(Memorandum for Richmond
meeting-May 19, 1938)

As a general principle, deficit-spending by the government should only be undertaken in depressed times as a means of offsetting in part or compensating for the lack of private activity. Conversely, when private debt is rapidly expanding, there should be a contraction of public debt as a counterbalancing and stabilizing influence. However, there may be times when national income is at a high and rapidly advancing rate when it would be desirable from every standpoint to increase taxation—for example, by broadening the tax base—in order to maintain a flow of funds to impoverished elements of the population, to the aged and unemployables, whose purchasing power is necessary to sustain production and thus help to preserve existing capital and make possible further profitable expansion of facilities. This, in turn, would provide an outlet for accumulations for savings in the field of private investment. Otherwise, as happened in the late twenties, there may be excessive accumulations of investment capital which, unable to find outlet in productive demestic enterprise, are diverted to unproductive channels and to speculative bidding up of stocks and other equities or put into uncollectable foreign loans.

The problem to which I refer seems to me to be basic in our economy. I think it has been well outlined by the Brookings Institution in their studies. Thus, in their volume entitled "Income and Economic Progress", they point out that we have always had, even in boom times, a sufficient supply of manpower, of fuel, of money

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and credit and of material resources to produce far more than was actually produced. They point out (p. 37) that "the consumptive requirements or wants of the people were far from satisfied during the period of our highest economic achievement"; and (p. 36) that "the great problem of American business men is not how to produce more, but how to sell what they have already produced."

Having called attention to the maldistribution of income, they then raise what seems to me to be a most fundamental problem, namely, the maintenance of a balance between the three factors of savings, consumption, and capital formation. They state (p. 41 et seq.):

> "According to traditional views the way in which income is divided as between spending and saving in no way affects the degree to which our productive resources will be utilized. If more money is saved, the greater, it is contended, will be the construction of capital goods; if more is spent, the greater will be the output of consumption goods. An increase in savings thus merely shifts labor and materials from employment in the consumption goods industries to employment in the capital goods industries; and the total disbursements for wages, interest, etc., remain unaffected. Society would, however, have the benefit of an increasing supply of capital goods.
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> "This traditional analysis, it should be carefully noted, is based on the primary assumption that all money savings automatically become new capital equipment. Such an assumption

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"implies that business men will always expand plant and equipment to the full extent of the funds available. Stating the matter another way, it is assumed that the formation of new productive capital in no wise depends upon consumptive demand—that business men will increase the supply of capital goods even though the demand for consumptive goods is declining. In other words, it is assumed that consumptive demand and the construction of capital equipment are _independent variables_. Now if this is true we should always have--barring other maladjustments--full employment either in the production of capital goods or consumer goods. But if it is not true—if the expansion of capital goods _depends upon_ a concurrent expansion in the demand for consumption goods—then an increase in savings might have very different results. How have we been able to clarify the basic issue thus raised?

"First, we sought to show, on the basis of general reasoning and observation, that an increase in savings _at the expense of_ consumptive demand would reduce the construction of new capital goods as well as of consumption goods. Since business men are concerned with making profits, and since profits from the use of new capital depend upon the manufacture and sale of consumer goods by such productive establishments, we contended that an expansion of plant and equipment will not take place in any large

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"way when consumptive demand is declining and the general business situation as a whole is accordingly unpropitious.

"Second, we surveyed the facts of our industrial history as a check on the validity of this general reasoning. The available evidence showed conclusively that new capital is constructed on any significant scale only during periods when consumption is also expanding. In periods of declining consumption the construction of new capital also decreases sharply.

"We concluded from this analysis that if new capital is to be constructed there must of necessity be an increasing flow of funds not only through investment channels but also through the channels of retail and wholesale trade. This led inevitably to the question: How is it possible to finance simultaneously an increase in the output of consumption goods and of capital goods? We showed that a concurrent increase in the flow of funds through consumption and investment channels is made possible by the expansive quality of our commercial banking system, which is a manufactory of credit. In a period of expansion, credit is in fact extended both for working capital purposes—to facilitate the production of consumptive goods—and for fixed capital purposes—to finance the construction of new plant and equipment. In either case the funds are in due course disbursed in payment for wages, materials, and other production costs, and thus the aggregate money income received by the people is enlarged. This

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"makes it possible to spend more as well as to save more, and thus the flow of funds through consumptive and trade channels is increased concurrently. The facts with reference to investments and consumptive expenditures prove that this is the case.

"Third, we found from the study of our industrial history that the growth of capital is closely adjusted to and dependent upon an expanding demand for consumption goods. The evidence bearing on this question is of two types.

