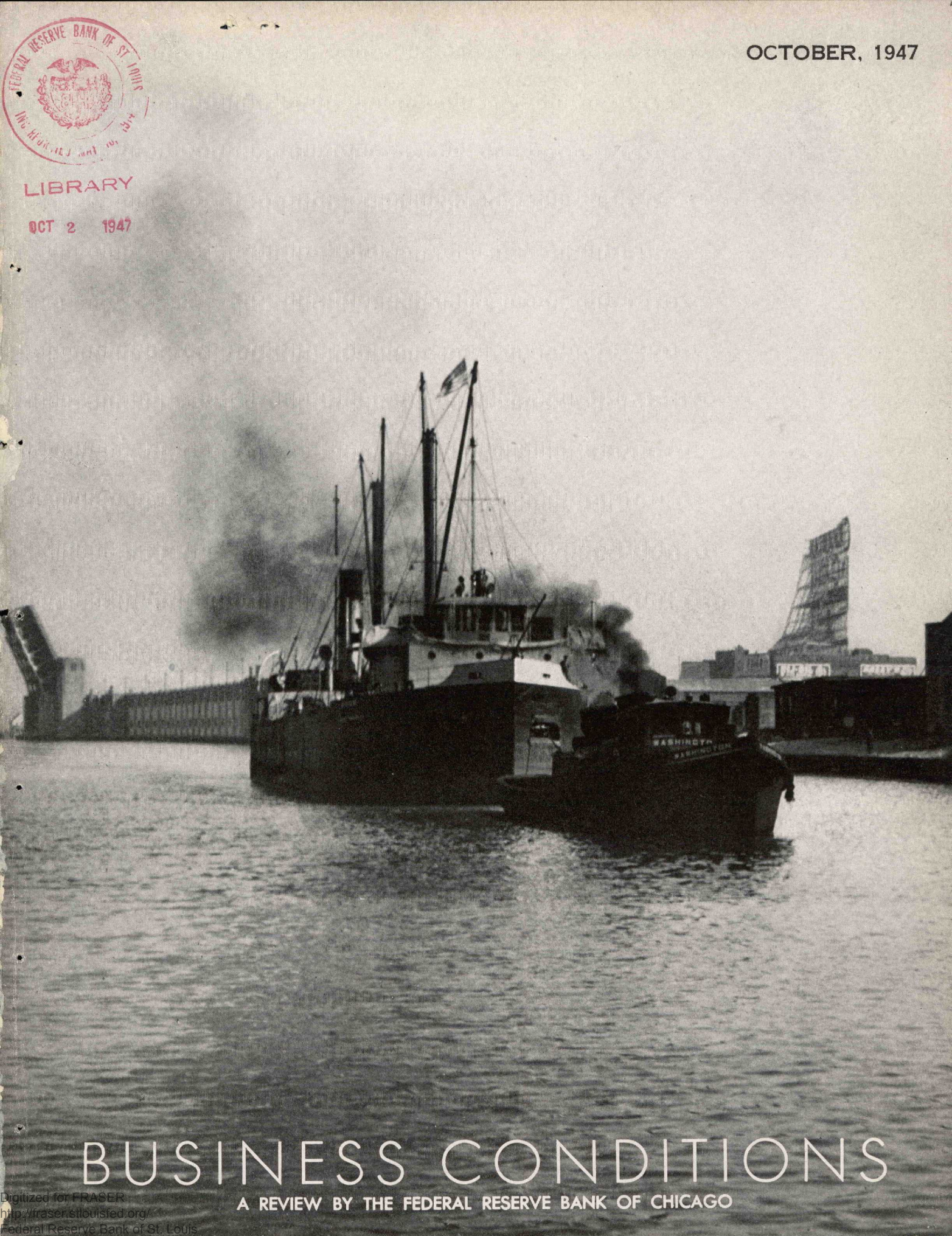
OCTOBER, 1947



BUSINESS CONDITIONS

A REVIEW BY THE FEDERAL RESERVE BANK OF CHICAGO

Farm Income Continues High

Domestic Demand and Foreign Outlets Both Important

With gross farm income expected to reach all-time record proportions in 1947, some estimates running as high as 30 billion dollars, the relative strength and stability of dominant underlying factors in farm income assume increased importance not only currently but especially also for the months and years ahead. There is probably nothing new for most readers in saying that the gross returns to agricultural producers are very closely related to the level of general economic activity, and particularly to the level of total disposable incomes of individuals.

