BUSINESS CONDITIONS
A REVIEW BY THE FEDERAL RESERVE BANK OF CHICAGO
Two Postwar Booms Compared—II

Similarities Increase After Decontrol

Business developments since September 1 indicate a movement of convergence with the inflation-deflation pattern of 1919-20. Whether the convergence has been postponed for a period sufficiently long to avoid or mitigate a decline remains open to question, but general business prospects appear favorable for the next six months.

The absence in 1946 of several disquieting features of 1919 was commented upon under the heading of "Significant Differences" between the two postwar booms compared in the September 1946 issue of Business Conditions. Although important differences persist, certain of these features have developed subsequently. They merely appear to have delayed somewhat longer putting in their appearance after World War II than after World War I. These features include particularly: (1) a decline in real wages, as prices outdistance money wage rates, (2) inventory accumulation, which has reached an all-time high, and (3) a "back-to-normalcy" drive involving a revulsion against controls and increasing disregard of past history.

DANGER SIGNALS REVIEWED

Five specific "danger signals" were mentioned in the September article. In addition to inventory accumulation, these included: (1) commercial loan expansion as a sign of financial weakness, (2) cancellation of business programs for expansion of plant and equipment, (3) large-scale multiple ordering, and (4) a rise in exports to a scale which cannot be maintained.

1. The volume of commercial loans has risen above the ten-billion dollar mark, a new all-time record. Consumer credit also has expanded sharply, and Series E bond redemptions have run ahead of sales during the first eleven months of 1946, both developments reflecting that some low-income consumers are living beyond their means.

2. Cancellations and postponements of industrial expansion plans have become increasingly frequent, although no estimate of their total volume is available. Despite these cancellations, however, planned capital expansion reported by business firms to the Securities and Exchange Commission continues to increase at a decreasing rate.

3. New multiple ordering has fallen off noticeably, but there is evidence that the effects of outstanding multiple orders remain to be faced. The total of new orders in the Chicago industrial area appears to have turned downward in July, and suppliers are endeavoring much more generally to assure themselves of the firmness of new orders accepted.

4. According to monthly Census reports of foreign trade, American commercial exports (excluding UNRRA, relief, and residual lend-lease) reached an all-time monthly high of 741 million dollars in August, of which 117 million dollars represents a favorable balance. Subsequent monthly figures were cut sharply as a result of maritime strikes on both the coasts, but new gains are now anticipated.

The response of the cotton market in October to rumors of excessive textile inventories may prove a preview of things to come. Other farm prices appear to have passed their peak and to be headed downward, with futures substantially below spot prices on grains and even on such presently scarce items as hides and lard. (In 1919, the break in farm prices preceded the decline in manufactured goods prices.) Mail order and other retail outlets anticipate post-holiday weakness as their percentage increases over the dollar volume of last year tend to fall off. Buyers for the large department stores and mail-order houses are showing more conservatism and caution in their buying for the spring and particularly the fall of 1947 than at any time since Pearl Harbor. In certain individual lines, such as table-model radios, costume jewelry, expensive furs, raincoats, women's dresses, and upholstered furniture, a "buyers' market" is reported.

PATTERN RETRACING DELAYED

The general argument against the "boom-and-bust" forecast for 1947-48 appears to be changing its basis from substantial departure from the 1919-20 boom pattern to the somewhat weaker ground of greater delay in its retraction. The current movements of basic commodity and security prices (other than obvious immediate beneficiaries of decontrol) suggest this delay to have been sufficient to permit a substantial volume of reconversion and peacetime production. This in turn may restrain future inflationary and deflationary movements to a scale somewhat below that of 1920-21, despite prospects for wage and rent increases. Washington economists have been quoted as anticipating further cost of living increases of no more than ten per cent as the wartime price rise "grinds to a halt."

When and if prices turn downward on a substantial scale, it should be remembered that certain Government controls against deflation, particularly in agriculture, remain in force to cushion any downturn and moderate any threatened repetition of 1920-21. The extent to which these controls will be needed and their effectiveness remains to be seen.
Continued High Farm Output Asked for 1947

Strong Demand at Good Prices in Prospect for the Year

Another year of top production by the nation’s farmers is the aim of the 1947 production goals set up by the United States Department of Agriculture. With many farmers becoming a little apprehensive over the prospects for farm prices and farm income there may be some skepticism over plans to continue farm production in 1947 at the high levels sought and achieved during the war years when the needs for American agricultural products were presumable at a maximum. Continued high volume farm output in 1947 finds justification, according to U.S.D.A. officials, in the operation of several factors.

Foreign needs, especially in the war-devastated countries, are expected to require continued exports from this country, particularly food grains (mostly wheat) and fats and oils, in spite of the termination of UNRRA at the end of 1946 (except for a brief continuation in the Far East). The United Nations organization recently voted against continuing international relief and in favor of taking care of the needs on a national basis, each country able to provide relief bestowing aid directly. This country is expected to be asked for substantial aid to the countries in which distress will continue in 1947, notably Italy and Greece. By what methods such relief will be handled financially has not at this date been settled, nor even yet discussed in Congress. Financing of such relief would presumably be done by either gifts or loans from the U.S. Government. Each method has advocates. In addition to the needs for such distressed areas it is believed that substantial demand for our farm products will also come from countries able in one way or another to provide the financing or cash and exchange to buy here. During 1946 about half of the value of our exports to foreign countries was represented by relief in the form of lend-lease, UNRRA benefits, and private gifts to those abroad. In 1947, foreign nations will have to depend on their limited exchange reserves to finance about 80 per cent of the value of the imports they are expected to take from us.

