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THE LONG-RANGE ECONOMIC PROBLEM OF DEMOCRATIC CAPITALISM

This evening I would like to talk with you about a problem that has been on my mind for many years, a problem whose solution we must find if we are to maintain a healthy democratic capitalism. The problem I speak of is that of assuring the spending of enough money to take off the markets the steadily rising production of a labor force that is increasing in productivity as well as in numbers. Let me spell out what I mean by this problem a little more specifically.

People spend part of their incomes and save the rest. The part that is saved must be returned to the income stream by being invested in tangible assets, or incomes and employment will fall. Savings that are held idle contribute nothing to the income stream or the volume of employment. In such a case, the flow of money from the businessman to the consumer and back again to the businessman is interrupted. When this happens, the businessman loses markets, which means he also loses his incentive to produce, to employ people and to pay out incomes.

This process of spending, saving and investing involves millions of businesses and consumers and, with an elastic credit system, no single enterprise or individual need spend or invest all his current savings as they accrue. Nevertheless, unless the over-all flow of spending is maintained, unemployment and low incomes will result, and these developments will inevitably tend to feed upon themselves and create even more unemployment and even lower incomes.

To insure an adequate volume of over-all spending, a proper balance between consumption and investment must be maintained. It is the present relationship of consumption to investment that bothers me particularly at this time. The maintenance of investment depends not only on a large but on an expanding level of consumption. Can we expect to maintain the present volume of investment on the basis of today's volume of consumption? There is a widely prevailing view that we may not. Let me review certain recent developments in the current economic situation and examine their main implications for the proper functioning of our economy in the future.

The Current Economic Situation and its Implications for the Future

From 1941 through 1945 we solved the problem of adequate spending in the economy temporarily by building a war machine that was unequaled in history. That war machine was built with Government money obtained from an addition to the public debt that was unprecedented. The addition to the public debt was absorbed to a large extent by the banking system. This absorption resulted in a large expansion in our money supply which has been an important factor in our postwar inflationary situation.

In the years immediately following the war we also had no spending problem for two reasons. First, we had huge backlog demands for goods and services on the part of consumers, business enterprises, State and local Governments and the rest of the world. These demands had been pent up during the long war years when strict controls were put on normal, peacetime spending. Second, these demands were backed up by a large accumulation of war-created financial resources as well as a vast reservoir of untapped credit power to finance them.

Recently, signs have been emerging that aggregate spending is not increasing fast enough to sustain high and rising levels of employment. What are these signs?

Following the peak of postwar inflation pressures towards the end of 1948, we had quite a little readjustment with substantial declines in production, employment and prices. This readjustment period continued through mid-summer of last year and there has since been a moderate though sustained recovery. Still our industrial production has only come back to a level of 185 compared with 195 in the late fall of 1948. Meanwhile population and the labor force has been growing, and today we have an unemployment level substantially above that which we had at the low point of industrial production of last summer. Even if we grant that since early fall strikes have been an important factor in swelling the ranks of the unemployed, the record does not look too good.

The disturbing thing about the present level of unemployment is that it is occurring at a time when incomes and accumulated savings of consumers as well as business enterprises are at very high levels, when both public and private debt are increasing at record rates, and when expenditures by Federal, State and local Governments are at new peacetime peaks. It is occurring despite the fact that consumers, business concerns and all levels of Government are rapidly ~~using up~~ expanding their borrowing ~~capacity~~ and despite the fact that spending power available through current incomes and accumulated reserves is still very large.

We must not be lulled into complacency by the fact that most of the over-all economic and financial figures look favorable. Certainly it is true that, in relation to prewar, our gross national product is still very large, that consumers' expenditures are still very high, and that business investment is still substantial. But problems are arising in our economic and financial structure. Let me mention a few of them.

In the first place, per capita disposable income has been declining since early 1949. In addition, consumers in our postwar prosperity have been going heavily into debt and an increasing proportion of their income has had to be committed to debt repayment and interest charges. The larger these payments become, the less money consumers have available for spending on goods that are currently being produced.

Secondly, the profit prosperity of business enterprises has recently been much more uneven than earlier in the postwar period. The profits of large corporations are in general being maintained. With their expansion programs being completed, these corporations are accumulating large amounts of liquid assets that are not flowing back into the markets for goods. Many small concerns, on the other hand, have experienced rather sharp declines in their profits and liquid asset holdings. Business failures have also increased, particularly among the smaller and newer companies. These developments in business profits are disquieting even though it is recognized that they reflect, in part at least, natural readjustments from postwar inflation.