This relationship, or seeming dependence of farm income on disposable incomes, was most obvious during the depression and prewar years. An important factor in this relationship is the fact that agricultural production remains relatively stable in spite of price fluctuations and, therefore, most of the variations in farm income occur in relatively wide ranges of price fluctuations. But in addition to this relationship the war and postwar years have been marked by an increase in the importance of agricultural exports to the level of farm income. While farm income has been enhanced in total by a large volume of exports, their importance to prices, and hence incomes from individual commodity groups, has been often underemphasized.

Turning first to the civilian domestic demand situation, the total of cash receipts by farmers from sales of farm products in years of relatively low general economic activity, such as the years 1932 and 1933, has been equal to only about 10 per cent of the total of disposable dollar incomes of all individuals. On the other hand, in years of high levels of economic activity such sales by farmers have been equal to as much as 15 per cent of total disposable incomes. In other words, farm income not only rises and falls with general economic activity, but also fluctuates somewhat more than disposable income because it is a small part of small totals and a larger part of large totals. If the predictions of a farm income of 30 billion dollars for 1947 are correct, that total will be equal to more than 15 per cent of disposable incomes. It should be understood, of course, that consumer expenditures for farm products are much larger in total than farm income because of the processing and marketing costs involved. These costs bring the current level of consumer expenditure to about 30 per cent of disposable income.

Such variations are due in part to the fact that when incomes are high consumers are disposed to spend not only more on food generally, but also for some kinds of farm products they will spend a larger proportion of high incomes than they will when incomes are low. In addition to this relationship it has been made obvious by the experience of the last few years that when periods of high totals of disposable income are associated with high levels of employment and wages new customers are added to the total number of consumers buying some kinds of farm products. This is true of some "luxury" or "semi-luxury" foods which are bought only by consumers whose income is high enough to afford such expenditures.

An indirect measure of these relationships may be seen from an examination of the farm income from selected commodities. For example, in 1929 and 1930 the farm income from sales of cattle and calves was equal to 1½ per cent of the total of disposable incomes. By 1932 and 1933 the proportion was only 1¼ per cent, but for the past two or three years it has risen again to 1½ per cent. An even more marked change is shown for hogs. At the 1929 peak of disposable incomes the proportion was 1.8 per cent, dropped to 1.2 per cent in 1932, and since 1944 has been above 1.8 per cent again. Income from poultry and eggs shows less extreme variation in relation to incomes. The comparable ratio to total disposable incomes ranged from 1.7 per cent in 1929 and 1930, to 1.5 per cent in 1932 and 1933, and back to 1.7 per cent for current levels. For wheat the proportion of cash income to disposable incomes was 1.0 per cent in 1929, 0.6 per cent in 1932, and 1.2 per cent recently.

An interesting picture in this respect is presented by comparable figures for farm income from the sale of milk and dairy products. The ratio of farm income from the sale of milk and dairy products to disposable incomes has remained quite constant through high and low levels of the latter. In 1929 and 1930 the ratio was 2.8 per cent. Again in 1932 and 1933 the ratio was of the same proportion. For the last two or three years the ratio has been only 2.4 per cent, but if allowance is made for production subsidies paid to milk producers, the ratio would be again about 2.8 per cent. It would seem from this stability of the proportion between farm income and disposable income that as consumers we tend to allocate a fairly constant proportion of income to milk and dairy products as a whole. This is the only major class of farm products for which this is true. It should be emphasized that this conclusion would not hold for each dairy commodity, such as fluid milk, butter, cheese, etc., separately. Levels of income have a pronounced effect on the proportion spent on such items.

In the case of wheat, farm income equalled one per cent of disposable incomes in 1929 and 1930, but for 1932 the proportion was only 0.6 per cent. For the past three years the proportion has been higher than in 1929 and 1930, ranging up to 1.4 per cent. This record high ratio is due in large part to the very great rate of wheat and flour exports in the past several months.