A second factor affecting the need for continued all-out farm production is the anticipated high level of domestic demand for farm products. While there is much talk in many quarters currently of an economic recession or downturn in this country sometime about mid-1947, the official U.S.D.A. thinking appears to discount such anticipations, or at least to believe that such a reverse will not be of sufficient magnitude to reduce greatly the strong demand for agricultural products. It is pointed out that purchasing power is relatively high and those who hold this view see it continuing high. This optimism is based on the backlog of unsatisfied demand for goods and services in the domestic economy and the high level of industrial activity and employment it will take to catch up on these deferred wants.

Replacement of depleted reserve stocks is a third factor cited in justification of the high goals for farm production. Stocks of several products are materially below normal. It is, therefore, thought desirable to restore such stocks to the level of safety found by past experience to be warranted.

Finally, the continued high farm output is predicated on the possibility that agriculture may at any time run into serious reverses in weather and growing conditions. High output goals, especially in terms of acres planted, would thus be some insurance against a serious loss in output due to low yields.

WHAT DO THE “GOALS” MEAN?

Do the U.S.D.A. goals have any practical significance? How are they derived? The process of setting up goals for farm production is a technique developed to facilitate meeting wartime needs. As a form of social-economic planning, the technique has been faced with many serious difficulties both as to setting up the goals and to implementing them. The uncertainties and shifting fortunes of war made such planning an unenviable chore. Now 1947 uncertainties about the future of prices for some commodities make goal-setting particularly difficult and hazardous.

The process of setting up the production goals involves several steps. National needs, including likely foreign relief, military requirements, and domestic demand, for end-products are first set up as best they can be estimated. These needs are then converted to terms of farm production and related to the agricultural capacity of the nation and of each state. The goals go to working committees or councils in each state in the form of recommendations. The state people go over the recommendations in the light of their knowledge of capacity to meet the goals and in terms of what they think farmer performance will be in meeting the goals, especially in terms of available resources (such as labor, machinery, feeds, fertilizer, etc.) and the cost-price relationships facing the farmer. At regional meetings the state committees from several states then go over the goals with U.S.D.A. representatives and suggest revisions and alterations which they feel bring the goals in line with state and local conditions. On the basis of these suggestions final recommended goals are established by U.S.D.A. In some cases such goals are a compromise between what Government farm officials see as needs and what state and local people see as possible and probable performance.

Once established, the goals become the subject matter of educational dissemination among farmers by college and experiment station workers, other state agricultural agencies, and the various Governmental farm agencies throughout the nation and the states. The success of the program depends largely upon voluntary cooperation of farmers in proportioning or shifting production according to the recommendations. Support prices have been used to induce acceptance of and
adherence to the goals in some cases, and in others benefits under certain special programs have been made contingent upon conformance with recommended goals. But for the most part the success of the goals technique has had to depend upon the effectiveness of leadership in “selling” the goals to farmers by educational methods, and the whole program would never have worked without the voluntary cooperation of farmers. The goals become guides to production, rather than orders from high quarters. The program has succeeded admirably in mobilizing agricultural efforts to a common task, and while criticisms can and have been leveled at the program, performance under the methods is probably all that could be expected in view of the difficulties involved.

**SOME SHIFTS IN PRODUCTION CALLED FOR**

To say that the U.S.D.A. recommendations call for another year of “all-out” production in 1947 should not be taken to mean that farmers are asked to produce as much or more of everything as they did during the war or in 1946. On the contrary, the goals call for substantial realignments in production patterns in line with probable 1947 needs. While the combined goal for cultivated crop acreage is three percent larger than the total acreage indicated for 1946, decreases in acreages planted are recommended for corn, oats, peanuts, potatoes, truck crops, and flue-cured tobacco. Increases in acreages are asked for rye, dry beans, soybeans, flaxseed, cotton, sugar beets, and sugar cane. In addition to these changes in cultivated crops, increased acreages are suggested for grass and legume seeds, tame hay, and cover crop seeds.

On livestock and livestock products the recommendations call for a reduction in beef and milk cows on farms, for an expansion of the spring pig crop, and for a decrease from 1946 in egg production and in the number of chickens and turkeys raised. The goals for milk cow numbers, however, contemplate a slowing down in the recent reductions.

**Wheat**—While nationally the goal for wheat acreage calls for little change, the states of the Seventh Federal Reserve District are asked to increase their plantings to wheat over the 1946 indicated totals. The increases range from 4 percent for Indiana to 15 and 17 percent for Michigan and Illinois, respectively. In announcing the wheat goals, Secretary of Agriculture Anderson cautioned against breaking out sod or grass land for wheat where it is not adapted to continued cultivation and would create future erosion hazards. Some states were asked to reduce wheat acreage. These shifts are a part of the effort made in the 1947 goals to begin to convert land back to soil-building uses and away from soil-depleting crops. While recognizing fully the urgency of such reconversion for the nation’s farms, Government officials felt that only a partial beginning should be made in 1947 in view of the continued pressing need for heavy production. Therefore, some of the regional goals differ materially from the national goals in recognition of these needed shifts.

