or reduce levies on some 35 of these long-lingering excises, and it largely succeeded in its purposes, even though "temporary" extensions again became necessary to help meet the financial demands of the Vietnam war.

The Act repealed the four major retailers' "luxury" excises (luggage, furs, jewelry, and toilet preparations), most of the manufacturers' excises (major appliances, sporting goods, cameras, and musical instruments), and a number of miscellaneous excises (communications messages, admissions, club dues, playing cards, and coin-operated amusement devices). The Act called for a series of reductions in the passenger-auto levy, and it also made permanent the alcohol and tobacco taxes which had initially been imposed as temporary levies in 1951.

As would be expected, the 1965 Act substantially affected Federal revenue in the years immediately following. Excise-tax revenue dropped almost 10 percent in the first year following the passage of the legislation, and earlier levels were not matched until the 1968-69 period. Indeed, the fall-off in excise-tax revenue would have been even greater if Vietnam tax legislation had not restored certain excises to earlier rates.

The manufacturers' excise on passenger autos, which had been reduced from 10 percent to 7 percent in mid-1965, and to 6 percent in early 1966—and which was scheduled to fall to 2 percent by mid-1968—was actually pushed back up to 7 percent in 1966, and has been frozen at that level ever since. It is now scheduled to decline in several stages, starting in 1972, and to die as of January 1974. Similarly, the excise on telephone bills, which had been reduced from 10 percent to 3 percent as a result of the 1965 Act, was put back up to 10 percent only four months after the first rate decline and has been maintained at that level ever since. It too, presumably, will be gradually phased out by 1974.

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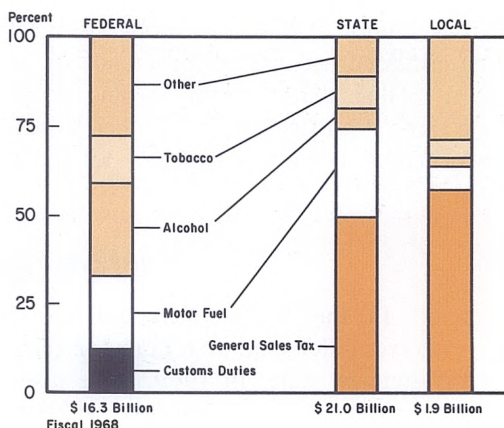
government institutions, or the costs of compensating for the damage to property or lives caused by drunken drivers.

Sumptuary taxes generally have been highly effective revenue producers, largely because the demand for the products taxed tends to hold up even in the presence of high tax rates. Indeed, some tax experts contend that using taxes both to check consumption and to produce revenue is not a very consistent policy. (Alcohol and tobacco taxes account for roughly one-quarter of total sales-tax revenue and for roughly two-fifths of excise-tax revenue.) Obviously, the more a sumptuary tax is designed to yield in revenue, the less effectively will it curb consumption. Furthermore, critics maintain that sumptuary taxes fail to limit the use of harmful commodities by those most in need of having their consumption controlled, while penalizing those consumers who use such commodities only in moderation. More basically, some critics argue that tax policies simply should not be designed to support certain subjective moral doctrines.

A second type of excise tax, categorized by purpose, consists of *user charges*. These taxes assess the costs of specific government services and facilities against those who enjoy the benefits rather than against all taxpayers, users and non-users alike. User taxes are an attempt, however crude, to apply the pricing system to particular government services. (In that connection, they are generally less costly and more convenient to administer than direct fees or charges.)

The most common such taxes are motor fuel and other highway user taxes, which provide one-fourth of Federal excise-tax receipts and a substantial one-half of state excise-tax revenues. In fact, all fifty states now impose a motor-fuel tax. In addition, the Federal Government is now turning more and more to airline-related user taxes. This July, for example, it raised its tax on airline tickets from 5 to 8 percent, and imposed new taxes on jet fuel, air-cargo way bills, and jets' take-off weight.

Different agencies show variation in consumption-tax patterns



Federal *customs duties* also fall within the ambit of consumption taxes. While these once supplied a major part of Federal tax revenues, they have become an insignificant revenue producer over the years. (They now account for less than 2 percent of Federal tax receipts.) Actually, customs-duty collections have been rising gradually in the recent past, but they will probably continue to decline in relative importance, partly because of the nation's commitment to the lowering of tariff barriers, and partly because of protectionists' preference for quotas over tariffs as an import-fighting device.

