

October 31, 1937

SUMMARY OF PROGRAM TO COMBAT THE RECESSION

1. The true cause of the downturn.
2. The gravity of the current situation - vicious spiral of deflation.
3. What it means for the budget.
4. Positive action must be taken without delay:
  - (a) to assume leadership and dispel pessimism
  - (b) to maintain consumer incomes through Government expenditures
  - (c) to stimulate private expenditures
5. Psychological background:
  - (a) Acknowledge present situation
  - (b) State causes and enunciate a general wage, profit and price policy of the Administration
  - (c) Suggest business men recognize that the Government can and will act to stop recession, and make their plans accordingly
6. In fiscal accounts:
  - (a) Recognize that the Government proposes to collect \$400,000,000 more than it spends in fiscal year 1937
  - (b) Increase current expenditures in W.P.A. and crop loans
  - (c) Anticipate and speed up contemplated expenditures
7. Stimulate private expenditures by:
  - (a) a well-rounded housing program
  - (b) by amending undistributed profits tax

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## A PROGRAM TO COMBAT THE RECESSION

### Why Production Turned Down

Business activity is declining at an alarming rate. The basic cause of this development is not the tax policy of the Administration; it is not monetary; it is not security regulations or the decline in the stock market. The present downturn is a direct consequence of the rapid cost and price advances last winter and spring.

These cost and price advances led to a great wave of forward buying which had resulted for months in production in excess of current consumption. These advances led also to a collapse of the building revival on which we were relying to increase incomes and buying power to match current production and to permit the Government to proceed toward its objective of a balanced budget. With the downturn in building, and the decrease in Government expenditures and increase in tax receipts, the growth of national income ceased after May. When by September industry in general had caught up with its backlog of orders there was nothing to take up the slack and production declined. The break in the stock market both reflected and intensified the downturn.

We are now reaping the consequences of the cost and price advances of last winter and spring, particularly in the construction industry. Both minority labor and capital groups contributed to the development of the present recession.

### The Current Situation

At the present time efforts are being made to reduce inventories and production is falling short of current sales. But as production declines unemployment increases. As unemployment increases, incomes and consumer demands fall off. As sales decline and profits diminish, expenditures for new plant, equipment and maintenance will decline. This is the vicious deflationary circle of 1929-1932. If the situation is not changed there is nothing in the picture that would increase buying power and thus arrest and turn the downward trend of business.

### The Budget and Business

If the present downturn is allowed to continue and gather momentum, there is no hope of a balanced budget in the fiscal year 1939. We are in danger of starting again the hopeless attempt to increase Federal revenues when the national revenue is shrinking. The attempt failed in 1929-1932. It must always fail because taxes are paid out of income, and when national income declines, tax revenues diminish. The only condition under which the Federal budget can be balanced in 1939 is to stop the present deflationary trend in business and bring about an increase in national income.

### The Necessity for Positive and Prompt Action

Unless direct positive action is taken there is no good reason why the national income should not continue to decline. Existing shortages in durable goods will not lead to increased activity because, with a decline in consumer demands and consequent decline in production, what are now shortages will disappear and there will instead be surpluses.



Deficient capacity will become excess capacity. A further decline in production and increase in unemployment will check the rise in rents and make the construction outlook even more unfavorable. Comparisons have recently been made with the relatively mild recession of 1924, but in that year housing construction was kept up and aggregated over \$4,000,000,000, compared with an estimate of less than \$1,500,000,000 this year.

The Republican Party was wrecked by relying on wishful thinking that business would turn up, while at the same time pursuing policies that intensified the depression. The Democratic Party can likewise be wrecked if it makes the same mistake. The situation today is too serious for us to rely on wishful thinking. A drastic and long-continued recession at this time would discredit the whole New Deal.

Whether or not we overestimate the gravity of the present situation, we must take action now to make certain that we do not enter upon another downward spiral. There is everything to gain and nothing to lose by acting. We cannot afford to take the risk of a further decline. Effective action taken now would be mild in comparison with what would be required if the present trends are allowed to gather momentum. Effective action was unduly delayed last winter to check cost and price advances. We are now reaping the consequences. If effective action is again delayed at this time, the repercussions on our whole social, political and economic structure may be disastrous.

### Forms of Action Required

The Administration should take action on three different fronts:

(1) It should seek to dispel present pessimism and to create a favorable psychological background for the prosecution of its specific measures. (2) It should, through the handling of its fiscal accounts, operate to maintain current consumer incomes and buying. (3) It should take measures to induce an expansion of private capital expenditures, and thus bring about an increase in consumer incomes and buying power.

### I

#### The Creation of the Proper Psychological Background

An important factor back of the slump in new orders, the postponement of commitments and the panicky feeling in the capital markets, is the fear that a major turning point is at hand. It is fear of declining profits that makes business pessimistic.

It is generally recognized that the Government has done much to bring about recovery. The public has confidence in your leadership. Prompt action to meet the present situation would serve to dispel the prevailing pessimism.

The Administration's attitude against advances in prices of industrial materials is right and proper. It would be helpful to make it clear that these advances can be prevented only by restraining the exactions of certain labor groups.