**Rye**—An increase over 1946 of one-third is suggested for rye. This grain has been relatively unprofitable for farmers to produce in recent years. The 1946 acreage was less than half the prewar average. Consequently the supply situation has deteriorated to the point where it is desirable to expand production enough to provide the quantities that would be used if supplies were available.

**Corn, Oats, and Barley**—Acreage goals for feed grains, taken all together, contemplate a slight increase from 1946 levels because the requirements for livestock feeding are expected to remain high in 1947 and 1948 and also in order to increase somewhat feed reserves in the form of carry-over. But the feed grain increases suggested are in barley and grain sorghums, with a slight reduction indicated for corn acreage and a decline of about five percent from 1946 suggested for oats. It is generally felt that Corn Belt lands have been too heavily cropped by corn and soybeans in recent years. Consequently, the goals call for corn acreage reductions in the Corn Belt states, with the reductions partly offset by increases for states outside the area. The goals for 1947 corn acreage ask a reduction from 1946 of seven percent for Illinois, five percent for Iowa, three percent for Michigan, two percent for Indiana, and one percent for Wisconsin. The goals for oats call for a reduction of seven to ten percent for Seventh District states except for Wisconsin where a reduction of only one percent is recommended. The barley acreage goal for the nation is 18 percent above the 1946 indicated acreages. A reduction of six percent is recommended for Iowa, but the other four District states carry the following recommended increases: Illinois, 23 percent; Indiana, 54 percent; Michigan, 23 percent; and Wisconsin, 18 percent.

**Soybeans**—Heavy and unrestricted demands for oils are expected to continue for the next year and possibly two years. To meet the needs, production increases in soybeans and flaxseed are recommended. The recommended increase nationally is 19 percent over 1946 indicated acreages. The acreage increases asked of District states are: Illinois, 17 percent; Indiana, 12 percent; Iowa, 28 percent; Michigan, 18 percent; and Wisconsin, 79 percent.

**Potatoes**—A sharp upward trend in the production of potatoes in recent years has made this commodity into more or less a “problem child,” and unless smaller acreages are grown in the future, a permanent surplus problem will face potato producers. Concentration of acreages on higher yielding land, increased use of fertilizers and of insecticides have substantially stepped up the yield per acre. Because of the serious surplus problem, U.S.D.A. authorities have deemed it necessary to apply production quotas to individual producers, and producers will be eligible for price support benefits only if they plant within their individual farm goals. Quotas have been allocated to states on the basis of the 1941-45 average of acreage planted. This method gives a goal, or quota, for Seventh District states ranging from three to six percent above the 1946 planted acreage.

**Sugar Beets and Truck Crops**—Continued shortage of sugar throughout the world and here in our own country dictates continued effort to expand sugar beet production. A suggested national goal 15 percent above 1946 indicated acreage is asked for 1947. Sugar beets are, in the Seventh Federal Reserve District, concentrated mostly in Michigan, although they are of some importance also in Wisconsin.
The recommended 1947 increase in acreage is 31 per cent for Michigan and 13 per cent for Wisconsin.

Demand for fresh, canned, and frozen vegetables in 1947 is likely to be slightly less strong than in 1946. Therefore, the goals call for a reduction from 1946 of about eight per cent in the acreages planted to truck crops. No goals for individual states have been published.

LIVESTOCK GOALS CALL FOR MORE MEAT

Production goals for livestock are aimed at producing a civilian per capita meat supply of 157 pounds in 1947 as compared with about 146 pounds in 1946. Beef cattle slaughter goals are expressed in terms of desirable levels of numbers on farms January 1, 1948. Nationally the goal calls for a cattle and calf slaughter of around 34.5 million head. This compares with the estimated slaughter of about 32.5 million in 1946. Meeting the goals would reduce beef cow numbers on farms at the end of 1947 about four per cent below present estimated levels. Reduction for this District as a whole would be five per cent, ranging from seven per cent for Wisconsin and six per cent for Illinois and Indiana to five per cent for Iowa and four per cent for Michigan.

Basing needs on what is expected to be a strong demand for meats in 1947 and into 1948, the hog production goals call for an increase in the 1947 spring pig crop of 13 per cent. Ample grain supplies are available to feed the increased numbers. The goal for the 1947 fall pig crop will not be announced until next spring. Allocations of the goal for spring operations were made to the states on the basis of recommendations resulting from state appraisals of production capacity and the available feed supplies in the states. Goals for the states of this District call for increases as follows: Illinois, 17 per cent; Indiana, 7 per cent; Iowa, 18 per cent; Michigan, 11 per cent; and Wisconsin, 1 per cent.

