

BUSINESS IN A FREE ENTERPRISE ECONOMY



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Lecture by Dr. Edison H. Cramer, Chief of the Division of Research and Statistics, Federal Deposit Insurance Corporation, before the Colorado School of Banking, University of Colorado, Boulder, Colorado, August 16, 1954

In discussing the topic "Stabilizing Influences in Business and Banking" during the next five days, we will be focusing our attention on one of the most important problems facing the free world. For it goes without saying, that stability in business activity and the avoidance of depression is a prerequisite to the preservation of the American way of life. What are the chances that we can succeed in solving this perplexing problem? The record of business activity during the past two centuries is not reassuring. A cursory examination of this record brings us to the conclusion that periodic depressions with unemployment and unused resources are inevitable.

Nevertheless, there are many economists who now believe that serious business depressions can be avoided. For example, Dr. Gabriel Hauge, Administrative Assistant to President Eisenhower, during an address before the 46th annual meeting of the Governors' conference at Bolton Landing, New York, about a month ago, made this statement:

"I think that more and more Americans now are coming to the conclusion that we need not and will not have another depression, that our problem is rather one of so conducting our affairs that we can hold fluctuations about a growth curve within an acceptable range. I think the chances are excellent that we can do just that".



I agree with Dr. Hauge. It is my belief that we need never again have a prolonged business depression in the midst of vast productive powers and unused resources. Perhaps you are wondering why I am so confident of this in the face of the historical record. This confidence stems from the character and results of a vast amount of research that has been carried on in recent years as to the nature and causes of business fluctuations. I do not plan to discuss the research in detail in this series of classes, but will simply say that it offers convincing proof that our free enterprise economy is not inherently unstable. What I want to do is to explore the causes of the historical instability, in the light of this research, and suggest national policies that will take full advantage of the stabilizing influences that are inherent in our economy.

Today's lecture will furnish a background for those to follow by describing the essential characteristics of this system of ours that is usually described as a "free enterprise economy". When we use the word "enterprise" in this sense we are thinking of the activities of all individuals for supplying one another with the goods and services they want and need. The question to be discussed today is: How are these activities combined and coordinated in a free enterprise economy?

When we stop to think about this problem for a country like ours it takes on staggering proportions. There are about 160 million Americans, and every individual has his own likes and dislikes, natural



and acquired aptitudes, and all the other personal characteristics that make him a little different from anyone else. How can these diverse individuals be organized and directed so that the maximum value of material goods will be produced and the maximum of wants be satisfied?

Perhaps we can strip the question of some of its complexities and bring it into sharper focus by using a simple illustration. Let us go back about three centuries and imagine we are a small group of pilgrims that has just landed on the shores of America. The ships that brought us and our few possessions have sailed away and we are on our own. What do we do now to provide for our material needs? We must have food and clothing and shelter if we are to survive.

First of all, we must decide which of the many things we would like to have, we will produce. What goods and how much of each are important questions.

Second, we must decide who will work at each task and how the available natural resources will be assigned to each activity.

Third, we will have to have some method for dividing or sharing the products.

How can we arrange things so as to answer these three fundamental questions, and at the same time create an inducement that will result in maximum production? One obvious way is for the members of the group to scatter and for each one to produce only for himself. Each person would allocate his time and resources to the production of the things he most desired. All he produced, but no more, would be his to



enjoy, and, therefore, no other inducement to work hard would be necessary. Primitive man may have lived that way, and such an existence is described in the story of Robinson Crusoe. But even as pioneers of 300 years ago, we would know that by producing for each other, specialization would be possible and the output of economic goods would be greatly increased thereby. You studied this economic principle in the second chapter of your economics text "A Preface to Economics".

Another obvious way of organizing ourselves in this pioneer society is to select a boss to answer the questions for us and to see to it that each one does the task that is assigned to him. This method of organization is illustrated by the Army. The Chief of Staff decides the goals, and who will do what and how and when and where. A staff of experts works out how many men are needed by the infantry and artillery and supply corps and orders are issued accordingly. Another staff of experts decides how much food and how many tanks and rifles and overcoats are needed and a mess sergeant distributes the food to the men in his company and a supply sergeant passes out the overcoats. Presumably, all share and share alike. Incentive is provided partly by patriotism and the satisfaction one receives from doing a good job, but it results mainly from the fear of what will happen if orders are disobeyed. Most of us who served in the armed forces did so reluctantly. We had a job to do--winning the war--and we did it. But we hated the life we were obliged to live, and longed for the liberty and freedom we had as civilians. Consequently, we do not look with favor upon an



economic system organized along military lines. This is not the way a free enterprise economy is organized. This is slave enterprise and is called communism.