Finally, the possibility of a developing lack of balance in our debt structure should make us pause for thought. Private debt has increased sharply relative to public debt since the end of the war. The largest increases in private debt, in turn, have been in consumer loans and housing mortgages. Most recently, borrowing to purchase securities has increased sharply.

Mortgage debt on 1-4 family homes, for example, has doubled since the end of the war to a level of about 38 billion dollars. In other words, in four short years it has grown as much as it did in the first 150 years of our history. Consumer instalment debt has shown an even more rapid percentage growth but a lower dollar growth during recent years. From an outstanding volume of about 2 billion dollars at the war's end, such debt has grown over five-fold to almost 11 billion.

We were complacent about our economy once before in recent history, in the late 'twenties. At that time most of the over-all figures looked fine. The consumer price level was declining gradually throughout most of the 'twenties. Receipts of the Federal Government exceeded expenditures and the outstanding Federal debt was reduced from 23.7 billion dollars at the end of 1920 to 16.5 billion at the end of 1929. State and local Government debt and total private debt increased during this period but at a fairly moderate rate. It should be remembered, too, that it was during this period that taxes were low, the maximum corporate income tax rate being 13½ per cent and the maximum surtax on individual incomes being 50 per cent. no inheritance tax

Then something happened and in the midst of our most prosperous year we were thrown into the deepest depression our nation has ever known. Basically, I believe that depression was caused by the development of a bad debt structure, a serious inflation of credit, and speculation that led to a reduction of spending out of income on currently produced goods. Eventually, aggregate spending was unable to clear the markets of the growing volume of goods that our constantly improving technology and constantly growing plant and equipment was making possible. There were signs that this was occurring, but they were buried in our over-all statistics.

We sustained high levels of employment in the 'twenties with the aid of an exceptional expansion of certain types of debt, namely, mortgage debt, consumer debt, stock market debt, and foreign debt. In these circumstances, businesses freed themselves of debt and raised new cheap, stock capital. In addition they accumulated large volumes of cash which they in turn loaned out in the call market for security speculation. Early in October of 1929 corporations had over 6 1/2 billion dollars invested in stock market loans.

Secondly, consumer loans reached the quite extraordinary level of 11 billion dollars in 1929.

Finally, we made a large volume of foreign loans and investments in the decade from 1920 to 1929 which in part provided foreign countries with the purchasing power to buy from us an excess of exports over imports amounting to over 10 billion dollars. Stimulation to spending by debt creation like this is short-lived and cannot be counted on to sustain high levels of employment for long periods of time.

I do not mean to infer from these remarks that we are now in an economic situation similar to that of the late 'twenties. I use the analogy with the 'twenties only to illustrate the fact that the equilibrium of an economic situation can be upset by changes within the structure of economic institutions even though the structure itself as it is revealed by the overall statistics looks sound enough. It was upset in the 'twenties and it can very well be upset again unless we take active steps to avoid it.

What Can we do About our Future Economic Situation?

But what can we do about our future economic situation? At the risk of over-simplifying I should like to suggest that the majority of our professional and lay economists--and I count myself in the latter groups--would recommend the adoption of one of three alternative approaches to a solution to the problem of maintaining adequate spending for a full employment economy. I shall dogmatically classify these three approaches as:

(1) The "do nothing" approach;

(2) The "do everything" approach; and

(3) The "middle of the road" approach.

The "do nothing" approach

Believers in the "do nothing" approach would probably question the very existence of a spending problem. Their thinking would run along the line that total spending, consumption, or investment can never be too small or too large for any length of time. If spending is ever deficient, it means that either prices, money wages or other costs are too high and must come down. In such a case, the lack of spending would result in a lower volume of business activity, which in turn would produce unemployment and unutilized capacity of plant and equipment. These developments would then force prices, wages and other costs down.

Finally, reduced prices of goods and lower business costs would automatically stimulate investment by businesses and consumption by individuals out of accumulated savings or new bank credit, for real costs would be down and values would be up. This automatically induced spending by businesses and individuals would then begin to spiral, causing still more investment and consumption, and eventually producing full employment again.

This approach calls for as nearly a balanced Government budget as possible at all times. It does not rely on increasing Government spending sharply in recessions or depressions to initiate an upturn. It calls rather for curbing Government spending and increasing tax rates at such times in order to bring the budget into balance.