MILK AND DAIRY PRODUCTS

Demand for milk and dairy products is expected to exceed prospective supplies well into 1947. Supplies have been short of demand the past three seasons in spite of record production, and stocks of dairy products carried into 1947 are at abnormally low levels. Yet in the face of this strong demand, it appears that it will be difficult to achieve much of an increase in milk production in 1947 above the estimated 119 billion pounds of 1946 production. If any increase is achieved, it is expected to come from an increase of about one per cent in the production per cow since little or no change is expected in cow numbers. The goals are really not maxima in the case of milk. They represent what goal draftsmen think is possible, bearing in mind that if achieved, the production would still leave the country with a deficit of milk if sold at parity prices. The goals indicate an increase of two per cent for Iowa, about one per cent for Illinois and Indiana, and a decrease of about one per cent for Michigan and Wisconsin. These variations are due largely to differences in the capacity of the states. This does not mean that dairy states have reached their upper limits of dairy production. Given time and the appearance of factors favorable to long-run expansion, more production would be forthcoming. The 1947 capacity of each state takes into account the expected conditions as to feed concentrates, roughage, pasture, labor, and equipment in the state.

POULTRY AND EGGS

Setting of the production goals for chickens to be raised on farms in 1947 involved not only the prospective demand for chicken meat in 1947 but also the probable level of demand for eggs into 1948, since 1947 operations would need to be of such a scale as to leave the proper number of layers for 1948 egg production. The goals call for a substantial increase in chickens raised in the New England states where the recent feed shortages abnormally curtailed flocks. Goals for the midwestern states call either for reductions or for smaller increases in keeping with the decline in demand for dried eggs, drying plants for which were concentrated in this area. The goals call for decreases of about five to eight per cent for Iowa, Indiana, and Wisconsin, and increases of two per cent for Michigan and 11 per cent for Michigan. Egg production goals were not allocated to states, but the national recommendation is for a total production of eggs in 1947 six per cent less than in 1946.

A very slight reduction in the number of turkeys raised is recommended for the nation. The goal for Indiana is a decrease of 7 per cent; for Illinois, 11 per cent; Iowa, 19 per cent; Wisconsin, 4 per cent; and for Michigan an increase of 7 per cent.

SUMMARY

The goals technique has worked fairly well during a period when maximum production was a paramount consideration. Farmers have, of course, not always met the goals worked out. Such shortcomings as have developed serve to illustrate the inherent limitations in over-all planning and executing of gigantic and ambitious programs for a whole economy. The 1947 goals embrace in a very small way the problems to be faced if the technique is to be attempted indefinitely in peacetime, especially in a period when burdensome surpluses seem very likely to be the dominant problem for American agriculture. Farm output has expanded about 35 to 40 per cent above prewar levels. The expansion was stimulated by abnormal needs and demands and was achieved largely through a major technological revolution in agriculture, aided by favorable weather. The manifold fruits of that revolution are for the most part new and permanent factors in the agricultural economy. The nation's agriculture faces a period of major readjustment not only to a more rational and conservative pattern of land and soil management. If these problems of readjustment are to be dealt with on a national planning basis (as seems likely), it is doubtful that the goals technique, especially if the goals call generally for curtailed output, will have the efficacy it had in wartime when patriotism could be counted upon to support the program, and particularly when increased production was the objective. The nation's agricultural plant is much easier to expand than to shrink.
Price Trends Since V-J Day

Upward Movement Continues Despite Some Weakening

With the temporary ending of wage and price controls in July of this year, wartime-cumulated inflationary pressures became an actuality and pushed the price structure abruptly upward. Subsequent restoration of these controls in September proved ineffectual in combatting a price inflation already well underway, and their virtual abandonment a month later marked the termination of active Government leadership in the anti-inflation fight. Wartime fiscal developments previously had weakened considerably Federal control over loan and deposit (i.e., monetary) expansibility of the banking system.

COST OF LIVING PATTERNS

Since V-J Day cost of living has increased an estimated 17 per cent, equal to the increase during the entire war period from Pearl Harbor to V-J Day.1 The major increases occurred in food, clothing, and house furnishings (see chart). Rent remained practically unchanged while fuel and miscellaneous items rose moderately.

In analyzing the possible course of retail prices in the first quarter of 1947, commodities may be classified into three general groups. Group 1 contains commodities which promise to show continued price strength (i.e., either further increases or the absence of marked declines) because of demand remaining in excess of supply or because of institutional factors. The outstanding example in this group is rent. If, as seems probable, rent controls are relaxed in the near future, the acute housing shortage will ensure rent rises of approximately the amount to be allowed, now rumored to be from 10 to 15 per cent. Other commodities in Group 1, which together with rent have a relative importance of over 42 per cent in the consumers' price index of the U. S. Bureau of Labor Statistics, are: fats, oils, sugar, sweets, coal, automobiles, major household appliances, meat, medical and hospital care, household operating expenses, personal care, public transportation, and utility services.