"We found in the first place that expansion or contraction in the construction of new capital closely parallels expansion or contraction in the consumption goods industries. Moreover, fluctuations in the construction of capital goods have usually followed rather than preceded fluctuations in the output of consumption goods.

"The controlling importance of consumption was, however, more conclusively revealed by the discovery that the rate of growth of new plant and equipment in a period of industrial expansion is adjusted to the rate of increase of consumptive demand rather than to the volume of savings available for investment purposes. Savings are made in the first instance in the form of money. This money is directed into investment channels; but it does not follow that it will always be used in constructing new capital goods. We found that between 1922 and 1929 the volume

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"of funds rendered available for investment purposes was increasing rapidly, but that the volume of securities floated for purposes of constructing new plant and equipment remained practically unchanged in amount from year to year. In 1929 the volume of new securities issued for the purpose of actual capital construction plus mortgages was less than 5 billions, while the volume of funds seeking investment was in the neighborhood of 15 billions.

"The evidence thus shows conclusively that the construction of capital does not vary directly with the amount of investment money available. It is apparent that the decisions of business enterprisers with reference to the construction of additional plant and equipment are determined primarily by reference to the state of the markets for the products which such new capital equipment could turn out.

"When the volume of money savings is in excess of the requirements for new capital construction, what becomes of the excess? The answer is that funds seek employment in one way or another--just how, depending upon varying economic conditions or situations. They may be loaned abroad, as large amounts were in the period from 1925 to 1929. They may be used in purchasing securities already outstanding in the markets, and be absorbed in bidding up the prices of such securities. Or, as during the

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"depression, when new security issues for purposes of private capital expansion have virtually disappeared, they may remain stagnant in bank deposits, be used in financing government deficits, or, again, in bidding up the prices of outstanding corporate issues.

"A flow of money savings into investment channels in excess of the requirements of the capital markets is a comparatively new phenomenon in the United States. Throughout our earlier history, indeed until approximately the World War period, the requirements of business enterprises for funds with which to develop new capital were characteristically in excess of the supply emanating from the savings of the people. The deficiency was made good by borrowing abroad and by the expansion of commercial banking credit. In the last twenty years, however, the situation has been profoundly altered. As a result of a higher average level of income, and particularly because of the concentration of income, the volume of money savings flowing to investment channels has so greatly increased that the balance has been shifted. Instead of having a deficiency of investment money, we have a surplus.

"This diagnosis or analysis of the economic mechanism may then be summarized as follows. Our study of the productive process led us to a negative conclusion—no limiting factor or serious impediment to a full utilization of our productive

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"capacity could there be discovered. Our investigation of the distribution of income, on the other hand, revealed a maladjustment of basic significance. Our capacity to produce consumer goods has been chronically in excess of the amount which consumers are able, or willing, to take off the markets; and this situation is attributable to the increasing proportion of the total income which is diverted to savings channels. The result is a chronic inability—despite such devices as high pressure salesmanship, installment credits, and loans to facilitate foreign purchases—to find market outlets adequate to absorb our full productive capacity.

In another volume entitled "The Formation of Capital", the same authorities state (p. 146):

"We had funds available for investment ranging from around 8 or 9 billions in 1923-24 to as much as 15 or 16 billions in 1928-29. On the other hand, the volume of new corporate issues for productive purposes, including mortgages, remained practically stationary at about 5 billions. The amount of the savings that passed into the hands of business enterprisers for use in buying materials and hiring labor for the construction of new plant and equipment was thus about 5 billion dollars annually. The question is what became of the balance."

Answering this question (p. 151), they state:

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"The answer is that, aside from that portion which went into foreign issues, the excess savings were absorbed, dissipated, in bidding up the prices of outstanding securities. Money savings were thus transferred increasingly into speculative profits rather than into productive plant and equipment. The inflation of security values resulted in a vulnerable financial structure, the collapse of which was an important contributing factor to the depression."

They state also (p. 152):

"When the amount of the national money income that is saved increases faster than the amount that is disbursed through consumption channels, there are various possible outlets for the excess savings. Funds not demanded for the construction of new plant and equipment may be invested abroad, as during the World War and again in 1925-29. They may be absorbed in bidding up the prices of existing securities, as in the recent boom years. They may stagnate in bank deposits--or go to finance government deficits--as has been the case during the depression."

This phenomenon of an excess of savings relative to productive outlets, they discuss in the conclusions to this volume (p. 159 et seq.):

"The rapid growth of savings as compared with consumption in the decade of the twenties resulted in a supply of investment

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"money quite out of proportion to the volume of securities being floated for purposes of expanding plant and equipment, while at the same time the flow of funds through consumptive channels was inadequate to absorb--at the prices at which goods were offered for sale--the potential output of our existing productive capacity. The excess savings which entered the investment market served to inflate the prices of securities and to produce financial instability. A larger relative flow of funds through consumptive channels would have led not only to a larger utilization of existing productive capacity, but also to a more rapid growth of plant and equipment.

