BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date September 2, 1966

To Chairman Martin

From J. Herbert Furth

Subject: Comments on The Fundamentals of a Free Enterprise Economy, by Stewart P. Coleman.

Mr. Coleman's paper represents an interesting attempt at reformulating both the theoretical basis and the practical consequences of "classical" economics. Mr. Coleman wants to reconstruct a perfectly free competitive economy--with "strict enforcement of the anti-trust laws" to avert "abuses by business in the monopoly control of goods and prices," and with the application of the anti-trust laws to labor and the enactment of a national "Right to Work" law to avert "upward pressure on labor rates resulting from labor monopoly," but without any other government intervention and especially without "government manipulation of fiscal policies" (page 72).

"Basic Fundamentals"

Mr. Coleman bases his model on the propensities to work and earn, to buy and consume, and to save and invest (page 1). He states two fundamental laws regarding those propensities: First, the proportion of the "working force utilized will vary with the economic variable of the real wages paid per unit of production"; and second, "as per capita real income rises, the proportion of that income going into consumption will become less and the proportion going into savings will become greater. The proportion

going into savings will also tend to increase as the return to be expected from the investment of savings increases" (page 3).

Both these laws seem to conform to common-sense reasoning. Nevertheless, their validity is extremely doubtful.

Increases in "real wages" indeed may attract some non-working members of the potential labor force; but they may also induce some other members to quit work (e.g., wives of working husbands; children of working parents). In 1965, when the unemployment rate was 4.6 per cent, the U.S. labor force (relative to the adult population) was lower by one full percentage point than in 1958, when the unemployment rate was 6.8 per cent--although "real" wages (average weekly earnings per worker) had meanwhile risen by nearly one-fifth.

Unfortunately there is not the slightest evidence that the savings ratio rises with a general increase in real income or that higher returns on investment measurably increase the savings ratio.

Detailed investigation of savings trends in the United States over the past 100 years has failed to discover any significant permanent increase in the savings ratio, despite the rapid increase in per-capita real income. In 1965, for instance, the ratio of personal savings to disposable personal income was

5.4 per cent--exactly the same as in 1936; it was lower than in other peak years of postwar prosperity (7.1 per cent in 1948, 6.7 per cent in 1957) and only negligibly higher than in 1929 (5.0 per cent).

The failure of the savings ratio to respond to an increase in the national income has puzzled economists for a long time: individual experience clearly suggests that a substantial rise in real income leaves not only a larger absolute amount but also a larger proportion of income free for discretionary use, and thus also for savings. But a general rise in real income raises the standard of living rather than the savings ratio--probably thanks to the so-called demonstration effect, or in simpler language, to the desire to keep up with the Jones'. Luxuries become necessities (in my own lifetime, this has happened with car ownership, central oil heating, refrigerators, telephone, radio, television, water heaters, automatic washers and dryers, dishwashers, garbage disposals, and it is right now happening with foreign travel); and once these new luxuries are paid for, the proportion available for saving remains, for the average household, as small as before (even though the absolute amount has risen).

For these reasons alone, it is impossible to build a realistic model of economic society on the "basic fundamentals" chosen by Mr. Coleman.

The ratio of prices to wages

Another cornerstone of Mr. Coleman's edifice is "the ratio of prices to wages (the P/W ratio)" (page 8). Unfortunately, this ratio is neither as unambiguous nor as important as the author believes.

Actually, Mr. Coleman uses that ratio in three different senses, without clearly distinguishing between the different meanings.

First, the P/W ratio may be applied to an individual commodity; in this case, a decline in the ratio reduces the profit margin per unit of commodity but not necessarily the total profits of the enterprise (or of the economy as a whole) since the effects on total profits of the decline in the per-unit ratio may be offset by an increase in the number of units sold.

Actually, this type of P/W ratio has remained remarkably stable: some 40 years ago, Professor (now Senator) Douglas, on the basis of both theoretical reasoning and extensive statistical research, discovered his famous "law," according to which the proportion of returns to capital and to labor in industrial production tends to remain unchanged in the course of economic development; and the validity of this law has been well confirmed by later investigations.

Second, the P/W ratio may be applied to the movement of price and wage-rate indices. In this case, a decline in the ratio indicates a rise in "real" wage rates. This rise in wages may be associated with a fall in profits but alternatively--and more frequently--with a rise in profits since "real" wage rates tend to be the higher the greater the productivity of the economy and the greater therefore prosperity in general (including the profitability of enterprises).