This approach could conceivably work, but I am afraid that it would be prevented from doing so by the numerous important price and cost rigidities in our economic system that are so resistent to change. Our failure to act quickly and vigorously on the spending problem in the depression of the early 'thirties is an illustration of the difficulty of relying on this approach, and to approach in the wrong way, that is by increasing tax rates, when we did first try to do something. Even if it might work ultimately, that is if it were allowed enough time, it would probably involve such a cost in terms of unutilized resources, unemployment and human suffering that it would be economically, to say nothing of socially, undesirable.

The "do everything" approach

I would classify as adherents of the "do everything" approach all economists who would rely primarily on Government expenditures, subsidies and controls to assure enough spending in the economy to maintain full employment of an increasing labor force. These people say that if Government expenditures were only large enough, adequate spending power would always be channeled to individuals and businesses and consumption and investment would steadily rise. As a result, employment would also constantly expand. We would have both stability and progress.

In the "do everything" category I would also put those who rely almost exclusively on increased wages to solve our consumer spending problem. Such persons say that even if the increased wages were to go first only to a few already well-paid labor groups, eventually they would spread to all working groups. This, they continue, would so increase the incomes of workers that consumption and investment would be raised to levels high enough to sustain the employment of all our people.

This approach to the spending problem could also conceivably work, but I am afraid it might eventually involve too much inequalty not to mention too great a loss of individual freedom and personal liberty. Persons who accept this approach lay too little stress on the adverse effects of their recommendations on other types of spending. Government spending must be financed either out of taxation or borrowing. Very high taxes and excessive Government borrowing, particularly from banks, both have serious adverse affects on both private consumption and private investment. If private investment does not respond to Government spending, the only alternative is for the Government to assume the responsibility for new investment. That, too, can be a cumulative process. I for one am not convinced that expanding Government ownership and operation of our basic industries would be economically efficient or desirable.

The "middle of the road" approach

If we are, then, to reject both the "do nothing" and "do everything" approaches to the problem of assuring adequate spending to maintain full employment, is there any approach we can accept? Yes, I think there is, and I call that approach the "middle of the road" approach. Most economists would probably classify themselves in the group espousing this approach. Their views would differ, of course, one from another, as well as from mine.

I have neither the time at my disposal tonight nor the ability to blueprint an over-all plan as to how to achieve adequate spending using this approach. That is the primary job you economists should be working on. Basically though, I feel that more spending, particularly by consumers, is necessary, but that such spending should be achieved neither by ever increasing Government expenditures and deficits nor by large wage increases for a few, selected labor groups. It should be achieved mainly by offering buyers greater values. Gains in technology and productivity should be passed on to all consumers in the form of lower prices and should not fall to one or a selected few groups.

Wise Government policy is needed to achieve the required increase in spending, but such policy should try to facilitate and make possible the additional spending by private individuals and businesses. Notice that I use the word "policy" instead of "planning". I avoid the word "planning" because we have so many phobias about it. By "policy" I mean the sympathetic study and understanding of our economic system and how it works, with Government action confined to fixing the rules and otherwise making it function more effectively by adjusting the Government's own economic role. We are a large and complex economy and Government necessarily has a large economic role as a spender on community services, security, and other Government functions.

But let me illustrate what I mean by the "middle of the road" approach to the spending problem more specifically by indicating what could be done in three very important fields, namely social security, fiscal policy, and monetary and credit policy.

Social security. Regarding social security, let me say at the outset that I think this is a field in which a great deal can be done to provide for a stable expansion of consumption expenditures, with associated favorable effects for investment. But if we want such a social security system, we will have to change our whole approach to the subject.

In the first place, it must be a Federal Government program and it must be greatly expanded in scope from the one that is in existence today. The Government should underwrite and guarantee for all of its citizens income, education, health and old age security up to its ability to pay for such benefits and without creating adverse affects on incentives for private investment. By doing this, the Government would assure a basic level of purchasing power in the economy that would provide a certain market for a substantial share of the commodities and services produced by our industry and agriculture.

Secondly, the social security benefits should be paid for currently out of general tax receipts. They should not be financed out of payroll tax receipts that have been accumulated over time in a large reserve fund. Payroll taxes are too heavy a burden directly on consumption and indirectly on investment and are therefore undesirable when what we need in the long-run is increased private consumption and investment. Large reserve funds have to find lodgment, in the main, in Government obligations which can only eventually be redeemed out of tax money anyway. The only justification such funds have is that they are a current source of meeting monetary costs of Government, but it would be much more desirable if such costs, where necessary, were paid for with receipts from an integrated and balanced tax structure. I shall have more to say about this subject a little later.