IMPORTANCE OF EXPORTS MAGNIFIED

Total exports during the first half of 1947 reached record levels, and the annual rate for May was above 16 billion

(Continued on Inside Back Cover)

World Dollar Shortage Hits U. S. Exports

Mixed Reactions on Domestic Economy

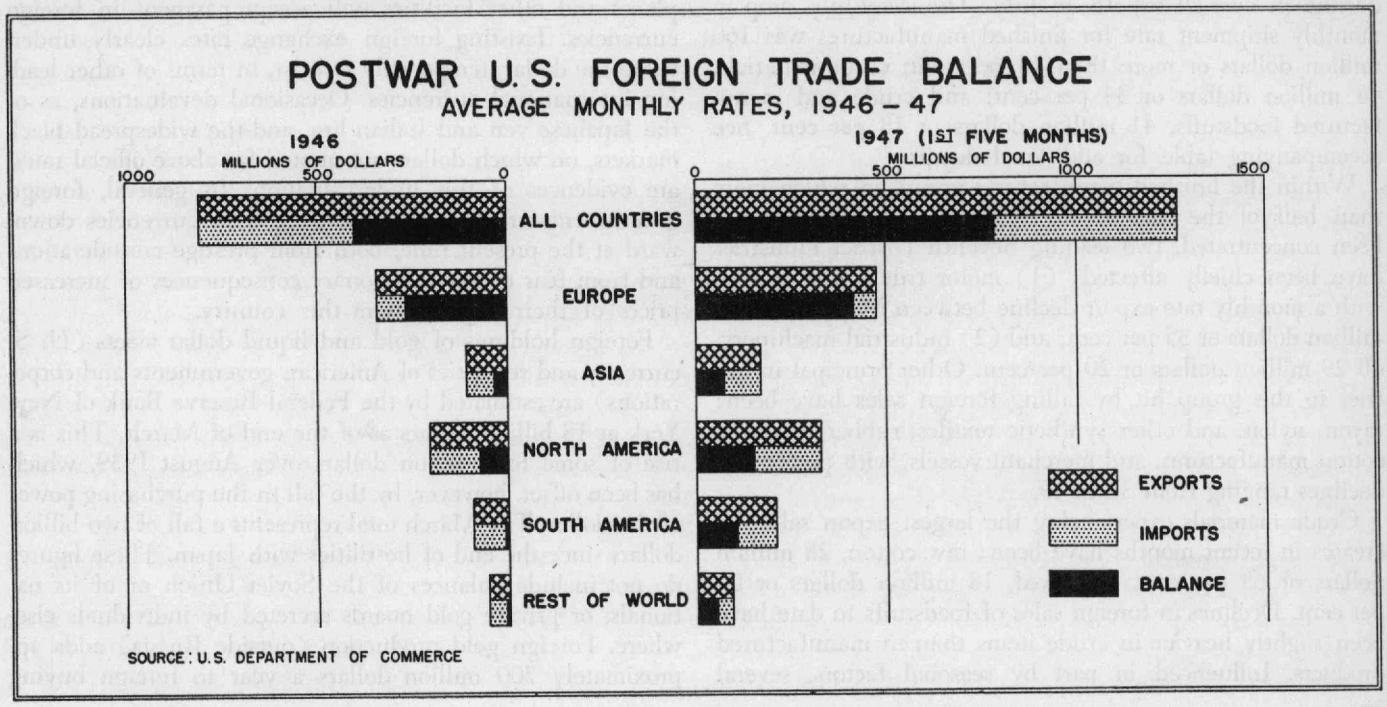
As the pace of postwar inflation has quickened once more, the most significant present sign of possible future deflation and difficulty for national and Midwest business is the drop in American exports and in the American balance of trade. Some leveling off from the 1946 figures had been expected early this year; contrary to the general expectation, the export volume and export balance continued upward through the month of May (see accompanying chart), with the net balance rising from 49 to 62 per cent of the export volume. Then came a 12 per cent decline in exports between May and June and a further drop of 7 per cent in July. Later figures very likely will show further downward movement as they become available from the U. S. Bureau of the Census.

The initial May-June decline is not highly significant in itself and is attributable in part to a three-day maritime strike. The July export total of over 1.1 billion dollars still exceeds the monthly average of any past year except 1944 and is nearly 50 per cent above the 1946 monthly average of 812 million. The retreat from the May height, however, appears to be only the first phase of a steady decline brought about by a world-wide shortage of gold and short-term dollar balances. Compared with a half-year peak of 7.5 billion dollars in exports during January-June 1947, this decline may amount to 2.5 billion dollars during July-December of this year. With exports accounting for somewhat less than 10 per cent of our gross national product (GNP) of 225 billion dollars, such a drop in exports—unless offset by expansion in domestic sales—would lead to a short-term fall of from two to 2.5 per cent in this record GNP total. Export trade at present is estimated to furnish employment for perhaps 1.5 million American farmers and over two million industrial workers.