For instance, between 1946 and 1965 this type of P/W ratio declined in the United States by about one-third as wage rates (adjusted for overtime and inter-industry shifts; otherwise the rise would have been even larger) rose by 140 per cent while wholesale prices increased 55 per cent and consumer prices 60 per cent. Over the same period, corporate profits (both before and after taxes) rose about 200 per cent. Clearly, neither "real" nor "nominal" profits were hurt by the decline in the P/W ratio and the corresponding rise in "real" wages.

Finally, the ratio may be meant to signify the relation between national income and wages. Subsuming all non-wage income under "profits," a decline in this ratio would indeed (by definition) mean a decline in the share of profits in the national income. But it again would not mean a decline in total profits

(Mr. Coleman should not be blamed for this confusion: both Ricardo and Marx apparently fell victim to a similar misunderstanding). For instance, between 1946 and 1965 the share of labor in total non-agricultural income rose from 70 per cent to 72 per cent; but this increase did not prevent "real" profits from rising about as rapidly as "real" labor income since the sharp increase in aggregate national income (which nearly doubled in terms of constant purchasing power) completely overshadowed the effect of the modest change in its composition.

Hence, Mr. Coleman is mistaken in believing that a decline in "the" P/W ratio would lead to a situation "where the incentive to save and invest would drop to a level where capital would be available only for the replacement of existing facilities but not for further expansion" (page 8). Since a large part of Mr. Coleman's reasoning is based on this belief (see his discussions on pages 15-19 and 47-50), his conclusions cannot be considered to be theoretically justified.

The role of credit

Contrary to classical economics, Mr. Coleman believes that the use of credit distorts the economy and is responsible for those economic ills that cannot be attributed to monopolistic behavior of business or labor.

Mr. Coleman views with understandable alarm the rise in total debt in the United States, from $191 billion in 1929 and $397 million in 1946 to $1,260 million in 1965. He believes that "a substantial mortgage has been placed on industry's markets which, at the same time, has greatly inflated consumer demand. Ultimate deflation of this demand will mean that industry will have over-invested in surplus capacity. The use of credit to finance capital expenditures . . . is not sound when resorted to by industry in general as a substitute source of capital for that which, in general, should preferably be generated from the operations of industry" (page 25).

There is a core of truth in the author's apprehension, especially as to the rise in consumer debt. But Mr. Coleman not only exaggerates the "burden on the overall economy" resulting from the increase in total debt; he also exaggerates the difference between equity and debt financing of business.

While the amount of debt outstanding in 1965 was indeed very large, it represented a slightly lower ratio to gross national product (185 per cent) than did the amounts outstanding in 1929 (186 per cent) or 1946 (190 per cent). It is quite true that a sudden liquidation of that indebtedness would have catastrophic consequences; but there is no inherent reason for such "deflation" to occur.

Moreover, the great bulk of that debt ($810 million) represented corporate, non-corporate business, farm, and mortgage indebtedness. These debts can be considered to be economically equivalent to "equity" participations (this reasoning was familiar to the medieval "schoolmen," who used it to defend the legitimacy of such credits against the condemnation of "usury"). The owner of an enterprise, farm, or building goes into "partnership" with the owner of liquid funds (in some common-law jurisdictions, the mortgage holder rather than the mortgagor is indeed considered to be the "owner")--with the only difference that the "partner's" share in the partnership's receipts and assets is a fixed sum instead of a ratio, and that the time of the dissolution of the partnership also is fixed (which incidentally could be the case in an ordinary partnership, too). It is quite true (as Mr. Coleman states) that these arrangements increase the "leverage" for the owner if profits are high and increase his risk if profits are low or nonexistent; but this merely means a change in the distribution of gain and loss between the two "partners," which is of little if any significance to the economy as a whole.

The situation is somewhat different in the case of the debts of the Federal Government ($270 million), State and local authorities ($93 million), and consumers ($87 million).

In the case of Federal, State, and local authorities, the contraction of debt can be understood as a modified form of taxation, which affects the distribution of the tax burden rather than its aggregate impact on the economy.

In the case of consumer credit, consumers may indeed be said to mortgage their future income for present rather than future consumption. But since most consumer debt is incurred in connection with purchases of consumer durables (such as cars), the transaction can also be interpreted as involving the promise of future payments for the future services to be derived from the continuing use of the commodity (in Britain, the legal fiction of "hire-purchase" is consistent with this interpretation).