The U. S. Department of Commerce estimates that consumers are now spending on an annual basis 12 billion dollars more for non-durable goods, and 12 billion dollars less for durable goods than during the immediate prewar years. As durable goods become increasingly available the prewar relationships will probably be re-established. This will mean a general shift in purchasing power away from non-durables, with varying degree of deflationary pressures on particular items. Mentioned as most vulnerable are certain foods and textiles, the supply of which seems to have almost, if not completely, caught up with demand. Included are dairy products, poultry, fish, eggs, fruits and vegetables, and some lines of women's apparel. Together they comprise Group 2 and have a relative importance of slightly over 25 per cent in the U. S. Bureau of Labor Statistics consumers' price index.

In Group 3, which accounts for the remaining one-third of the index, are commodities which appear to fall somewhere between those of the other two groups. Most important are cereals, bakery products, men's clothes, some lines of women's apparel, and house furnishings.

The declining real wage of workers since decontrol has already evidenced itself in demands by organized labor for second round wage increases of up to 25 per cent. Second round increases already granted by a number of meat packing and petroleum companies will intensify the pressure on other organized industries to follow suit when their contracts expire in the first quarter of this year.

A U. S. Bureau of Labor Statistics survey indicates that almost 60 per cent of the employees in non-manufacturing (predominantly unorganized) industries have not shared in any general wage increases since V-J Day. The growing union organization in these industries in the past year, recent strikes of unorganized public school teachers, high labor turnover, and the growing disparity between unorganized and organized wage levels will tend to have the effect of increasing the pressure on employers of unorganized workers for raises in pay.

Greater use of credit to buy consumers' durable goods and housing, drawing down of savings, and adding to earnings through entry of more members of the family into the labor

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market will also continue to be of some aid for a time in supporting purchasing power. All three of these methods have been increasingly relied upon in recent months.

Second round wage increases, superimposed on the increase in railroad freight rates of over 14 per cent (effective January 1, 1947), will put a further strain on the price structure. Some industries may be able to bear all or part of the increased costs through improved output per man hour or through cutting profit margins. Factual data are not available as to the extent of such absorption. A possible psychological drawback to price increases is industry's fear of pricing more and more people out of the market. However, until supplies of scarce products actually catch up with demand for them, this deflationary influence will be potential rather than actual.

An evaluation of all the factors above mentioned points to the tentative conclusion that the cost of living should show no signs of weakening at least through the first quarter of 1947.

WHOLESALE PRICES

Wholesale prices were an estimated 35 per cent above the V-J Day level at the end of 1946. Over four-fifths of this increase occurred after decontrol (see chart). Through the end of November 1946, foods had increased the most since V-J Day, 54 per cent; all commodities other than foods and farm products the least, 21 per cent; and farm products, 34 per cent.

The rate of increase in wholesale prices has tapered off and even shown some signs of leveling in the last few months. However, the business structure will have to adjust itself to the average increase in railroad freight rates mentioned previously. This, plus second round wage increases now in progress and continued shortages in supply, should either support further price increases or prevent price declines for some time in metal products, building materials, chemicals, drugs, and coal. These particular commodities have a relative importance of about 36 per cent in the combined wholesale price index of the U. S. Bureau of Labor Statistics.

The reasons for not expecting substantial drops in farm prices in the immediate future were discussed in the December 1946 issue of Business Conditions. The short-run outlook for food prices at wholesale parallels that for farm products. One of the most talked of aspects of the 1920-21 deflation is the slash in meat prices, the severity of which was in large measure dictated by heavy inventory accumulations. Meat packing stocks are recovering today from their all-time lows of October 1946, which together with the continued strong demand for meat, lessens the chances of a repetition of the 1920-21 situation in extent, if not in pattern. Meat prices have a relative importance of one-third in the U. S. Bureau of Labor Statistics index of wholesale food prices. Textiles are, perhaps, most vulnerable to price declines. One bright spot in the textile picture, however, is the strong foreign demand for cotton and synthetic fabrics. In physical terms, cotton fabric exports in 1946 were two and one-half times the 1937 level.

INFLATIONARY PRESSURES CONTINUE

Inflationary pressures built up through the wartime period of expanded money supplies and goods scarcities continue. In the price field the principal pronounced decline thus far has been in the stock market. Between June and October 1946 the Dow Jones industrial and rail averages fell respectively 23 and 35 per cent and since then have moved somewhat sluggishly within a narrow range. There is no general agreement as to the cause of the stock market downturn, but widespread attention is being focused upon new wage demands, further work stoppages, and recession forecasts.

In the field of commodity prices, however, inflationary pressures to date reveal only a few scattered signs of weakening, for example, futures prices under cash prices for most basic farm products in the organized markets, price reductions by a number of retail stores on certain luxury items, and slackened rate of growth in wholesale and retail prices generally.

It seems likely, however, that deflationary forces to an increasing extent will offset inflationary pressures both from the consumer side, as wages and salaries of substantial segments of the working population fail to keep up with prices, and from the producer side, through growing imbalance of inter-industry wage-price structures and through release of the flood of commodities which industry is potentially capable of producing. Some prices, as indicated, have already weakened, and many others are expected to follow the same pattern during the months immediately ahead. The number of commodities with high demand relative to supply at present prices seems sufficient to exert an important stabilizing influence upon cost of living and wholesale prices generally during at least the first quarter of 1947. Prices of many individual products can be expected to diverge noticeably from over-all price averages and hence will bear watching.
Indiana State Finance — I

Tax Boosts Ahead?