A third way we could organize our society and decide on the answers to the three questions is by voting. Let us see how that would work. What do we want to produce? Someone says, "I make a motion we raise wheat". Someone else says, "I second the motion". "Is there any discussion?" And then the question is debated and a vote taken. How much wheat? Another debate and another vote. Who is going to raise the wheat has to be decided, and volunteers are called for. Each one who wants to raise wheat states his qualifications, and a wheat grower is elected. What land will be assigned to wheat will take another vote. And then the wheat grower wants to know what he will get for raising wheat. That takes another debate and another election. Who is going to get the wheat? More debate and more voting.

After the wheat question is settled there are left several thousand other commodities to be voted upon the same way. Your first reaction to this method for organizing our group is doubtless one of skepticism. "Don't be silly" you say, "We would all starve or freeze to death before we finished balloting". And of course you would be right except for the fact that we have evolved an extremely efficient ballot for communicating our economic desires. That ballot is money, and each dollar spent is a vote cast in favor of the production of the kind of goods or service which is being purchased. This one-dollar-



one-vote method of organizing society permits a maximum of free decision-making by individuals, yet at the same time induces efficient and coordinated production of the things which the dollar-voters desire. This is the kind of economic system which was in fact established by the pioneers 300 years ago, and although time has produced many changes in our national wealth and living standards, the fundamental nature of the economic system remains unchanged. This system is called "capitalism", "the price and profits system", or "free enterprise".

It seems almost incredible, but it is nevertheless a fact, that our vast and complex economy is organized and regulated by this simple voting procedure. The votes are tabulated through the price mechanism, and market prices guide and direct us in the production and consumption of economic goods.

What should be produced? Look at prices. If the price of a commodity is such that it can be made and sold at a profit, society is saying that it should be produced. If it is not wanted, the price will be such that there is no profit for the producer. How much should be produced? Prices tell us. If less of a given commodity is being produced than consumers wish to buy at its prevailing price, the competition of buyers will force its price upward, and the price of the commodity will continue to rise until enough producers have expanded their output or enough buyers have been driven out of the market by the higher price.



If too much of a given commodity is being produced then just the opposite happens, except it will be the competition of sellers that will force the price downward. Price will continue to fall until enough producers have contracted their output or shifted to other lines of production so that the reduced output equals the demand for the product. This may not be a pleasant experience for the particular businessmen involved, nor for their employees, but it is a necessary process if production is to be adjusted to the wants of consumers. Fortunately, when a commodity loses favor with the public the needed shift in production is gradual, because the lower price is likely to bring in new increments of demand. Very often in our growing economy shifts take the relatively painless form of failure on the part of an industry which is losing favor with consumers to grow as rapidly as the rest of the economy. Thus, for example, cotton textile production in this country is now running about 150 percent of the prewar level, but rayon production over 300 percent greater. In other cases one product may actually deprive another of all or part of its market, as bookkeeping machines have done to the bound ledger or television to the moving picture theater.

Such shifts in production--some industries expanding and others contracting--are brought about through changes in the intensity of consumer demand for various products and services, as reflected in the prices which consumers will pay and amounts they will buy. It is in this manner, through the impersonal direction of dollar votes, that a free enterprise economy is continually seeking and finding answers to



the questions of what and how much of various goods and services it shall produce.

Who will work at each task? Again prices, this time in the form of the wages which can be earned in various occupations, provide the answer. Each individual, within the limits of his abilities, makes his own choice of occupations, but these choices are influenced by wage and salary rates. About two million new workers come on the labor market each year, and millions more move from job to job, but there is no central bureau in Washington issuing orders to each one and allocating labor to the thousands of tasks that need being done. Instead each person does the thing at which he can earn the best income, after giving some consideration to other advantages or disadvantages of the job. If a given kind of skill is increasingly needed to produce the products demanded by consumers, business concerns will offer increasing rewards to persons possessing such skill. Other workers, especially young people just entering the labor force, will therefore be encouraged to acquire the needed skill. An example in recent years has been the strong demand by business concerns for industrial and chemical engineers. Over a longer period, the advent of motorized transportation has lessened the job opportunities of horse shoers but bettered those of automobile mechanics, with evident effects upon the numbers of persons acquiring those skills.