Equity . . .

The relative advantages and disadvantages of sales and excise taxes vis-a-vis other forms of taxation—notably income taxation —have long been a subject of heated debate in economic and political circles. Each year, as the cry for additional tax revenue echoes throughout legislative chambers across the land, these arguments are inevitably renewed. Time has not lessened the

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intensity of this perennial controversy between the critics and proponents of consumption taxes.

Consumption taxes are probably most often criticized because of their tendency to take a smaller share of total income as income rises. With such taxes, in other words, lower-income taxpayers suffer a relatively greater burden than higher-income taxpayers, as is illustrated by a 1966 study conducted by the Advisory Commission on Intergovernmental Relations. In that study, sales taxes accounted for 2.8 percent of (Federal adjusted gross) incomes under \$2,000; 1.8 percent of incomes between \$5,000 and \$5,999; 1.6 percent of incomes

Western Funds

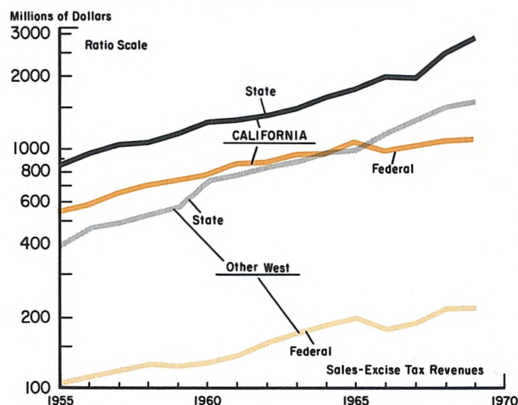
In the West, sales and excise taxes differ somewhat in importance, state by state. In 1969, these taxes accounted for as much as 86 percent of total state tax revenue in Nevada and 80 percent in Washington, but for only 23 percent of tax receipts in Oregon and 25 percent in Alaska. For the Twelfth District as a whole, consumption taxes provided 56 percent of all state tax collections. (Some caution must be exercised in making comparisons, however, because of interstate differences in the scope of services provided by different levels of governments, as well as differences in the pattern of distribution of particular governmental functions.)

Seven of the nine Western states currently impose a general retail-sales tax, with rates ranging from 2 percent in Nevada to 4½ percent in Washington. (Alaska and Oregon are the two exceptions.) General-sales taxes provided for 33 percent of District tax revenue in 1969, as against 30 percent nationally, and for 59 percent of all consumption-tax revenue, as against 52 percent nationally.

Following the national pattern, District sales-tax revenue has far outpaced excise-tax revenue in recent years; since 1965, the former advanced by 73 percent, to \$2.6 billion, and the latter by 45 percent, to \$1.8 billion. Revenue from the tobacco levy nearly tripled in the past half-decade. However, the tax on motor fuels remains the most important excise tax, accounting for more than half of all District excise-tax revenue.

Western States, of course, provide a substantial portion of Federal excise-tax receipts — roughly one-twelfth of the national total in 1969. The bulk of this sum (83 percent) came from California spenders.

Western consumers enrich state and Federal tax coffers



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between $10,000 and $14,999; and 0.4 percent of incomes over $100,000. Indeed, at each step on the income ladder, sales taxes consistently decreased as a percentage of income.

But these results are hardly surprising. After all, consumption taxes tend to be imposed at a flat rate, and the consumption of the commodities taxed typically rises less rapidly than income.

The impact of consumption taxes on lower-income groups becomes particularly acute, because these groups generally spend a higher percentage of their income than higher-income groups. For this reason also the tax tends to burden larger families more than smaller ones at given income levels. Indeed, consumption expenditures frequently exceed income at the bottom of the income scale.

Sales-tax supporters suggest that the problem of equity should best be assessed in terms of some other concept than that of current income. With the use of permanent income—the average income a family expects to earn over its entire planning horizon—or disposable receipts—money income plus any changes in asset and liability levels—consumption taxes would appear more equitable than the critics maintain.

Advocates also warn against overlooking the actual amount of taxes paid by different income groups, rather than focusing solely on taxes as a percentage of some measure of income. Low-income groups generally pay less in consumption taxes than higher-income groups—obviously because they buy less—yet receive no less in benefits from government spending. Besides, consumption taxes provide a way to obtain some taxes from lower-bracket individuals who would otherwise pay none in the form of direct taxation.