Indiana is one of the forty-four states in which legislative sessions are scheduled to convene early in 1947. In these biennial meetings the determination of tax and expenditure policies for the last half of 1947, all of 1948, and the first half of 1949 is a major item of business. Through the consideration of executive budgets and the ensuing appropriation acts, the legislatures will specify and quantify the major interests of their state governments.

In common with the majority of states, Indiana will consider its financial plans for the next biennium with substantial balances in its operating funds and a well established and productive revenue system. Whether the cash in the State treasury together with the current yields from its tax system will be sufficient to meet the expenditure requirements that have of necessity been postponed during the war years and will also suffice to cover the higher unit costs of state government is the question that the executive department and the legislature will have to determine in the coming months.

The flush yields of state tax systems just prior to and during the war concealed the incapacity of many such systems to support even prewar patterns of expenditure at prewar price levels. This condition is evidenced by deficits in operating funds of many states during the fiscal years 1939 and 1940. The effect on tax yields of expanding employment and prices was not communicated in like degree to state operating expenditures, and with the necessitous delay of capital outlays, the ensuing state surpluses gave rise to the impression that prewar state revenue systems were adequate to meet essential postwar expenditures. It is now becoming apparent that one of the first tasks of many 1947 legislatures will be to enact new taxes and raise the rates of others in order to finance well established or newly developed expenditure programs. In other states sufficiently large balances in operating funds will finance the more urgent construction projects and absorb small or moderate operating deficits during the coming biennium. These states can postpone the adoption of new taxes without jeopardy to their financial condition or to needed expenditures until the more disturbing impacts of the war on state finance have been absorbed giving a clearer view of state resources and responsibilities.

BALANCES IN OPERATING FUNDS

At the end of the fiscal year 1946, the balance in Indiana operating funds aggregated a record 98.1 million dollars, of which 64.4 million was in the General Fund (Appropriated and Obligated), 20.6 million in the state highway funds, 8.1 million in the Postwar Construction Fund, and 5.0 million in all other operating funds. The real significance of these balances is contained in the fact that their total is approximately equivalent to the average expenditure requirements of the State for a period of ten months instead of two to five as has been characteristic of prewar relationships. In the late 'thirties, balances of three to five months' expenditures were typical, and in the preceding decade they ran as low as one and a half months. In this earlier period, however, the State found it necessary to resort to interfund borrowing and bank loans. In light of its own experience then, as well as that of comparable states in the Middle West, Indiana has a fairly adequate cushion for unanticipated declines in tax yields or temporarily large expenditures.

The balances referred to are not, of course, completely available for any expenditure. A portion is encumbered by commitments to participate in joint Federal or local programs, a portion is earmarked for such functions as highways where the level of expenditure is set by the yield of highway-user taxes and State policy is not ordinarily subject to the biennial budgeting process, and a portion is committed by the appropriation acts now in force. However, such commitments are always outstanding; therefore, the comparison between periods and on the basis of the current rate of expenditure at least affords a rough approximation to the amount available for alternative expenditure or tax reduction (or at least the postponement of new levies).

The fiscal year-end balances do not fully reflect significant fluctuations in the daily cash position of the State's funds. Since state receipts are not available in a steady day by day flow but are concentrated around annual, quarterly, or monthly tax-due dates, and since many disbursements, particularly those for highways, are seasonal in character and since large payments to local units of shared taxes and aids occur only infrequently during the year, the balances vary widely within the accounting period.

Some indication of the importance of these variations may be obtained from the quarterly balances for the major state operating funds (see the right hand portion of the accompanying table). It will be noted that there is a fairly marked seasonal movement in the balances, but that the pattern changes from time to time during the period as such factors as changes in the State's tax system have become operative. These seasonal movements in the 'twenties were very large in relative terms, i.e., a June 30 balance might be two, three, or even four times the March 31 or September 30 total. These wide swings have gradually been reduced with the growth and diversification of state revenues and operations, and today, although there are moderately large dollar shifts

1 In Indiana the General Fund consists of the Appropriated Account, which is alternatively available for general state purposes, and the Obligated Account. Into the Appropriated Account are deposited all taxes not designated by statute for specific activities, interest receipts, and certain earnings of the educational and benevolent institutions; from it disbursements are made directly for a variety of state services, and indirectly via transfers to distribution accounts for aids to local units of government. On the other hand, the Obligated Account receives earmarked taxes, licenses, and fees for all purposes except highways. Prior to 1935 there was no separation of these two accounts, although the Rotary Funds (1924-35) included that portion of the Obligated Account covered by departmental earnings reserved for department expenditure.
from month to month, their relative effects upon the size of the balances have been reduced to insignificant proportions.

The Postwar Construction Fund was created by the 84th General Assembly in 1945 to accumulate the proceeds from an additional excise tax on spirits, malt, and various beverages for the postwar construction of penal, benevolent, charitable, and educational institutions of the State. The additional taxes were effective May 1, 1945, and doubled the prior rate of tax on alcoholic beverages.

