

THE LONG-RANGE ECONOMIC PROBLEM OF DEMOCRATIC CAPITALISM
An Address Before the Social Science Section of the Ohio
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This evening I would like to talk with you about a problem that has been on my mind for a long time, 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.

Businesses and individuals as a whole spend a part of this income on current consumption and save the rest. The part that is saved must be returned to the income stream by being invested either directly or indirectly in new capital goods or houses. If it is not, incomes and employment will fall. In such a case, the flow of money from producers (Meaning all kinds of business and agricultural enterprises) to consumers and back again to producers is interrupted. When that happens, markets are reduced or lost, which means that the incentives to produce, to employ people and to pay out incomes are also lost.

This process of consuming, saving and investment in capital goods and housing involves millions of consumers and producers and no single enterprise or individual need consume or invest all his current income as it accrues. This is because an elastic credit system provides a mechanism for taking up the slack in case of a slow use of funds. Unless the over-all flow of spending is maintained over a period, unemployment and low incomes will result. These developments will inevitably tend to feed upon themselves and create even more unemployment and lower incomes. This is what is commonly known as the "deflationary spiral".

To insure an adequate volume of over-all spending, a proper balance between consumer and capital expenditures, including housing, must be maintained at all times. It is the present relationship between consumer and capital expenditures that bothers me particularly at this time. The maintenance of capital expenditures depends not only on a large but on an expanding level of consumption. The only reason for expenditures on new capital goods is to produce more consumer goods and to increase the standard of living. If individuals do not have the incomes to buy the added consumers goods, there is no incentive to invest and increase capacity.

Can we expect to maintain the present volume of capital goods expenditures on the basis of today's volume of consumption? There is a widely prevailing view that we can not. Let me review certain recent developments in the current economic situation and examine their effect on the future functioning of our economy.

The Current Economic Situation and its Future Effects

From 1941 through 1945 we solved the problem of adequate spending in the economy temporarily by devoting to war purposes nearly 50 per cent of our manpower and productive facilities. This was brought about by Government

money obtained about 40 per cent from taxation and 60 per cent borrowing. Of the borrowed money, about a third was supplied by the commercial banking system and thus helped to create a more than doubling of our money supply. This increase in our money supply was a major factor in our postwar inflationary situation. The balance of the borrowed money was obtained from excess savings and Government expenditures returned this money to the spending stream.

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, producers, State and local Governments as well as the outside world. These demands were built up during the long war years when strict controls were maintained on spending. Second, these demands were backed up by a large growth in our money supply and a large volume of other liquid assets, largely Government securities held by nonbank investors. In addition to this, was the vast reservoir of untapped credit power to finance nearly every credit demand.

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 toward the end of 1948, we had some very desirable downward readjustments in particular lines of production 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 as shown by the Federal Reserve index. 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 indirectly have been an important factor in swelling the ranks of the unemployed, these have not been sufficient to explain the present unemployment level.

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 producers are at very high levels, when both public and private debt are increasing at record peacetime rates, and when expenditures by Federal, State and local Governments are at peacetime peaks.

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, by comparison with prewar, our physical production as well as its dollar value is still very large, that consumers' expenditures are still very high, and that business investment is still great. 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 throughout 1949. In addition, consumers in spite of 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, many of 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 are disquieting even though it is recognized that they reflect, in part at least, natural readjustments from postwar inflation.

Finally, the form that our private debt has been taking should make us pause for thought. The largest increases have been in consumer loans and mortgages.

Mortgage debt on 1-4 family homes, for example, has doubled from the beginning of 1946 to the end of 1949 and has reached 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. Total consumer credit has grown from $6\frac{1}{2}$ to $18\frac{1}{2}$ billion dollars during the same period. The instalment debt part of total consumer credit has shown an even more rapid percentage growth. From an outstanding volume of about 2 billion dollars at the war's end, it has grown over five-fold to almost 11 billion dollars.

We were too complacent about our economy in the late 'twenties and as a result experienced the devastating deflation of the early 'thirties. In the late 'twenties the statistics superficially looked fine. The consumer price level was gradually declining throughout most of the 'twenties. Wholesale prices remained stable, for both the national income and the money supply increased about 40 per cent over the eight-year period ending in 1929. Federal income exceeded expenditures sufficient to reduce the outstanding government debt by approximately seven billion dollars during this period.

There was practically no unemployment even though there was a gain of about five million workers. The increase in labor productivity was substantially greater than the normal trend. Corporation taxes were low, the maximum rate being $13\frac{1}{2}$ per cent, and corporate profits increased in these years by over 75 per cent. Taxes on individuals were also relatively low. There were no inheritance taxes or capital gains taxes. In other words, there was little or no Government interference with the free enterprise system. Private initiative was given every encouragement.

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 debt outside of the banking system. This debt was provided by the large growth of business savings as well as savings by individuals, particularly in the upper income groups where taxes were relatively low. Private debt outside of the banking system increased about 50 per cent. This debt, which was at high interest rates, largely took the form of mortgage debt on housing, office and hotel structures, consumer instalment debt, brokers loans and foreign debt.