In certain important Seventh District industries and agricultural specialties, the importance of export trade is particularly great. In steel, it has been estimated that as many as 18 of every 100 workers are currently producing for export; in machinery and automobiles, 12 out of 100; in chemicals and rubber, 11 out of 100. The importance of exports to Seventh District agriculture is discussed in an article entitled "Farm Income Continues High" in the present issue of *Business Conditions*.

MARSHALL PLAN POSSIBLE EFFECTS

The 2.5 billion dollar decline in exports foreseen for the second half of 1947 is expected to occur in the face of the 4.3 billion dollars for "international affairs and finance" estimated in the President's August 1947 review of the budget for the fiscal year 1948, which ends June 30 of next year. (This is less than a billion below the sum paid out in the fiscal year 1947.) The Marshall Plan for the economic unification and reorganization of Europe with American assistance will perhaps envisage net additional payments of three to five billion dollars a year in Europe over an approximate five-year period. If aid under the Marshall Plan or some equivalent in early 1948 is felt sufficiently likely, the decline in American exports, of



course, will be less great in 1947. Europeans might then permit their dollar balances to fall to levels which would be considered dangerously low in the absence of some foreign aid plan.

No politically feasible program of aid to Europe alone, however, can prevent a considerable decline in American exports. The dollar shortage extends beyond Europe, and Secretary Marshall has rebuffed overtures toward extension of relief to Latin America.

BREAKDOWN OF FOREIGN TRADE DECLINE

Much publicity has been given to British efforts to reduce the volume of their imports from this country in the "dollar crisis" which ensued on the unexpectedly rapid exhaustion of the 3.75 billion dollar loan made by this country in 1946. All but 400 million dollars of this line of credit, originally planned to suffice for five years, had been drawn by September 1. Cuts in British imports of tobacco, motion pictures, petroleum products, and even "semi-luxury" food items like dried, canned, and fresh fruit, dried eggs and milk, fresh meat, and cheese have been planned and in some cases put into effect, despite resentment of American suppliers. By the end of October, the British expect to withdraw from the American grain markets as well, after purchase of approximately half their estimated 1947 demand.

Less well known is the fact that the United Kingdom, alone of this country's major customers, continued to increase its imports through June, and that since the first of May, Argentina, Brazil, Chile, Colombia, Ecuador, Mexico, Peru, and Uruguay have all moved to reduce their imports from the United States.

The June downturn, according to the U. S. Bureau of the Census, affected all the principal commodity categories of American export trade except crude materials, and the latter group was the principal element in extending the decline in over-all exports in July. The May-July drop in monthly shipment rate for finished manufactures was 160 million dollars or more than 18 per cent; crude materials, 48 million dollars or 34 per cent; and crude and manufactured foodstuffs, 41 million dollars or 18 per cent. See accompanying table for additional details.

Within the finished manufactures group, in which more than half of the current shrinkage in overseas sales has been concentrated, two leading Seventh District industries have been chiefly affected: (1) motor trucks and busses, with a monthly rate export decline between May-July of 17 million dollars or 35 per cent; and (2) industrial machinery, off 29 million dollars or 20 per cent. Other principal industries in this group hit by falling foreign sales have been: rayon, nylon, and other synthetic textiles; rubber products; cotton manufactures; and merchant vessels, with percentage declines ranging from 33 to 19.

Crude materials experiencing the largest export sales decreases in recent months have been: raw cotton, 28 million dollars or 68 per cent; and coal, 18 million dollars or 28 per cent. Declines in foreign sales of foodstuffs to date have been slightly heavier in crude items than in manufactured products. Influenced in part by seasonal factors, several leading Midwest food products have participated in the export downturn: wheat and wheat flour, off 16.5 million dollars or 23 per cent; corn, 15 million dollars or 38 per cent; meat, 12 million dollars or 53 per cent; and lard, 6 million dollars or 67 per cent. Semimanufactured iron and steel products, and particularly ingot steel, have led in the export decline among partly finished products, experiencing a May-July drop of about nine million dollars or 20 per cent.