Furthermore, the argument goes, the objections against the general-sales tax on grounds of equity can be largely overcome if taxing authorities use an income-tax credit for sales taxes paid to the states and municipalities. An alternative would be a judicious use of exemptions in the tax base, particularly on items which are important in the consumption patterns of lower-income groups, such as food, shelter, and medicine. Today, 17 of the 45 sales-tax states exempt food from the tax, either fully or partially, or tax it at a lower rate than the general-sales levy.

Still, the critics argue, increased reliance on progressive-type taxation would help offset the skewed distribution of income and wealth within the nation. In addition, they contend that progressive taxes, being based on income with certain adjustments for personal circumstances, have a much closer bearing to ability to pay than any type of consumption tax. For that matter, the states have exploited the regressive sales-tax system to the utmost without making any real headway in solving their serious fiscal dilemmas, and so must turn to the progressive tax if they are to have any hope of success in meeting their revenue needs.

(On the other hand, many income taxes adopted at the state-and-local level are not really very progressive, partly because of rate maxima which commonly apply quite low on the income scale, and partly because of very limited allowances for personal exemptions or deductions.)

Sales and excise taxes are often criticized also for having adverse effects on consumer welfare. These taxes are said to discriminate against those consumers who happen to have a high prefernce for taxed items, and to favor individuals whose tastes incline toward untaxed articles. (The person who enjoys a glass of grape wine with his dinner will be penalized, while the person who opts for a glass of grape juice will not.) This discrimination thus tends to distort the pattern of consumer choice to the extent that the consumer purchases untaxed substitutes for the

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taxed commodities. Assuming that the consumer starts out with a certain desired pattern of personal consumption, he would be no worse off, and would possibly be better off, if the taxing authority collected through an income tax the amount of revenue that the consumer had actually been paying through a consumption tax. With the consumption tax removed, the consumer might prefer to purchase additional quantities of the previously taxed goods at their new lower price, than to hold in a different form the value of the extra money involved.

. . . revenue . . . growth . . .

Consumption-tax advocates contend that such taxes fill an essential need by providing a stable revenue source for state and local governments. Lacking the fiscal and monetary powers of the Federal government, the states and localities might occasionally find their finances endangered if they relied on revenue sources, such as income taxes, which are responsive to cyclical swings.

Stable revenue may not be enough, however, especially since popular demands for state-and-local facilities have substantially exceeded the growth of income and consumption. According to the Advisory Commission on Intergovernmental Relations, "The fiscal problem of state (and local) governments is the failure of their revenue systems to generate yields that grow—without rate increases or new taxes—as rapidly as expenditure requirements." Thus, again, the practical solution may involve decreased dependence on consumption taxes and increased reliance on income taxes.

Perhaps the strongest argument in favor of consumption taxation is its alleged tendency to stimulate private savings and investment—and thereby, economic growth. To the extent that sales and excise taxes fall on spending and not income, they influence private decisionmakers to save rather than spend. Income taxes, on the other hand, tax spending as well as saving. Thus, a shift from income to consumption taxation presumably would result in an increase in the private sector's propensity to save.

Whether this increase in the savings rate becomes translated into a rise in investment —and thence a rise in real growth—strongly depends on other economic conditions, principally the degree of utilization of the economy's productive resources. An increase in the planned savings rate will increase the potential rate of capital formation. But if investment lags behind that increased potential, income will tend to fall, savings will not reach the anticipated level, and the possibilities for economic growth will be frustrated.

. . . and stabilization

Most authorities agree that sales and excise taxes are inferior to income taxes with respect to economic-stabilization policy. Taxes on income decrease more than proportionately as GNP declines and similarly rise more than proportionately as GNP increases. Thus, income taxes act as "automatic stabilizers." During recessions, income taxes automatically reduce the Federal Government's withdrawal of purchasing power —and during inflationary periods, automatically increase the withdrawal of purchasing power.

For the most part, consumption taxes perform inadequately as automatic stabilizers, especially so during periods of recession. At such times, individuals generally try to maintain their customary standard of living, so that consumption falls less rapidly than income. Moreover, any attempt to fine-tune the economy by reducing consumption-tax rates will undoubtedly have a perverse effect on demand (at least initially) because consumers would postpone their purchases in anticipation of the proposed rate reduction.