The stimulation to spending by debt creation, such as I have indicated, is short-lived and cannot be counted on to sustain high levels of employment for long periods of time. Had there been a better distribution of the current income from the national product, in other words, had there been less savings by business and the higher income groups and more income in the lower income groups, we would have had far greater stability in our economy.

I do not mean to infer from these remarks that our present situation parallels that of the late 'twenties, but I do believe there is a similarity developing. Our economic situation can be seriously upset again as it was in the 'twenties, unless the causes for disequilibrium are thoroughly understood and active steps are taken to avoid this.

What Can We Do About Our Future Economic Situation?

But this is not a simple matter, as there is great disagreement as to what should be done in order to maintain economic stability, which calls for maximum employment at all times. There are three general approaches to the problem. They can be classified as follows:

- (1) The "do nothing" approach;
- (2) The "do everything" approach;
- (3) The "middle of the road" approach.

I personally would discard the first two approaches, because I believe that the first approach would lead us into a repetition of the late 'twenties and early 'thirties, and the second approach tends to lead increasingly to Government interference, control, and ownership. If time permitted, I should like to elaborate on my reasons for the rejection of these approaches.

If we are, then, to reject these approaches to the problem of assuring adequate spending to maintain full employment, what is the approach we are to accept?

I admit the problem is a most difficult one and I do not profess to have the ability to blueprint a perfect program as to how to achieve at all times spending of a sufficient amount and for the necessary purposes in order to maintain maximum employment. I assume that you economists recognize the importance of this job and are devoting your best efforts toward its solution.

Basically, I feel that more spending, particularly by consumers, is necessary, and that such spending should be achieved without increasing Government expenditures and deficits and without further wage increases in the higher

paid 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 rather than in higher wages and increased profits.

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. Our economy is a huge and complex one, and Government necessarily has a large economic role as a spender on community services, security, and other essential Government functions. There is a clear distinction in a capitalistic democracy between the character of public and private spending. Private spending is motivated by the benefit to the individual or the business group, whereas public spending should be for the benefit of the entire community and should be of a nature that would not be undertaken by private groups.

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 more stable expansion of consumer expenditures, which would help to bring about a more balanced increase in capital expenditures. 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 unemployment income, education, health and old age security up to its ability to pay for such benefits and at the same time maintaining a climate that would produce sufficient savings and incentives to provide needed productive facilities for an increasing standard of living and an increasing population. 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. Reserve funds have to find lodgment in Government obligations the proceeds from which must be spent to pay for Government deficits or to retire other outstanding obligations.

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.

"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 executives and 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 developed and administered. Fiscal policy is by far the most important instrument of economic stabilization in a democratic, capitalistic economy because it is functional in nature and therefore does not involve the direct and detailed control of particular segments of the economy by Government.

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 deflationary years are unavoidable but we should have at least a balanced budget in time of full employment and a surplus if an inflationary price situation is developing.

I am disappointed that our fiscal policy has been such that in only two out of the last twenty years has our Federal Government balanced its budget despite the huge increases in taxes that have been imposed over the period. Government expenditures should be reduced to the minimum necessary to carry out efficiently and effectively needed Government activity. If this were done, the taxes that bear heaviest on consumption could be reduced or eliminated, and thus more money would be left in the hands of consumers to spend in their own way. Clearly this would call for a closing of tax loopholes as well as an increase in some taxes and in the revenue from certain Government services, such as the postal system.

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 pay for such expenditures place a heavy burden on the American consumer and investor. Federal Government receipts from 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. Most people in these income groups are not in a position to pay taxes out of accumulated savings or investments 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 excise taxes.

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 an important supplemental instrument to a proper fiscal policy in any program of economic stabilization and like fiscal policy it is functional in its nature and does not require direct controls, but relies primarily on influencing the over-all supply, availability and cost of money to all segments of the economy.

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 exercise selective control. Such a power is necessary to prevent the excessive growth of speculative credit in one sector of the economy as we now recognize was one of the principal evils in the credit structure 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 restrictive 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 at 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 even though higher rates may be required at times to retard inflationary developments. A low level of rates would provide an important, continuing stimulus to aggregate spending. It would (1) keep a downward pressure on the volume of savings, (2) keep an upward pressure on the inducement to make capital expenditures including housing, (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 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 based too much on political expediency. They deal with the effects and are not designed to deal with the long-run basic causes. There seems to be no philosophy or over-all policy of economic development. Economic statesmanship is completely lacking.

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 do not want you to think that the three areas discussed are the only areas in which the Government can and possibly should plan and act to

meet the problem of economic stabilization. I confess that the more I think about the overall problem the more I realize the complexities and hence the dangers of any oversimplification. But I am convinced that if our system of capitalistic democracy is to survive in the long run, it can be done, only if there is information and understanding as to what the enlightened self-interest of the people is. This implies that individuals having great economic power or occupying other positions of leadership must show a high level of statesmanship, and do all in their power to guide the Government wisely in the development of policies that would maintain maximum employment and production. In the type of economy we have today, the issue of national economic stability will not, and cannot be resolved alone by business, farm, and labor leaders in their own areas of self-interest and independent responsibility.