Expanding imports of foreign goods into the United States, of course, would provide a new supply of dollars for many nations desiring to buy American goods. Actually, the over-all U.S. import volume also has shown an irregular downward trend from 536 million dollars in December of last year. The figure was 455 million dollars in May and 445 million dollars in July, a 2.4 per cent drop during the three-month period. While imports of manufactured products, including foodstuffs, have increased, declines in crude materials and foodstuffs have more than offset these gains. The principal decreases have occurred in crude rubber, oilseeds, and raw wool.

THE DOLLAR SHORTAGE PROBLEM

In a few cases (e.g., shovels in Chile, nylon hose in Puerto Rico) there are reports of physical saturation of particular foreign markets with individual items of American merchandise. There are also commodities, such as lard, steel, and railroad cars, the exports of which have been reduced deliberately by public or private authority in order to relieve shortages in the United States. By and large, however, the principal problem facing the American exporter is the difficulty which his customer will find in obtaining dollars to pay for his goods.

Dollars are required by exporters, since only a few American firms which propose the erection of foreign branch plants and other facilities will accept payment in foreign currencies. Existing foreign exchange rates clearly undervalue the dollar, temporarily at least, in terms of other leading international currencies. Occasional devaluations, as of the Japanese yen and Italian lira, and the widespread black markets, on which dollars are quoted far above official rates, are evidences of this undervaluation. In general, foreign governments are averse to revaluing their currencies downward at the present time, both from prestige considerations and from fear of the inflationary consequences of increased prices of their imports from this country.

Foreign holdings of gold and liquid dollar assets (U. S. currency and securities of American governments and corporations) are estimated by the Federal Reserve Bank of New York at 18 billion dollars as of the end of March. This is a rise of some four billion dollars over August 1939, which has been offset, however, by the fall in the purchasing power of the dollar. The March total represents a fall of two billion dollars since the end of hostilities with Japan. These figures do not include balances of the Soviet Union or of its nationals, or private gold hoards secreted by individuals elsewhere. Foreign gold production (outside Russia) adds approximately 700 million dollars a year to foreign buying

power, although little of it rests permanently in foreign dollar balances. There has probably been more than a billion dollar fall in net foreign holdings during the two middle quarters of 1947.

About two-thirds of all foreign gold and dollar holdings are believed to consist of gold coin and bullion. Any increase in the American gold price above the present 35 dollars per ounce would, therefore, ease the position of foreign gold holders, at least for a time.[1] If the entire 18 billion dollars of foreign dollar balances could be mobilized at short notice, this would suffice to finance the American export surplus for approximately two years at its July 1947 annual rate of about 8.5 billion dollars. This, of course, assumes no other sources of financing would be used.

The immediacy of the dollar crisis arises from the impracticability of large-scale, short-term mobilization of foreign dollar resources. Much of the gold is held as reserve for currency, and a substantial part of the dollar balances constitute working funds needed for carrying on current trade. Many of the assets held by individuals cannot be confiscated under present laws.

Moreover, foreign dollar balances are not distributed in the same international pattern as the apparent need for American resources. The most serious losses have been those of the relatively needy "liberated nations" of Western Europe, with the exception of Belgium. The gold and dollar holdings of this group, including Belgium, have fallen from 5.4 billion dollars at the outbreak of World War II, to 3.7 billion at V-J Day, and 2.5 billion in March 1947. The wartime neutrals of Europe, on the other hand, are better off. The group of four nations, Portugal, Spain, Sweden, and particularly Switzerland, have a net gain of approximately a billion dollars since 1939. A proposal for a "Dollar Pool" in conjunction with the Marshall Plan is designed to make the dollar resources of Allied countries in the strongest relative positions available to finance imports of neighbors whose needs may be greater but whose dollar positions are weaker.

[1]A prospective increase to $50 per ounce has been rumored widely in recent months; the rumor has been officially and firmly denied.

DOLLAR SHORTAGES IN SPECIFIC COUNTRIES

The acute British dollar shortage arose following British action on July 15, 1947, to make sterling freely available for expenditures on "current transactions" in any currency area. An unexpected large drain on British dollar resources began in the latter half of July. Exporters to the United Kingdom secured payment in dollars or convertible sterling. Other holders of sterling (not on current account) appear to have evaded to some extent the limitations of the free convertibility provision. The British suspended the dollar convertibility of the pound on August 20, following consultation with American Treasury authorities. If Great Britain continues to lose dollars in substantial quantities, its 2.4 billion gold reserve, already reduced by 80 million dollars on September 17, will have to be tapped further.