Conversely, if the authorities legislate a

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consumption-tax increase as a means of soaking up excess demand during an inflation, consumers would tend to speed up their purchases and thereby accentuate inflationary pressures. Besides, to the extent that prices reflect increases in consumption-tax rates, there may be upward pressures on wages, especially in those industries in which wages are directly tied to cost-of-living changes. And this, of course, will just fuel the inflationary fire. Still, in those cases where demand is elastic, as it is for most non-necessities, a tax increase may reduce consumption—and ultimately production—and thereby dampen inflationary pressures.

On administrative grounds, consumption-tax advocates argue that such levies are easier to administer than income taxes, because they are collected from a comparatively small number of businesses rather than from an immense number of individual taxpayers. Further, sales figures are easier to determine and less subject to question than income figures. On the other hand, consumption taxes place a major burden on the retailer, who is forced into the role of tax collector for the government. But insofar as the legislative decision revolves around the use of a consumption tax along with—not in place of—an income tax, the total administrative effort is obviously greater with a sales or excise tax than without one.

Karen Kidder

Tax Exemptions

Who could oppose mother, God, and country? You'd be surprised.

In California, William T. Bagley, chairman of the state assembly's revenue committee, became irked by incessant pleas for special tax consideration. He offered his own measure, which asked an exemption from sales tax for "white canes for the blind, Bibles, the United States flag and Mother's Day cards."

The bill was meant as a wry attempt at "legislative enlightenment," Bagley says, but it isn't clear how much light is being shed. One legislator suggested a $10 tax credit for anyone who bought a flag. (It would be cheaper to give every Californian a flag, Bagley retorted.) Then a minister objected to favoritism for religion and asked equal treatment for Darwin. Even the blind complained that they don't need special treatment.

Nothing's been said about the Mother's Day cards. "Everybody's in favor of motherhood," says a Bagley aide. But no one's heard from the population people.

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Healthier Markets

Money managers breathed more easily in recent weeks, as their earlier fears of a liquidity crisis evaporated and as interest rates continued their summer-long decline—in some cases falling quite steeply. Long-term rates eased moderately, even in the face of heavy capital-market demands by businesses and governments, while short-term rates dropped to the lowest levels of the past year and a half.

This decline was highlighted by the late-September drop, from 8 to 7½ percent, in the commercial banks' prime business-loan rate. This was the second half-point reduction of the past six months. (The prime rate, incidentally, held within the range of 4 to 5 percent for most of the 1956-66 period, but it has since been changed 15 times—generally upwards.) The prime rate had come under pressure during recent months because of the steep decline in rates on short-term money-market instruments, and it was then reduced when the mid-September tax date elicited only a modest increase in net business-loan demand; large New York banks, for example, expanded their loans over the tax date at only one-third the year-ago pace.

The steepness of the recent decline in short-term rates has indeed been memorable. The three-month Treasury-bill rate, which had exceeded 8 percent at last January's peak, fell below 6 percent in mid-September, and bills even traded as low as 5.60 percent at one point recently. The Federal-funds rate, which had averaged almost 9 percent for several months last winter, also dropped below 6 percent in mid-September. And the commercial-paper rate, which had approached 9 percent at the January peak, dropped below 7 percent as the summer period came to an end.

The stance of monetary policy has helped along this interest-rate decline. The average level of net borrowed reserves fell below $600 million in September—the lowest level in almost two years. The money supply grew this summer in line with the Open Market Committee's decision in June to aim for a 5-percent growth rate during the third quarter, compared with a 4-percent rate of growth of the

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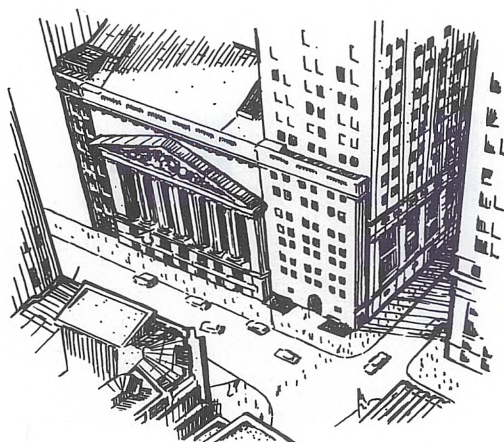
preceding six months and the almost zero rate of growth of the second half of 1969.