Nevertheless, it is bothersome that consumer debt has recently been rising much faster than consumer income and consumer expenditures: that debt represented in 1965 about 20 per cent of consumer expenditures, as against little more than 8 per cent in 1929. But this reviewer has for some time been concerned about that development--which is clearly unsustainable in the longer run--without sharing Mr. Coleman's theoretical or practical views.

To sum up, there is no good reason for Mr. Coleman to conclude that the rise in debt has reduced "the internal generation of capital" (in 1965, undistributed corporate profits plus capital

consumption allowances were a healthy $62 billion--in "real" terms about 3-1/2 times as much as in 1929, representing 9 per cent of GNP as compared with 7 per cent in 1929); that "the present high volume of production could have been achieved without incurring debt" (Mr. Coleman himself expresses the opposite opinion on page 25, where he concedes that "borrowing has been an important factor in the development of our economy"); that "with the above described increasing debt load the U.S. economy is in no position to withstand the impact of a recession"; or that there is danger of "the limit of borrowing capacity" being reached (page 26).

Government intervention

No objective observer can doubt that government intervention in economic problems at times hampers rather than promotes sustainable economic growth; the tendency to protect inefficient or obsolescent industries against domestic and especially foreign competition is a flagrant instance. But Mr. Coleman concentrates his attack on compensatory fiscal and monetary policies--exactly that kind of intervention that has been most consistent with the principles of a market economy and that has been most successful in practice.

Mr. Coleman believes that the "lowering of interest rates . . . through manipulation of government monetary and

fiscal policies" results "in increasing the burden of interest cost to industry" and means "a regularly rising price level over the years as more and more debt is accumulated" (page 28). Actually, the "burden of interest cost" as a proportion of national income is less heavy today than it was before the advent of the "New Economics": net interest was equal to about 3-1/4 per cent of national income in 1965, as compared with 5-1/2 per cent in 1929. In the period 1946-53, it was less than 1 per cent of national income; the proportion is higher today mainly because after the Accord of 1951 monetary policies could again be used--in full accordance with classical economics--to raise interest rates in times of inflationary pressures.

The upcreep in prices is indeed bothersome; but it should be remembered that a tendency for prices to increase has been characteristic of prosperity long before the invention of the "New Economics." In the nine-year period 1898-1907--one of the most prosperous periods in U.S. history--consumer prices rose 27 per cent and wholesale prices 34 per cent (Historical Statistics of the United States, Series L 36 and L 15); in the nine-year period 1957-66, consumer prices rose 17 per cent and wholesale prices a mere 7 per cent. In those two periods the rise in total national income at current prices was quite similar: about 65 per cent in

1957-66, and about 67 per cent in the earlier period (Series A 154, extrapolated from data for 1899-1907). In "real" terms, the economic growth was thus substantially more rapid in the later period, and especially so on a per-capita basis since population rose 19 per cent in 1898-1907 (Series B 31) but only about 15 per cent in 1957-66. Apparently, under the "New Economics" economic welfare has improved more rapidly and at the cost of a considerably less rapid advance in prices than in the "gold old days."

Instead of the use of monetary and fiscal policies, Mr. Coleman recommends in a depression "the lowering of prices in relation to wages to increase consumption and eliminate inefficient production facilities" (page 31). But it was exactly this type of deflationary policies that became utterly discredited in 1929-33--and that had not worked very well in previous milder recessions--and therefore led to the emergence of the "New Economics." Clearly, there is no assurance that monetary and fiscal policies will always be able to avert catastrophes like the Great Depression; but their record over the past 20 years compares favorably with that of any other type of economic policy ever tried at home or abroad.

Labor policy

Mr. Coleman's attitude toward the labor problem is colored by his misconceptions about the importance of "the" P/W ratio.

Contrary to all available data, he believes that in consequence of the reduction in that ratio (meaning in this case the ratio between price and wage indices) "not enough capital is provided to maintain or expand production facilities" and "the share of the proceeds of production going to capital is so low that the extensive borrowing referred to above has been resorted to" (page 34).