France had spent by the end of August all but 30 million dollars of a 250 million dollar World Bank loan granted in the spring. The exhaustion of this loan, plus a shortage of dollars from other sources, caused the French to cut their planned imports by 250 million dollars, nearly 40 per cent, for a six-month period beginning in September. Imports from outside the French colonies are being halted except on necessities—coal, gasoline, cereals, and fats. In addition, the French Minister of Economy proposes to shift his country's purchases of cotton to Egypt, and of grain to Canada and Australia, so as to conserve American dollars.

The Latin American dollar shortage presents a different problem. Most if not all the Central and South American republics accumulated large dollar holdings from the sale of raw materials to this country during the war. They hoped to use these funds primarily to purchase machinery and other equipment for their own industrialization. With

WHICH INDUSTRY GROUPS ARE BEING HIT BY FOREIGN TRADE DECLINE?

(Amounts in millions of dollars)

EXPORTS

Group	Monthly Average		1947			May - July 1947 Change	
	1939	1946	May	June	July	In Dollars	Per Cent
Crude Materials	44.0	118.0	143.4	152.8	95.5	— 47.9	— 33.4
Crude Foodstuffs	9.2	54.0	80.0	56.8	62.0	— 18.0	— 22.5
Manufactured Foodstuffs	16.9	127.0	144.5	137.4	121.5	— 23.0	— 15.9
Semimanufactures	51.3	74.7	171.3	159.4	151.3	— 20.0	— 11.7
Finished Manufactures	138.9	418.2	869.2	721.8	708.9	—160.3	— 18.4
Total	260.3	791.9	1,408.4	1,228.2	1,139.2	— 269.2	— 19.1

IMPORTS

Group	Monthly Average		1947			May - July 1947 Change	
	1939	1946	May	June	July	In Dollars	Per Cent
Crude Materials	62.1	141.7	160.1	162.9	133.4	— 26.7	— 16.7
Crude Foodstuffs	24.2	67.9	61.2	55.6	55.1	— 6.1	— 10.0
Manufactured Foodstuffs	26.1	41.9	54.0	60.3	62.9	+ 8.9	+16.5
Semimanufactures	40.6	77.4	103.5	112.2	103.5	—	—
Finished Manufactures	36.7	70.5	76.7	81.8	89.9	+ 13.2	+17.2
Total	189.7	399.4	455.5	472.8	444.8	— 10.7	— 2.4

SOURCE: U. S. Bureau of the Census.

American metal products remaining in short supply for two years after V-J Day, however, they found their dollars being "dissipated" on imports of consumption goods, including luxury items. With the avowed purpose of conserving dollars until American capital goods become available for export, most Latin American republics have strengthened their exchange controls against continued imports of American textiles, automobiles, refrigerators, and the like. Argentina embargoed all imports temporarily late in August, following the British suspension of sterling-dollar convertibility. In Mexico, special measures have been taken to prevent American tourists from selling their automobiles while south of the border. Cuban and Venezuelan dollar holdings, however, remain at their peak because of our continued high imports of sugar and petroleum.

EUROPEAN SELF-HELP

The further accumulation, in Fort Knox or elsewhere, of an additional 10 or 12 billion dollars in foreign gold would be of questionable benefit to this country. The forced liquidation of five or six billion dollars in foreign assets over the next year or two, if at all possible, would probably be difficult for the security markets to absorb in any orderly fashion.

Proposals that Europe and Asia solve their own problems by lowering living standards and raising output and productivity with little or no further American assistance are common. Their proponents do not as a rule make adequate allowance for the actual destruction of capital equipment and the accumulated depreciation and obsolescence of the war years, or for the effects of poor health and minimal diets upon the efficiency of labor and, therefore, tend to underestimate the degree to which foreign living standards would fall in the absence of American assistance. The problem is rendered suddenly more acute by widespread drought which has cut 1947 crop estimates of grain and potatoes throughout Western Europe from Great Britain to Scandinavia, Italy, and Austria.