Approximately 1 million dollars was received during two months of fiscal year 1945 and 6.5 million during fiscal year 1946. These amounts together with an initial transfer of one-half million dollars from the balance of the Alcoholic Beverage Commission are held in custody of the State Treasurer. To date there have been no disbursements from this fund and no legislative specification of the particular institutions or project on which the fund is to be expended. The 1947 General Assembly will consider the budget requests for appropriations from this fund made by Indiana's twenty benevolent, charitable, and penal institutions.

The current balances in the highway funds are not substantially larger than in prewar years. Although the State has been unable to pursue a normal construction and maintenance policy during the war and thus has a backlog of construction projects, the reduction in earmarked highway revenues due to wartime rationing and the construction requirements in and around war plant locations have kept receipts and expenditures in that period in rather close balance. This has precluded the accumulation of large balances in the highway funds. On the whole, the policy in Indiana has been to segregate highway from other funds.2

TAX REVENUES

The Indiana revenue system has most of the elements common to state tax systems in the Middle West. The gross income tax, which is the major source of revenue for the operating funds, has more of the fiscal characteristics of a retail sales tax than a personal income tax; although as far as wage and salary income are concerned, it is in effect a flat-rate, low-exemption, net income levy. The broad base of the gross income tax makes for stability in yield comparable to that of a sales tax; however, it is more vulnerable to price

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2During the years 1922-24, the highway funds had sizable balances while the General Fund was drawn down to the point where loans from the Highway Commission Fund and from banks were necessary in order to meet current obligations. To prevent a recurrence of this situation, the 1925 Legislature merged the highway funds with the General Fund, but in 1929 separate accounts were again set up for the gasoline tax, auto theft, and auto license collections. Administration costs and expenses were paid out of these accounts and transfers were made to the Highway Commission Account for construction and maintenance. This account also received Federal highway grants and local reimbursements for highway purposes. In 1937 the Motor Vehicle Highway Fund merged all the separate highway revenues and received in addition the weight taxes, driver's license fees, Public Service Commission inspection fees, and all other highway revenues. After payments of administration and expenses, transfers are made to the Highway Fund.
changes and fluctuations in economic conditions than a property tax or such specific excises as those on alcoholic beverages or gasoline. An amendment to the gross income tax effective January 1, 1942, reduced the rate on retail sales from 1 to .5 per cent and decreased the over-all yield by approximately 15 per cent. This was the only important reduction in state tax rates in Indiana during the war years.

The State Government still raises some revenue from the property tax, although the amount is presently about one-fourth of levies annually made for state purposes prior to the adoption of the gross income tax. There has been no property tax levy for General Fund purposes since 1941, and property tax receipts at the present time are earmarked for State aid to common schools, for the State’s share of the contributions to the Teachers’ Retirement Fund, and for forestry, Board of Agriculture debt service, and the several parks and memorials. A decreasing reliance on the property tax reflects a nationwide trend that will probably eventuate within a few years in the complete abandonment of that tax for state purposes and its exclusive use by local governments. Indiana does not have a tax on cigarettes, a form of state taxation that has grown rapidly in the past decade. No doubt such a levy would receive serious consideration if the State were to increase its tax load. A step in this direction would be welcomed by some of Indiana’s neighboring states, where Indiana is regarded as a haven for the price conscious smoker who, by engaging in interstate commerce, avoids the cigarette taxes of his home state.

Forecasts of the probable yields from state tax systems are largely dependent on the outlook for economic prosperity and stability. In estimating state revenues, budget officials tend to exhibit a conservative bias, errors of underestimation being far less embarrassing than those of overestimation. The Indiana revenue system, for example, may very well in the ensuing biennium produce an amount equivalent to or even well in excess of that for the current biennium; but the State officials who are responsible for such an estimate might, with equally sufficient reason, estimate revenues at considerably less than the current level. The essential uncertainty of a forecast which depends on developments as far removed as two and a half years emphasizes the advantage of a substantial balance to absorb unanticipated economic changes.

EXPENDITURES

The level of Indiana expenditures in the immediate past is hardly likely to be indicative of requirements for 1947-49. Many factors point to a markedly higher level of disbursement, few to a lower. At some time, no doubt early in the period, capital outlays for highways will be resumed on a large scale; later, building construction at State institutions will be undertaken. Federal matching grants for highways, airports, and hospitals will stimulate these construction programs. The adjustment of salaries of many State employees to present price levels will add to the new budget as will the demands for expansion of pension payments and aids to local units of government. The extension of state services in such fields as education and veterans’ assistance must be expected to grow rather than contract.

Indeed, as during wartime there were few state activities that were expanded as a wartime necessity, there are few now to cut back. On the other hand, many state functions were put on a stand-by basis or frozen at abnormally low levels during the war; the return of peacetime economic conditions, particularly in the construction industry, will afford an opportunity for all the states to resume such programs and even expand their activities into new fields.

In Indiana, as in 43 other states, expenditure and tax policy must be brought into some kind of a balance at the forthcoming legislative sessions. The several alternatives for attaining such a balance depend upon policies adopted as to the character and extent of state services and aids to local government. How many miles of highway are to be constructed or maintained? How many dependent persons are to be supported? How are local schools to be aided?