In general, wages should increase with the increasing productivity of labor. Advances in wages in excess of increasing productivity are harmful to the economy. If they result in advancing prices, they encourage speculative inventory buying, or shut off demand, as is the case with housing. If they reduce profits below a reasonable level, they lead to decreased plant, equipment and other capital expenditures, as is the case with railroads.

The Government should favor wage advances in so far as they reflect increasing productivity or in so far as the industry can afford to meet them out of profits, but should discourage wage advances that lead to a rise in prices and to a decrease in employment.

There is a widespread feeling that the Administration favors wage advances in all circumstances and at all times, regardless of the consequences. I recommend that you restate the Administration's position on this matter. I suggest that you make it clear that the all-important thing is to maintain the volume of output and income, and that wage advances to small preferred groups of labor, which already receive the highest compensation, are injurious to the economy, particularly when they result in slowing down production.

At the same time that the Administration's wage and labor policy is outlined, occasion should be taken to acknowledge the necessity of fair profits. Profits are the main source from which the Federal budget can be balanced and the national debt retired; they constitute the main source of funds for the creation of durable capital goods,



and there must be an abundance of such funds if interest rates are to remain low; finally, they constitute the incentive for expanding production and employment. It should be made clear that the Administration has no desire to restrict profits to the extent of defeating the legitimate ends that they serve in our economic system. Its concern, rather, is that profits should not become excessive through exploiting labor by paying too low wages, or by victimizing consumers through monopoly price practices.

It might be pointed out also that the present situation might not have developed if business had better judged the situation in recent years. Business failed to add to plant facilities in 1934, 1935, and the first part of 1936, when costs were low. It was caught with deficient capacity in the latter part of 1936 and the early part of 1937, and in the scramble to add to plant and cover inventory requirements a long time in advance it forced costs up. Now business men are engaged in a concerted scramble to get out of inventories, thus creating losses for themselves.

Business men should be assured that the determination of the Administration to bring about full employment and a high national income remains unchanged; that all the power of the Government will be directed toward this end; that they will need their present level of inventories and will need much greater plant capacity before the objective of the Administration is achieved; and that if they persist in their present course they will again be caught short and be forced to bid up their costs against themselves.

The Administration is steadily pursuing a constant goal and it has given sufficient evidence in the past four years that it has the determination and the power to achieve it. Business men should take this determination and power seriously into account in making their calculations and decisions.

## II

### Maintenance of Buying Through Government Expenditures

In order (a) to maintain consumer buying power and (b) to make possible a technically-balanced budget in the fiscal year 1939 it is imperative that Government expenditures be maintained and, if possible, increased in the next six months.

When the Government disburses more to the community than it collects, in taxes, it adds to national buying power and the demand for the products of industry. The excess of spending over tax receipts in the years 1933-1936 increased national income and Federal revenues; it increased national demand for goods and made it profitable to make additions to plant capacity in 1936.

The excess of cash disbursements over cash receipts was particularly heavy in the fiscal year 1937, when it aggregated slightly over \$2,000,000,000. According to the revised budget estimates for the fiscal year 1938, cash receipts will exceed cash disbursements by nearly \$400,000,000. This would represent a decrease of \$2,500,000,000 in the net flow of Government money into the hands of the public. The difference between the bookkeeping deficit of \$700,000,000 and the excess of cash receipts of \$400,000,000 is due to the fact that over a billion



dollars collected from the public directly by the Federal Government or indirectly through the States will be transferred to trust funds, and not expended. From the point of view of business conditions, what is significant is not the bookkeeping deficit, but the decline in national buying power resulting from an excess of cash collections.

The business need for Government expenditures is far greater now than in the past year. The human need may also be greater. The present W.P.A. program made no allowance for the increase in unemployment which is currently taking place. Moreover, the drastic fall in crop prices suggests the desirability of additional crop loans. Increased expenditures for both these purposes would go almost 100 percent into consumer buying. On the other hand, they can be sharply curtailed when the need passes.

The Government might also examine all the expenditures that it has in prospect and make as many of them as possible now rather than later. A speeding up of expenditures would both stimulate consumption now, and help to check the recession and make it easier to reduce expenditures ~~in~~ later when, if the present program is successful, less stimulus to business may be desirable.

### III

#### Measures to Stimulate Private Capital Expenditures

1. Reversal of the recession and the continuance of the recovery movement depends in major part on increased expenditures in the residential building field. The revival of building is not merely a matter of concern to people in that field. It is of vital concern to the whole community. Apart from a great increase in Government expenditures, private expenditure on residential building is the one great source we can rely on to increase consumer income and buying power.

Moderate estimates of the need for new housing since 1934 have ranged from 600,000 to 800,000 units annually. The number actually built in 1935 was 129,000. The number built in 1936 was 270,000. The 1936 year-end estimates of the number that would be built in 1937 were from 400,000 to 450,000. The present estimate for the full year 1937 is only 300,000.

The great disparity between expectations and results this year follows a marked and unseasonal downward trend that began in April. This downward trend has more recently become accentuated. Furthermore, many houses completed earlier this year still remain unsalable except at a loss, and reports from numerous localities indicate a substantial curtailment in building plans for the next construction year.