"The phenomenon of an excessive supply of funds in the investment markets had never been anticipated. Not only had it been assumed that all savings would automatically be transformed into capital equipment, but it seemed impossible to conceive of a situation in which savings might become redundant. Such a point of view is natural enough in the light of our historical evolution.

"In the early history of this country the volume of funds available for the purposes of capitalistic enterprise was persistently inadequate. Business men often found it difficult to obtain the liquid capital, at any price, with which to expand the size of their business undertakings or to exploit new fields of

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"enterprise. In colonial days, for example, the shortage of funds was a continual source of difficulty and a primary cause of irritation with the mother country, which opposed the issuance of bills of credit by colonial governments. Until well into the nineteenth century the volume of savings rendered available through investment channels for the needs of business enterprisers was negligible in amount. The philosophy which emphasized the fundamental importance of increased savings was a realistic one for that age.

"In the period since the Civil War, however, two factors have combined to produce a profound change in this situation. The first has been the growth of a well-to-do middle class, with funds available for investment. The second has been the development of the commercial banking system, making possible an expansion of credit to business enterprise for both fixed and working capital purposes. It is these developments which account for the emergence of the United States as a great financial power. Not only do we now have an abundance of funds with which to finance American enterprise, but we are also able to extend credits to the world at large. In this development we have followed the road which England travelled at an earlier date.

"At the present stage in the economic evolution of the United States, the problem of balance between consumption and

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"saving is thus essentially different from what it was in earlier times. Instead of a scarcity of funds for the needs of business enterprise, there tends to be an excessive supply of available investment money, which is productive not of new capital goods but of financial maladjustments. The primary need at this stage in our economic history is a larger flow of funds through consumptive channels rather than more abundant savings."

It is, of course, essential that the economy have at all times an ample supply of private capital for investment in productive enterprise. I am speaking of conditions not as they have been, or as we would like them to be, but as we are forced to deal with them as we find them today. These conditions include the slow rate of increase in the population, restricted immigration, the disappearance of the frontier in the west and south, and restricted world trade due to tariffs and quotas, exchange controls and fluctuating currencies. These factors force upon the government the necessity for dealing with social and economic problems on a nationalistic basis to a degree that has never before prevailed.

I agree that as a general rule of the past we had a scarcity rather than a superabundance of investment capital relative to productive outlets, and that, therefore, recovery from depressions be-

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fore the last war was almost invariably led by new investment. I seriously question whether this rule, and the economic philosophy based upon it, is valid under present and prospective conditions. The point I wish to make is that it would be to the interest of capital under such conditions to advocate such taxation on a broad income tax base as would, in effect, sustain buying power and thus make for a sustained and expanding production which, in turn, serves not only to protect existing capital investment but also to provide a productive and profitable outlet for accumulated private savings.

The idea is by no means new or untried, for we have an example of its application in England and some of the other capitalistic democracies, where the level of taxation is extremely high—and bear in mind that I am just as unenthusiastic about paying taxes as you are—but where by various public expenditures a reasonably even flow of purchasing power has been maintained and production has been kept at continuously high levels. It seems to me that this is very much in the interest of the capitalist because he is better off in the end, since the products of the mill and factory continue to find a market and the return in profits to the owner of capital, after paying the higher taxes, is far greater than would be the case if the economy bogged down, the plants had to be closed and the value of all investment sharply depreciated.

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I recognize, of course, that the execution of such a policy would have to be very skillfully managed and well timed, and that, as I have said, there must be at the same time every encouragement for the employment of capital in new production--that there must be always an ample supply of funds for that purpose.

Accordingly, when the supply of savings is insufficient to meet the expanding needs of the country for new capital on a profitable basis, income taxes should be reduced. A condition such as this may develop in the future, for I realize that technical progress opens up indefinite possibilities for production, and education, by causing needs to become more refined and diversified, can increase the requirements of our people indefinitely. But in times when savings are too large relative to productive outlet, government should increase taxes and should apply the proceeds to depressed areas, to public health and educational purposes, to public improvements, conservation and protection of natural resources--to preservation of the resources, human and material, of prosperity and not to competition with private initiative. Higher taxation could well be applied, in these circumstances, to the income groups of, say, between $2,500 and $50,000, and to corporations, always, of course, on an ability-to-pay basis. It seems to me that some of the other capitalistic democracies, such as Great Britain and Sweden, have managed this general policy fairly well in net effect upon their economies, and I am inclined to think that it is their greatest economic safeguard in the preservation of democracy.

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