Mr. Coleman attributes these (nonexistent) consequences of the decline in "the" P/W ratio to "labor monopoly." In his opinion, "the benefits of the increased productivity . . . are not allowed to accrue the overall public in the form of lower prices to increase overall production and total national real income . . . . Instead labor insists that it should receive the entire benefits of increased productivity . . . . Had the benefits of increased productivity . . . not been appropriated by labor our overall production today would be greater and distributed on a more equitable basis" (page 37).

It is difficult to recognize recent developments in the U.S. economy in this picture. Actually, the benefits of increased productivity--although in the form of increased money incomes rather than of reduced prices--have been shared by virtually all classes of the economic society. It is true that recipients of fixed incomes have been hurt by the price increase while the "active"

members of the economic society, who receive variable incomes (profits, salaries, and wages), have benefited from the change. This inequality indeed creates hardship in individual cases, and it is one of the main reasons for demanding that economic policy be conducted in such a way as to avert even slowly creeping inflation.

But it should be remembered that creeping inflation is not exclusively attributable to "labor monopoly": there was no "labor monopoly" in the years preceding the First World War, when prices rose much faster than during the past nine years. Moreover, falling prices create far greater hardship for the far greater number of people (farmers, businessmen, home owners) who have to service a constant debt out of falling receipts. The period of falling prices that culminated in the recession of the 'nineties has--in contrast to the postwar period--not been one of the most prosperous and harmonious episodes of U.S. economic history.

Mr. Coleman is more justified in attacking the price creep for reasons of the U.S. payments balance. He rightly asks that "we restore in all segments of our economy the free unrestricted action of competitive forces so that we may reduce our costs of production to a basis where we can meet world competition" (page 73). It is not correct to say, however, that "this country is becoming more and more a high cost island," or that "our competitive costs

disadvantage is further aggravated by excessive taxation and high interest costs as the result of government manipulation of fiscal policy" (page 67). Actually, in recent years prices and costs in the United States have risen considerably less than in most if not all other industrial countries; taxation in the United States has not been heavier than in most other industrial countries; and interest rates have been lower than in most of them.

Recommendations

Some of Mr. Coleman's recommendations are highly valuable. He rightly suggests "to reduce marginal unemployment (by) the training of marginally unproductive labor" (page 48). He rightly exhorts business to follow a policy of "low prices and low profit per unit rather than restricting volume to bring about high prices and unduly high profits which create idle capital and unemployment" (page 64). And he rightly warns labor "that raising wages above normal competitive levels by monopoly control can only result in inevitable inflation and unemployment" (page 74).

But the means Mr. Coleman recommends to achieve these purposes are of dubious value. It can hardly be expected that "the strict application of anti-trust laws" (page 75) will bring perfectly free competition to our basic industries (steel, aluminum, copper, automobiles, airplanes, railroads, airlines, TV networks, telephone,

telegraph, electric power, oil, and many others). And even if it did, many instances would remain in which private gains and losses clearly deviate from social gains and losses: air and water polution are cases in point. Even if the most extreme form of the classical arguments for free enterprise is accepted, the scope of inevitable government intervention is much greater than Mr. Coleman seems to realize.

This is particularly true for fiscal and monetary policy. Mr. Coleman strongly objects to the present use of such policies but he does not propose an alternative. After all, money is, even according to the most extreme classical economists, a public rather than a private matter. Does Mr. Coleman advocate return to a quasi-automatic gold standard; or adoption of some automatic rule for money creation (as proposed by Professor Friedman); or return to the free private issue of bank notes (as in the period of "wildcat" banking)? He does not say.

Similarly, taxation is inevitably a public rather than a private matter, and every tax burdens some member of the community for the benefit of others. Does Mr. Coleman advocate a single strictly proportional income tax (as proposed by Professor Hayek), or exclusive reliance on indirect taxes (as apparently proposed by those who want to repeal the 16th Amendment), or levies on the States (as under the Articles of Confederation)? He does not say.

And what about boom and recession? Does Mr. Coleman want public policy to follow a strict laisser-faire policy in the hope that reasonable behavior of business and labor will avert all inflationary and deflationary danger? And if this hope is disappointed, what then? Mr. Coleman's suggestion to train sub-marginal labor shows that he is fully aware of the social implications of unemployment; does he wish to leave that problem to the uncertain mercies of private charity? He does not say.

There is only one point on which Mr. Coleman is explicit: his desire to make the anti-trust laws applicable to unions and to enact a national "Right to Work" law (page 75). In this instance, we are fortunately able to draw on extensive experience with the very legislation Mr. Coleman recommends.