The development of a marked recession in construction at a time when there is a widespread housing shortage and a steady rise in rents is an incongruous situation. The recession cannot be ascribed to a decline in money incomes, for it got well under way during months when money incomes were still rising. It cannot be ascribed to the disturbed

public sentiment of recent months or to the more recent drastic decline in security values. The recession in housing construction preceded these other developments. The fact that it got under way during the very months when a substantial increase in construction should have occurred was itself an important factor in rousing business uncertainty and unsettling the security markets.

The explanation of the housing slump that began in April lies solely within the construction industry itself. It is that wages, costs, and prices were raised, beyond all reason, to a point that drove potential builders and buyers out of the market.

During the latter part of 1936 and the early part of 1937, the hourly and weekly wage rates of workers engaged in the building of houses and in the manufacture of building materials were sharply increased in anticipation of a large demand for housing this year. Besides this, the work-week of building labor in various localities was reduced. In New York, for example, this reduction was from 40 hours to 35 in some cases, and from 40 to 30 in others.

In the case of building materials, the increase in prices was disproportionately high in comparison with the increased cost of labor and also in comparison with the increased prices of finished products generally. Striking evidence of the unwarranted extent to which prices were increased is to be found in the earnings during the first half of 1937 of 11 important corporations. These corporations show a greater profit than for the corresponding period in 1929, notwithstanding the fact that in 1937 their output was only half what it was in 1929.



These facts make it abundantly clear that, between the over-reaching of building-trades workers on the one hand and building material manufacturers on the other, the development of the great potential market for housing in this country is being thwarted.

This situation will not cure itself in time to prevent a severe recession. The decline in employment and incomes will tend to prevent a further rise in rents. Building costs, with the exception of some materials prices, remain sticky. Positive intervention by Government appears absolutely necessary to make building new homes more attractive than renting old ones.

The Government can do much in this direction by lowering the cost of mortgage money, and by stimulating building in other ways along the lines proposed in the accompanying separate memorandum. It is fruitless, however, to do this unless there is some assurance that lowered financing costs will not be promptly offset by an advance in labor and material costs as soon as there are any signs of a pick-up in building. Any subsidy given must be a subsidy to the home builder, not to the industry. The industry will get its gains in increased volume and in steadier and more full employment.

The main weapons that are available to accomplish this result are publicity and persuasion. The various factors in the industry must be made to see that their interests, as well as the interests of the whole economy, are tied up with lower costs and higher volume. An atmosphere

must be created in which any group whose actions bring about a rise in costs alienates all public support and sympathy.

As a powerful aid in creating this atmosphere national conferences and local conferences might be called in which the various groups in the industry, together with public officials, would participate. Conferences would be called for the express purpose of canvassing ways and means to reduce costs. The emphasis should be placed on this aspect throughout. In particular, the possibilities of substituting guaranteed periods of work at lower hourly rates, for the present irregularity of employment at high hourly rates, should be thoroughly explored. The British building conferences of 1924, which led to stable and low costs and were followed by a long-sustained period of heavy building activity, could serve as a model for these conferences.

If some assurances can be obtained that the unions and other elements in the industry will make certain concessions for their own and the public good, and will not nullify any constructive measures initiated by the Federal Government, we may then proceed with a well-rounded housing program as outlined in the accompanying memorandum on this subject.

2. A second way to stimulate capital expenditures and thus add to consumer buying is to offer a concrete inducement to business men for a limited period to add to their plant and equipment facilities. This could take the form of an amendment to the tax on undistributed profits which would permit, for the period of the year 1938, plant and equipment expenditures in excess of depreciation allowances to be credited against undistributed profits for that and the following two years

in determining undistributed profits for the purpose of the tax liability.

By limiting the privilege to a year, a powerful inducement would be created to anticipate new plant expenditures at a time when the community would be most benefited by increased expenditures. Insofar as plant capacity is added to in 1938, the danger of insufficient plant capacity, bottlenecks and rapid price advances in subsequent years of the recovery would be lessened. An added reason for permitting corporations to retain earnings for a limited period for the purpose of plant expansion is that the disturbed state of the capital markets renders it difficult for many corporations to float new issues.

In addition to this amendment, consideration should be given to the complete exemption from the tax of all earnings withheld up to \$15,000. Even on the basis of 1929 returns, corporations reporting earnings over \$15,000 amounted to only 10 percent of the total number of corporations and yet accounted for 94 percent of the total net income. The proposed amendment, therefore, would exempt the overwhelming bulk of corporations while entailing little loss of revenue. It would be a cheap price to pay for the removal of the bulk of the opposition to the tax, much of which, in the case of the small corporations with no access to the capital markets, is legitimate.

These amendments would accomplish two desirable purposes. They would be evidence of a conciliatory attitude on the part of the



Administration, in meeting legitimate complaints and in adjusting its tax program to the changing character and requirements of business activity. They would also provide a stimulus to private expenditures at a time when it is sorely needed, and at a small cost to the Treasury.