The healthier tone of the credit markets developed against a background of apparently increasing success in the Administration's anti-inflation drive. The consumer price index advanced at a 3.5-percent annual rate during the June-August period (seasonally adjusted), as against a 6.0-percent rate in the preceding three-month period and a 7.3-percent rate of increase last winter. Policy-makers remained dissatisfied with the continued advance in prices —and they visualized future increases in such diverse fields as transportation, fuels, and utility charges—but they were heartened nonetheless by this summer's partial success in curbing inflation.

Continued sluggishness in the national economy also has helped along the easing trend in financial markets. August's statistics on production and employment were slightly weaker than July's, and these developments, plus the auto strike in September, underscored the concern over the speed of the business upturn.



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High Tide for Foreign Cars

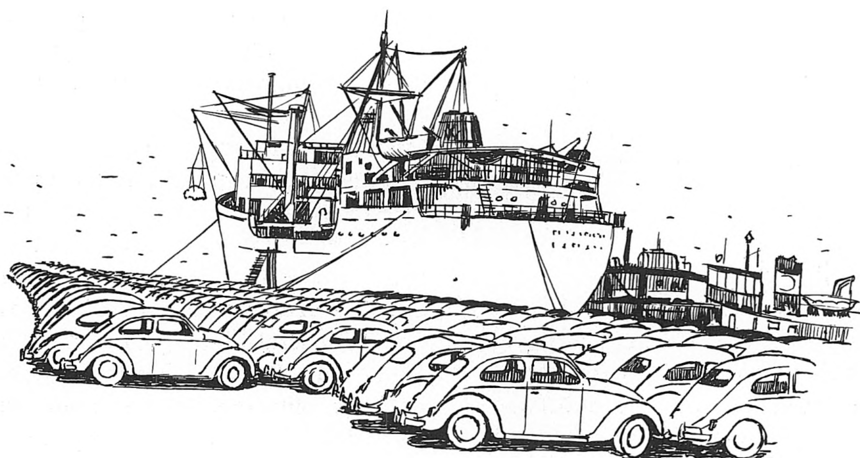
The 1971 model year should be a crucial one for the American auto industry, since Detroit will be making a major effort this fall to stem the rising tide of imports of German, Japanese, and other foreign cars. In addition, the industry will be trying, through inter-governmental negotiations with Canada, to define more closely the Canadian stake in the American market, as will be discussed later on in this article.

Detroit's belated recognition of a significant consumer demand for stylish yet inexpensive products has cost the U.S. industry a substantial share of the market in recent years. In 1969, for the first time, sales of new foreign cars exceeded one million units, or more than 11 percent of the new-car market. In 1970 to date, the trend strengthened even more; imports garnered over 13 percent of the market in the first half of the year and 16½ percent of the market in the July-August period.

First counterattack

In some ways, this recent performance has been a replay of the late 1950's. In that earlier period — the era of tail fins and chrome—a rebel cadre of car buyers turned in growing numbers towards the more modest offerings of foreign manufacturers. But the domestic industry soon recaptured most of these buyers as the Big Three joined American Motors and Studebaker, which already had entries in the field, to produce an attractive assortment of compact cars. (Compacts are generally defined as cars with a length of 190 inches or less.)

Between 1959 and 1962, imports shrank from 10 percent of total registrations to less than 5 percent of the total. The Corvairs, Valiants, and Falcons were not only a little larger and more powerful than the competing imports, but they were more attuned to American driving conditions. The domestic compacts' greatest advantage, however, was



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the existence of a broadly-based dealer network which promised convenient servicing and parts' replacement.

Despite the current feeling of *déjà vu,* no one in Detroit can be certain that the import tide will be stemmed as effectively today as it was a decade ago. Foreign auto makers have spent the intervening years studying the needs and tastes of American consumers. They have strengthened their ability to deliver, and have gradually built up a product loyalty based on continuing performance. Indeed, they view Detroit's current reluctant reaction as an affirmation of their own market reading and as a sanction removing the final stigma attached to small cars.