These and similar questions regarding state functions must first be answered in physical terms—department plans for a wide range of labor services, materials, and supplies. The conversion into monetary units of these physical requirements involves some assumptions regarding future prices of goods and services but is essential to the comparison of alternative expenditure programs. Most expenditure decisions have to be made with a knowledge of the effect on both money cost and service units. They involve a comparison and judgment by elected authorities which in their opinion balances a variety of alternative services and total taxes against total revenues. But these decisions involve something more—an element that is too often only implicit in budget discussions—the assumptions regarding the price level and the nature of business conditions during the budget period. At what level have the services and commodities the State buys been priced? Is it consistent with the level of prices predicated in the estimate of tax yields?

In periods of settled economic condition such factors are not of great significance. The ensuing biennium, however, is different; it involves the initial postwar budget, the plans for resumption of normal capital outlay programs, and uncertainties regarding numerous portions of the price structure as well as conflicting forecasts of economic conditions. It thus extends the range of alternatives to include those which rest solely upon differences of opinion on the prospects for economic activity during the next two and one-half years. Those who regard a higher level of state expenditure desirable may now push the horizon back even further with an optimistic forecast of the country’s economic future. Those who prefer a lesser role for government and contraction rather than expansion may also include in their numbers the pessimist who sees a dark economic future as a reason for further restricting government expenditures. These real differences in opinion as to economic prospects may be resolved in part by temporizing with many important expenditure decisions and by making programs for the ensuing biennium intentionally tentative. Such a policy is entirely practical only because a substantial balance in the State treasury is capable of absorbing any moderate operating deficit that may arise and because there is a backlog of needed capital outlays that can be purchased with any treasury surplus that may accrue.
### Indiana Operating Funds: Receipts, Disbursements, and Balances
#### Fiscal Years 1920-46

**Table: Indiana Operating Funds**

<table>
<thead>
<tr>
<th>Fiscal Year</th>
<th>Receipts</th>
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*Consists of the General Fund (General Fund Appropriated beginning in 1935), the Agricultural Experiment Station, Benevolent Institutions, Educational Institutions, Vocational Education, and Hydrophobia Funds maintained as separate accounts through 1925, the Rotary Funds (1920-33), the General Fund Obligated (1936-46), the highway funds, and the following all other operating funds: School Revenue for Tuition (1921-43), Fire Marshal, World War Memorial (1921-46), Sale of State Lands (1920-24), Swamp Lands (1925-46), Dunes State Park (1926-46), State Forestry (1926-46), George Rogers Clark Memorial (1928-46), Educational Improvement (1930-46), Library Building (1930-46), Board of Agriculture (1933-46), Financial Institutions (1934-46), Excise (1935-46), Motor Police (1936-38), Unemployment Administration (1936-46), New Harmony Memorial (1929-46), Wolf Lake Park (1926-46), Common School Relief (1940-44), State School Tuition (1944-46), and Postwar Construction (1945-46). Trust fund revenues including payroll taxes for unemployment compensation and withdrawals for benefit payments are excluded from the totals. Also included are earnings from the auxiliary enterprises conducted by the universities and colleges and from the State Fair.

**Notes:**
- Fiscal Year ended on September 30; 1933 is the nine-month period from October 1 to June 30, 1933; in 1934 and thereafter the fiscal year ends on June 30.
- Interfund transfers and investment operations are eliminated. Totals for all fiscal years 1922-24 include the net amount of bank loans made: 1.5 million in 1922, 1.1 million in 1923, and $.9 million in 1924.
- Consists of the gross income (1934-46), the property tax for state purposes except the Teachers' Retirement Fund levy, highway-user revenues, (gasoline tax, motor vehicle registration fees, driver license, Public Service Commission fees, and all other highway revenue), liquor excise and alcoholic beverage fees (1933-46), the poll tax, the inheritance tax, the intangibles tax (1933-46), insurance taxes, store license fees, fees for conducting various businesses, and miscellaneous taxes. Taxes are net of tax refunds.
- Consists of regular Federal aid for highway, vocational education, and public health, emergency grants for highways and unemployment relief (1934-39), and the social security aids (1935-46). Does not include Federal grants to Purdue University for agricultural purposes and P.W.A. grants to universities and colleges for construction purposes.
- Includes hunting and license fees, interest earnings, university fees and earnings, except those derived for conducting auxiliary enterprises, and all miscellaneous receipts of the departments.
- In 1925, $5 million of the total and, in 1926, 1.8 million of the total are net amounts of bank loans repaid.
- Totals include monies expended from all sources for state education, highway, charities and correction, conservation, health, safety, and general government purposes.
- Includes local shares of the gross income, intangible, gasoline, and excise taxes, aids out of state funds particularly for education and welfare, and a redistribution of Federal grants.
- Includes hunt and quarter balances as the Auditor's STATE BALANCES of the amount of cash on hand in the State Treasury less the warrants outstanding at the end of each period.

**Sources:**
- Yearbook, Indiana; Statistical Report for the State of Indiana; Analysis of the Finances of the State of Indiana (1913-1923), Indiana University Study No. 63, Office of the Auditor of State; and the Indiana State Chamber of Commerce.