These ideas on Federal social security are by no means radical. I should like to quote from an editorial published in the New York Herald Tribune on March 2nd:

> "What our social security system demands today is not a mere expansion of the existing structure; it demands first of all a thorough re-study of the problem and revision of that structure if it is to have any chance of carrying the much vaster needs now contemplated for it.
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> "The system was set up in 1936. Thirteen years' experience has established beyond serious question the principle of national and public responsibility for providing security against the hazards of old age and dependence; the same experience has at the same time led powerfully to the conclusion that the system was not well designed, that it is extravagantly wasteful and in an important sense a virtual failure.
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> "It is impossible for such a plan to offer any insurance against changing price levels and particularly so when the very operation of the plan can have its inflationary effect. It cannot in any real sense save up through a reserve fund, when Government bonds are the only possible investment for the fund and its only 'earnings' are those provided by the taxpayers who meet the interest on the bonds.

> However the financing may be juggled, the provision for old age is a current cost on the community, coming in any given year out of the current production, and it is already an urgent question whether a frank shift to a current cost or 'pay-as-you-go' system would not yield a structure far more economical, more equitable, more adequate to current needs and offering much more genuine security for the citizen's future than the present one."

I could not state my views on the social security question more simply and directly than the editors of the New York Herald Tribune have done in that editorial.

As a final point on social security, I should like to say that I think the recent growth in private pension funds is a very undesirable long-run economic development. I am opposed to this development primarily because I feel that the growth of these funds will tend to affect the functioning of the economy adversely in two important ways. They will result in the further accumulation of funds in reserves seeking low risk investment opportunities. This encourages Government deficits to provide securities to absorb accumulating reserves. They will also result in some redistribution of income from low to higher income groups. This will come about because the financing of private pension funds will increase the prices of goods and services that are purchased in the main by the low income groups. The pensions will be paid, on the other hand, only to a few selected and relatively well paid groups of industrial workers.

I am also opposed to the development of private pension funds on other economic grounds. They will discriminate against small companies, for only large companies can afford them. The growth of private pension funds will make it even more difficult for small businesses to survive in a world of industrial giants. Private pension funds will also greatly inhibit the mobility of labor from one firm to another for workers will be extremely reluctant to forfeit the pension rights they have built up. They will also probably lead to discrimination against older workers, for employers will hesitate to employ people near the retirement age.

Fiscal policy. Another specific area of public policy that I should like to say a few words about is fiscal policy. Fiscal policy, like social security, can be an extremely important factor in stimulating spending, and in maintaining balance between consumption and investment, if it is properly planned and administered.

Although I believe strongly in a compensatory fiscal policy to help stabilize total spending over the course of the business cycle, I do not believe that high Government spending, subsidies and deficits should be a permanent feature of our economy. Government deficits in poor years should be balanced, to a large extent at least, with Government surpluses in prosperous years.

It disturbs me greatly that in only two out of the last twenty years has our Federal Government balanced its budget despite the large increases in taxes that have been imposed over the period. Government expenditures should be reduced to the minimum necessary to carry out effectively needed Government activity. If this were done, taxes could be reduced rather than raised, and more money would be left in the hands of private consumers and businesses to spend in their own way on the goods and services that they valued most highly.

Federal as well as State and local Government expenditures could be cut considerably without serious loss to the economy. Let me make very clear that I do not believe that drastic cuts could be made at this time in

Federal expenditures for such purposes as foreign aid and military preparedness, but there are many other areas in which spending could be reduced. I have been very impressed by the fact that the main increases in the 1950 Federal cash operating budget that developed as the year progressed were in three areas, namely, housing, agriculture and veterans' benefits. Expenditures in such areas should not have been allowed to rise during the fiscal year 1950.

The main reason why I am opposed to the current high level of Government spending is that the amount and structure of taxes needed to help finance such expenditures place a heavy burden on the American consumer and investor. Federal Government receipts from transportation, tobacco, and other retail and excise taxes accounted for almost a fifth of total Federal revenues in the fiscal year 1949. Personal income taxes withheld from wages and salaries accounted for another quarter of revenues in the last fiscal year.

A large part of these two types of taxes rest on single persons and families in low and medium income groups who also pay a substantial share of the burden of social security taxes. People in these income groups are not in a position to pay taxes out of incomes earned on accumulated savings but must pay them out of current wage and salary incomes. As a result, their ability to use current incomes to pay for currently produced goods is reduced.

State taxes bear even more heavily on consumption than do taxes collected by the Federal Government. About 60 cents out of every dollar collected by State Governments during the last fiscal year came either from general sales taxes on consumer purchases or from specific consumer taxes such as those on gasoline, automobiles and tobacco.