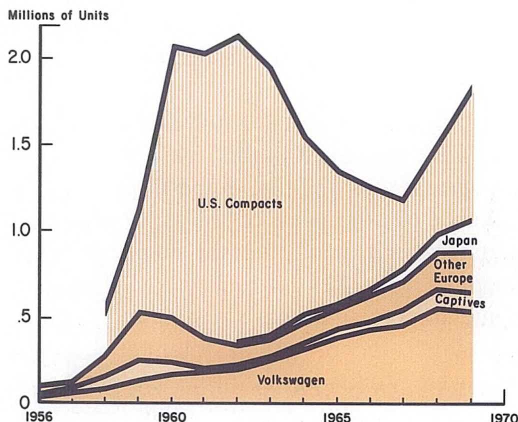
The domestic auto industry's hesitation about concentrating on small-car production stems in part from the low profit per car earned on compacts. A standard U.S. sedan with a basic price of $3,000 yields something like $250 to $300 in profit to its manufacturer. When the price falls by a third, to $2,000, the factory profit is roughly halved. Below a $2,000 price—the approximate ceiling of the low-priced line—the profit decline becomes ever more precipitous.

The bad news does not stop there. Profit margins on optional equipment are usually higher than on the basic car itself—but the economy-minded buyer of a compact is unlikely to be interested in hundreds of dollars worth of options, whereas the buyer of a $3,000 standard might be quite interested. In fact, the maker of an option-rich car like the Mustang can frequently earn more from the sale of optional gear than from the car itself.

New counterattack

Despite these considerations, Detroit read with great interest the recent marketing statistics—which showed a 21-percent gain in import sales, as against a 9-percent decline in domestic sales, between first-half '69 and first-half '70—and speeded up its production lines for low-priced 1971 models. Actually, the first low-priced Detroit entry, the Ford Maverick, was unveiled over a year ago, but with its wheelbase of 103 inches and a sticker price of just under $2,000 for its cheapest model, this car represented something of a compromise which could just as easily cannibalize heavier domestic lines as compete with imports.

Imports sell over one million units in '69, exceeding U. S. compact sales



American Motors' Gremlin, introduced in April of this year, was the first direct import contender, and the field will broaden this fall with General Motors' Vega and Ford's Pinto. Chrysler Corporation plans to introduce the Cricket in January of next year and, in the meantime, will import and distribute Japanese Colts under an agreement with Mitsubishi Motors Corporation.

The Colt, then, will join the list of "captive" imports—cars that are manufactured on foreign soil by companies that are at least partly owned by one of Detroit's Big Three. Leading examples are Ford's Cortina and Capri, General Motors' Opel, and Chrysler's Simca and Rootes. Incidentally, since remitted profits represent a capital inflow in the balance of payments, "captive" imports

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do not affect the balance as much as imports made by foreign-owned companies. They are, nevertheless, imports, and they do have a negative impact on both the U.S. balance of payments and the domestic auto industry's output and employment.

Altogether, almost 1.1 million new foreign cars were registered in this country last year, as against 1.8 million domestic compacts. Since 1962, the peak of the U.S. industry's counterattack, new domestic compacts have dropped from over 2.1 million to 1.8 million, while import sales have just about tripled. Of 1969's record import total, about one-half were Volkswagens, over one-tenth captive imports, over one-fifth other European models, and about one-sixth Japanese. (In addition, Canadian subsidiaries of U.S. firms have produced a sharply expanding amount of autos and parts for the U.S. market.)

To meet the subcompact competition, domestic manufacturers are exercising more and more ingenuity in the vital area of cost control. Some Detroit makers expect to leave the design of the basic models unchanged for the next five years. Some are using overseas plants to manufacture automotive parts; some are utilizing robots on a speeded-up production line to assemble parts; and to conserve railcar space, some makers are shipping finished products vertically like metal carcasses. Withal, it is Detroit's hope to win the day with showroom contenders that combine economical performance with appealing style.

From north of the border

A discussion of auto import trends—and their balance-of-payments implications — is complicated by the unique position of Canada in the international auto marketplace. Better than half the value of U.S. auto imports in 1969 derived from cars built in Canada by Detroit subsidiaries. This year, with Detroit's production rates (and payrolls) at relatively low levels, negotiations

Western Preferences

Back in 1956, when imported cars were as rare as seat belts, the West accounted for 36 percent of foreign-make registrations. This share later declined under the counterattack of the domestic compacts and the growing appeal of foreign cars to buyers elsewhere in the nation. Since 1962, however, import sales have grown even faster in the West than elsewhere. Indeed, the Western share of the growing national market jumped from 20 to 29 percent between 1962 and 1969.