Until quite recently, labor organizations in the United States were indeed subject to the "common law notions of conspiracy," and later to the Federal anti-trust law. The earliest attempt to exempt labor unions was made in the Nebraska Anti-Trust Act of 1897; and this attempt was "deemed unconstitutional favoritism when the law first came before a federal court sitting in Nebraska" (Frankfurter and Greene, The Labor Injunction, New York, 1930, page 138). The Sherman anti-trust act was applied by the courts to "combinations of labor" as early as in 1893 (Frankfurter and Greene, page 8).

That law was also used to pass prison sentences on labor leaders (e.g., on E. V. Debs in connection with the great Pullman strike of 1894, and on the mild and conservative Samuel Gompers as late as 1911; see Frankfurter and Greene, page 9).

The Clayton Act of 1914 was designed to put an end to the application of the anti-trust laws to labor, but this purpose was fully achieved only 19 years later, in the course of the New Deal legislation. Hence, until 1914 (and to a large extent in practice until 1933), the anti-trust laws were indeed made applicable to labor unions.

Similarly, the "right to work" was fully supported in that period. In fact, the right to strike, or even to union membership, was denied. A Federal statutory provision as well as State laws prohibiting discrimination against union members was declared unconstitutional by the Supreme Court in 1911 and 1914, respectively (Adair v. United States, 208 U.S. 161; Coppage v. Kansas, 236 U.S. 1). Even after the passage of the Clayton Act, the Fourteenth Amendment was used to support court action against strikes, and a State law prohibiting such action was declared unconstitutional by the Supreme Court in 1921 (Truax v. Corrigan, 257 U.S. 312).

It cannot be said, however, that labor relations in that period were ideal. Strikes were not only numerous--as evidenced by

the large number of "labor injunctions" listed by Frankfurter and Greene (Appendices I - III)--but also tended to be violent--as evidenced not only by a number of notorious incidents involving strikers, professional strikebreakers, and security forces, but also by the emergence of the radical and even anarchistic Industrial Workers of the World in 1905.

Even today, "right to work" laws are in effect in a number of States. If there is any evidence that these laws have served to keep wages in those States closer to the level that would be reached in a perfectly free labor market, or in any other way to make labor relations in those States more harmonious or economic development more rapid, the advocates of a national "right to work" law have been strangely silent about it. Or if there is any evidence that these laws have seriously diminished the legitimate status and power of labor, the opponents of a national "right to work" law have been equally silent about it. The conclusion to be derived from this mutual silence is that a national "right to work" law would neither significantly help management nor significantly hurt labor--in short, that it would not significantly affect the economy and that the issue is therefore irrelevant.

To sum up, it seems unlikely, to say the least, that a return to the pre-1914 legal status would result in a free competitive

labor market. Legislative action might outlaw "monopolistic" labor unions; but it could no more assure truly equal and free bargaining between an individual worker and General Motors than it could establish meaningful free competition between General Motors and a mechanic trying to build an automobile in his backyard.

Conclusions

The main reason for Mr. Coleman's failure to establish a valid theoretical basis for economic policy is to be found in his method of making general abstract statements and then deducing from these statements concrete policy recommendations.

In doing so, Mr. Coleman is in good company--though not in the company of the Founding Fathers of classical economics, Adam Smith and Malthus, who were careful to base their theories on thorough factual research. But like so many others, Mr. Coleman seems to forget that economics--in contrast to mathematics--is an empirical science, and that its laws can therefore be derived only from an analysis of actual experience.

Experience has shown that economic reality is less simple than Mr. Coleman seems to assume, and even less simple than it was at the time of Smith and Malthus. Mr. Coleman believes that nothing more is needed to achieve optimal economic behavior of business and labor than stopping government intervention. Actually, the relevant question

is not whether or not there is need for government intervention in the economy but where, when, and how the government should intervene--just as in modern city traffic control the problem is not whether or not there is need for traffic lights and traffic police but where, when, and how traffic lights and traffic police should operate.

The "New Economics" has become an important force in economic policy because, whatever its shortcomings, it has at least recognized this basic truth. It can and will one day be replaced by a better system of economic policy--but only after its opponents become willing to base their reform proposals on analysis of actual experience rather than on an imagined world of perfect human behavior.

JHF