Clearly, a revision of our tax system is called for that would bring some relief to the consumer without bearing too heavily on incentives for private investment. This is exactly the opposite kind of a revision that we had in the Revenue Act in 1948, which helped the high rather than the low and moderate income groups. A revision helping the latter groups would contribute greatly to long-range economic stability.

Monetary policy. Finally, I should like to say a few words about a third specific area of public policy, monetary and credit policy, and the role it can play in contributing to sustained progress toward goals of high employment and rising standards of living.

Monetary and credit policy is a particularly important instrument of economic stabilization because it is entirely consistent with the maintenance of our democratic system and the fostering of free competition. It involves little detailed and direct control of particular segments of the economy by the Government, but relies primarily on influencing the over-all supply, availability and cost of money to all segments of the economy, whether they be public or private.

The Federal Reserve System has three weapons it can use for this purpose: (1) changing the discount rate at which it will lend to member banks, (2) open-market operations in Government securities, and (3) changing the reserve requirements of member banks. Only in the case of regulating margin requirements for the purchase of securities does the Federal Reserve operate in a specific area of activity. Such a power is necessary to prevent the development of a lack of balance in debt structure that everyone now recognizes was an unfortunate characteristic of the late 'twenties.

Responsibility for monetary policy has been placed in the Federal Reserve System by the Congress. Such policy must be flexibly and vigorously applied if it is to contribute to economic stability and to the achievement of the purposes of the Employment Act. Credit must be eased sometimes and restricted at other times. The vigorous use of a restricted monetary policy in an inflationary situation promotes economic stability and not instability.

During the inflationary postwar years a restrictive monetary policy was prohibited because of circumstances that made it necessary and desirable for the System to engage in support purchases of U. S. Government securities. Such circumstances, however, are no longer compelling and the System's responsibility for the Government securities market has increasingly and properly shifted to a responsibility for maintaining in all times orderly market conditions.

As I wrote to Senator Douglas, Chairman of the Subcommittee on Monetary, Credit and Fiscal Policies of the Joint Committee on the Economic Report:

> "It is obvious, of course, that Government financing needs must be met and the responsibility of the Federal Reserve to insure successful Treasury financing must continue to be fully recognized. But Treasury financing can be carried out successfully within the framework of a restrictive credit policy, provided the terms of the securities offered are in accordance with that policy."

In addition to believing that we need a flexible monetary policy with fluctuating interest rates, I believe that we need a generally low level of interest rates as a longer-run matter. A low level of rates would provide an important, continuing stimulus to aggregate spending. It would (1) keep a downward pressure on the propensity to save, (2) keep an upward pressure on the inducement to invest, (3) favor the low and middle-income groups in the distribution of income, and (4) keep down the financial costs of production and hence provide goods more cheaply.

As a last point in this field of monetary policy, the role of the Federal Reserve System in relation to Government lending to business, particularly by the Reconstruction Finance Corporation, should be clarified. I do not question the need for an agency like the RFC in emergency periods to provide direct Government loans to projects outside the field of private credit. But such a Government lending program should always be consistent with the over-all monetary and credit policies of the nation. Moreover, it should not compete with or invade the domain of private bank and credit institutions. It is much more desirable for the Government to stimulate private lending by loan guarantees or insurance than for it to engage in large-scale direct lending itself.

Concluding Remarks

I have dealt with social security, fiscal policy and monetary and credit policy, at considerable length to give you some idea as to the specific types of Government policy and activity that could be undertaken to help solve what I think will prove to be the basic long run economic problem of this country and every other capitalistic democracy, namely, to generate enough aggregate spending to clear our markets of the fruits of our tremendously productive economic machine.

At present we are drifting. Our economic policies are too hit and miss, too opportunistic. We do one thing today to solve today's problem, and we do something completely different tomorrow to solve tomorrow's problem. We have no philosophy or over-all policy of economic development. We have no economic statesmanship.

We have been able to muddle through the past decade, first, because of the huge military spending required by World War II, and then because of the large private investment program and continued Government spending of the postwar years. But the private investment program is now declining and we must not put increased reliance on Government spending, subsidies, support programs and deficits. Some way must be found to give more individuals the means and the incentives to increase their consumption, and through increased consumption to get expanded investment.

I confess I have not been able to develop a satisfactory over-all program of economic development that would assure full employment as well as the maintenance of our private domestic economy. My plea is, however, that we recognize the need for such a program and then try to develop it. It is to you economists that America and the rest of the world must look for the ideas and leadership in meeting this challenge.