California, with less than 10 percent of the U.S. population, is the center of this expanding market. During the 1969-70 period, California has purchased 20 percent of all the Mercedes sold in the U.S. market, plus 18 percent of the Volkswagens and 40 percent of the Toyotas and Datsuns.

The buyer of an imported car generally is better educated, better paid, and younger than the average new car buyer. By these standards, the Western market is a prime target for foreign-car salesmen. The pool of college grads with some postgraduate training is about one-third larger in the West than elsewhere; per capita income in Twelfth District states is 10 percent higher than elsewhere; and the younger (18-44) car-buying public accounts for over 36 percent of the Western population, or slightly above the average in the rest of the nation. Other favorable market factors include terrain, weather, and the price advantage of coastal location, but there is also some residual factor—perhaps ascribable to flair.

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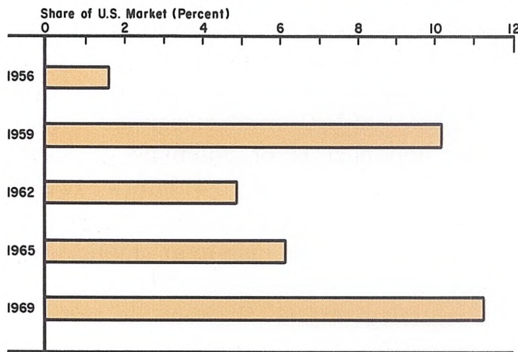

with Canada about possible modifications of the 1965 bilateral auto agreement are taking place in a very sensitive atmosphere.

The U.S.-Canada Automotive Products Agreement assured manufacturers of duty-free shipments between the two countries for such products as cars, some trucks, buses, special-purpose vehicles, and original-equipment parts and accessories. But although virtually all automotive shipments in both directions across the border have been duty free, the agreement did not establish "free trade."

Strict qualifications were established for duty-free treatment, particularly for U.S. shipments into Canada. In addition, the auto companies signed separate "letters of undertaking" with the Canadian government that specified certain increases in Canadian production and also guaranteed Canadian firms a given share of the value of Canadian final sales. Specifically, U.S. producers agreed to an increase in Canadian value-added of Canadian $260 million (U.S. $241 million) between the 1964 and 1968 model years, plus an increase in Canadian firms' production of 60 percent of the growth in Canadian car sales and 50 percent of the growth in Canadian commercial-vehicle sales.

The agreement and other commitments have led both U.S. and Canadian producers to reorganize some of their production operations. More to the point, the Canadian producers have exceeded (by a substantial margin) the conditions required to achieve duty-free status. As a result, the once-substantial surplus in U.S. automotive trade with Canada has dropped sharply in the last two years, after averaging over $600 million annually throughout the 1964-67 period. It must be remembered, however, that the decline in net U.S. automotive sales is not an accurate measure of economic loss to this country. Account must also be taken of the profit performance of the Canadian subsidiaries of the U.S. parent companies involved.

Both countries originally believed that the agreement would not cause any significant change in the automotive trade balance. The vast unexpected shift was due in part to an overly optimistic projection of the growth in the Canadian market for motor vehicles, but other factors were involved as well, such as "lumpiness" in the addition of production facilities and the disappearance of Canada's relative cost disadvantage in automotive production.

The latter factor is particularly interesting both as an explanation of the overfulfillment of the present agreement and as a prime determinant of the future course of automotive trade between the two nations. Most observers prior to the agreement had generally believed that the Canadian auto industry was relatively inefficient, although there were some differing views on this score.

Prices of cars were certainly higher by 10 to 17½ percent in Canada, but in an oligopolistic industry this might have been caused by other factors than that of comparative costs. Exports were low, but given the U.S. tariff, Canadian production costs would have had to be lower than American costs to permit profitable entry into the U.S. market. But other measures of productivity

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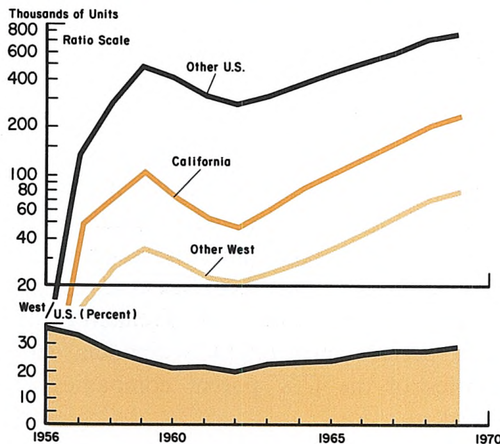
California and other Western states represent prime import-car market



—for example, Canada's high ratio of non-production to production workers, and its low return to capital per production worker—created the picture of an industry that was a costly, excessively diversified miniature of the U.S. industry.