Resources other than human effort are allocated by the price mechanism in much the same way. How much land shall be planted to cotton or oats or peanuts? The prices of these commodities furnish the



answer. If too much land is in one kind of crop, its price will be low relative to other crops, and farmers will be induced to shift production to something else. Today Colorado is suffering the consequences of shifting grass land to wheat farming in response to the high price for wheat during the war. The process of shifting back is long and costly, but the price of wheat is saying that some change must be made. As cities have grown, land has been shifted from farming to urban uses. Alike in cities and on the farm, machines have replaced and economized human labor, all of this in response to dollar votes--the dollar votes of consumers choosing among products and their reflection in the dollar votes of businesses in choosing among alternative places and methods of production.

Or to take another example, since silver is an excellent conductor of electricity, why are transmission lines not made out of silver? Its price is too high after considering the price and relative merits of copper. The price mechanism summarizes all of the thousands of possible uses for silver and their relationship to supply and all of the thousands of uses for copper and their relationship to its supply and says that copper, not silver, should be used for transmission lines. No central bureau, no matter how skillful and objective, could possibly weigh the relative importance of all the possible uses of silver, copper, and hundreds of other raw materials, and arrive at the correct answers as to just which uses should actually be made of each.



Assuming that freely determined market prices offer the best guide for channeling human and physical resources into their most important uses, what can be said for the distribution of goods that results therefrom? Since the money incomes of individuals tend to be in proportion to the value society places on the contribution of each to the productive process, it necessarily follows that there is an unequal sharing of economic goods. This is to say, goods tend to be allocated to the various members of society not in proportion to their need or not equally, but in proportion to a market place value of the contribution of each individual or his property.

"To each according to his contribution" may seem cold blooded and heartless, but in the long run more goods are available to the masses because of the powerful inducement it offers to those who are capable of making important contributions to production. Moreover, because the compulsion comes from freely determined market prices, and not from orders issued by a government official, it fosters individual liberty and freedom in other aspects of life. The automatic organization and regulation of economic activities does not depend upon individual uniformity. We do not have to have the same religion or language or political affiliation in order to cooperate effectively in free enterprise economy. When we go to a store to buy some article we want, we do not ask, "Was this made by a Republican or a Democrat?" We do not even care if it was made by a Communist. Our only question is, "How good is it? How much is it?" In my opinion, the most important advantage of



our free enterprise economy over Communism or Socialism is that it permits and thrives on the maximum amount of individual liberty.

I do not mean to imply that all economic problems can be solved automatically by the price mechanism. There remains many things the government must do to supplement the market place. First it must provide the rules and regulations under which individuals seeking their own self interest are to operate. Competition must be kept free and vigorous and, natural monopolies must be consciously regulated through public ownership or control. Rules regarding inheritance and transfers of property must be established and enforced. That is to say, the government must engage in those activities that are essential if a free enterprise economy is to operate effectively under the guidance of the law of supply and demand.

Second, government must modify the free enterprise system of distribution so that the weak and helpless receive some share of the output. Thus we have "social security", which includes unemployment compensation and old age and survivors annuities.

Third, the government should do those things it can do better and cheaper than private business enterprise. Building highways, providing parks and playgrounds, and supporting education are examples.

Fourth, the power of the State must be used to secure advantages to the group as a whole. The pure food and drug laws are outstanding examples of this. So also are the kind of measures



recently taken to overcome the threat of foot and mouth disease from Mexican cattle. The individual need not look beyond the immediate future, but the State can plan for posterity and conserve its natural resources. Thus we have soil conservation, reclamation projects, and forest preserves paid for with public funds.

However, I want to emphasize that these activities of the State are modifications only of the essential characteristics of our free enterprise economy. It is in the main a system that is organized and regulated automatically by market prices. But if this system for producing and consuming economic goods is to work smoothly, there is one thing above all others that is required. The ballots we use for voting on economic affairs--our circulating medium--must have stability. Tomorrow's lecture will discuss the characteristics of our banking system and the part it plays in creating money.