Since 1965, however, the auto companies have increased Canadian productivity by restructuring their Canadian facilities to permit longer runs of fewer models. Meanwhile, Canadian autoworker wages, which had originally been 30 percent below the U.S. level, have crept upward in recent years, partly because of union pressure on the companies to bring about nominal wage parity this year. The recent freeing of the Canadian dollar should work to make actual wages even more uniform.

Because of the problems involved in these wage developments, Canada would like to obtain production safeguards in the current negotiations. The U.S. position, however, leans towards unhampered free trade — towards relaxation of the restrictions which, under the 1965 agreement, have been imposed on the shipment of U.S. automotive products into Canada.

The agreement was a hastily conceived reaction to Canada's "duty-remission plan" of 1963, which had been challenged as being in conflict with U.S. customs legislation. (Although the pact is of unlimited duration, each Government may withdraw twelve months after giving written notice of termination.) Now, as the long-term implications are more fully realized, the affected parties are becoming very vocal about the terms of the agreement.

Rep. Wilbur Mills, chairman of the House Ways and Means Committee, recently cited the automotive agreement as a prime example of a trade compromise whereby this country is "prohibited" from using its leverage in its trade dealings while others remain free to utilize protective devices. Meanwhile, the Autoworkers' International Executive Board recently called on both the U.S. and Canadian governments to "continue their negotiations in a spirit of recognition that both sides have benefited from the agreement." Canada, as always, remains unwilling to permit the level of automotive activity in that country to be determined solely on the basis of decisions by firms whose head offices are located elsewhere.

And so the public waits while the complex and far-reaching issues are discussed behind closed doors. The domestic auto industry is being challenged on many fronts these days, and it is in no humor to see sales continue to go elsewhere. But for the American consumer, the irony lies in the possibility that more imports — not less — might be an acceptable answer to the problem.

Joan Walsh

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Western Digest

Bank Credit Expands

Bank credit at large District banks expanded by $1.8 billion during the July-August period, as banks added to both their loan and securities portfolios. . . . The loan increase of $707 million was largely due to increased financing of securities dealers and sales-finance companies. Commercial-industrial loans and real-estate loans both declined in this two-month period, and consumer instalment loans rose by only a small amount. . . . District banks increased their holdings of Treasury bills and, as a result of the August Treasury financing, increased holdings of intermediate and long-term issues also—for a total gain of $860 million in U.S. Treasury isesues. In addition, they expanded their portfolios of municipal and other securities.

Deposits Increase

During the July-August period demand deposits (adjusted) at large District banks increased only $262 million, but time-and savings deposits soared by $2.0 billion. Passbook savings and consumer-type time deposits rose $776 million, large CD's $753 million, and public deposits $412 million.

Auto Walkout

Some 345,000 auto workers went on strike at General Motors plants throughout the country in mid-September. The walkout had less impact on the West than on other areas, however; in California, for example, about 11,000 workers were affected by the strike. . . . The strike had an immediate effect on the suppliers of the vast firm. At GM itself, facilities supplying other auto companies were not struck, but over one-third of the 73,000 nonstriking employees have already been laid off. Manufacturers of auto parts, rubber, steel, glass, and textiles, along with railroads and trucking firms, are all now curtailing production and scheduling layoffs.

Farm Receipts Sluggish

Cash receipts of District farmers rose only 2 percent above the year-ago level during the first half of 1970, as against a 6-percent year-to-year gain posted by farmers elsewhere in the nation. In the District, returns from crop marketings fell 4 percent below the year-ago figure, while livestock returns advanced at a slower pace than elsewhere. . . . Farm returns may turn even more sluggish during the remainder of the year. Crop output in District states is expected to fall below year-ago levels, especially for such major crops as processed vegetables, deciduous fruits, cotton, and rice. Farm labor disputes and a sharp reduction in the feedlot-cattle population also complicate this uncertain picture.

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