If Europe and Asia are left to starve or to their own devices of self-help, their dollar shortages will not be solved, and the decline in American exports will be assured rather than averted. Even the limited "mutual aid" provisions of the Marshall approach will have this effect to some extent by re-establishing prewar relationships whereby European countries mutually replenished each others' deficiencies. Continuance of a high level of U. S. exports without Government or World Bank assistance is possible only (1) if private capital undertakes foreign investment on a correspondingly large scale or (2) if foreign revival is concentrated in industries exporting to this country. The first alternative is extremely dubious in view of the skepticism of U. S. investors toward most foreign securities until political and economic risks have been reduced by other measures. Selling pressure has developed on Wall Street in the securities of the International Bank itself. The second alternative is hampered by a resurgence of American protectionist sentiment in favor of industries which rose during the war to reduce our dependence on foreign supplies. American imports of crude rubber, for example, will be held down for the benefit of the domestic synthetic rubber industry. Foreign silk is not expected to cut seriously into the American market now captured by nylon. Even in the service industries, the United States is seeking a much larger than prewar share in world shipping and air transportation revenue, using subsidies to overcome the handicaps of high wage rates and construction costs. In the short-run it is probably physically impossible to step up foreign import totals greatly, were this country to go so far as to eliminate tariff protection entirely.

DOMESTIC REPERCUSSIONS

For at least the remainder of this year, falling exports are expected to serve as an anti-inflationary weapon, a brake on rising prices, and not as an active deflationary destabilizer. This is particularly true for the durable goods industries of the Seventh District. Some individual prices may break, and there may be a certain amount of "frictional" unemployment, but the net effect on the American consumer will probably be favorable. Numerous shortages will be relieved somewhat – railroad equipment, automobiles, agricultural machinery, etc. There may be some downward pressure on food and clothing prices, although this is less likely in view of the pressing nature of foreign demand for the "necessary" items of food and textiles.

The more disruptive effects of falling exports will become apparent only later, perhaps before mid-1948 if nothing is done. There may then arise the falling demand, prices, and employment, which could have been mitigated and perhaps postponed by the maintenance of our export market close to its present admittedly abnormal level for a somewhat longer period.

Perhaps more important and for the still longer-run, when the volume of American exports must decline substantially in any case, will be the blighting effect of the present dollar shortage on the prospect for international trade as a whole, with special reference to American exports. The Geneva Conference on an international trade organization was expected to point the way toward a world-wide lowering of trade barriers. The dollar shortage may well have killed the conference in embryo, as regards concrete or immediate results. In a world struggling for dollar balances, prospects for general tariff reduction appear negligible. A turn toward state trading, bilateral dealings, and barter agreements is in the offing, as each country seeks to conserve its supply of undervalued dollars by cutting its imports or directing them to areas where dollars are not required in payment. The trend is, therefore, directed explicitly against this country. When world demand has fallen to normal and the agriculture of Europe and Asia is producing at its prewar rate, American exporters of both agricultural and industrial products may be handicapped indefinitely in international competition as they face a system of world-wide trade controls frozen into an anti-American pattern in consequence of the dollar shortage of 1947. The Bretton Woods agreements are the principal hope for reversing the trend after they take full effect in 1951.

Iowa State Finance III

Influence of State Constitution on Debt Policy

The infrequent resort to deficit financing by the states in the Middle West is attributable to the prohibitions and restrictions of their constitutions on the use of credit. The typical constitution in this area dates back to the middle nineteenth century. In that pioneer era, the desperate need for transportation facilities—canals, turnpikes, and railroads—and for banking institutions to service the capital needs of a rapidly expanding population had led to widespread direct and indirect use of state credit. The investment of the proceeds of state borrowings in banks and self-liquidating projects promised not only badly needed internal improvements but also a continuing investment income, for these projects were expected to more than pay their way. Just as the vision of a taxless state government living off its investments began to assume shape and substance, financial crisis and economic depression struck. Some states were unable to avoid serious default. All turned to higher taxation for interest on loans that were to have been serviced from enterprise earnings.

The framers of constitutions adopted in the 1840's and 1850's were so preoccupied with preventing a recurrence of over extension of credit that they virtually eliminated borrowing as an instrument of state fiscal policy. Loans to repel invasion, suppress insurrection, and defend the State in time of war, and to finance casual deficits in revenue were generally left within the discretion of the General Assembly. All other borrowing was prohibited unless specifically authorized by a vote of the people in a manner similar to the procedure required for amendment of the constitution.[1]

The provisions relating to financing casual deficits usually restricted such borrowing to a fixed dollar amount. The constitution of Iowa, for example, set this amount at $250,000. This was about the level permitted in Wisconsin, Illinois, and Michigan. No doubt the framers of these provisions were thinking in relative terms. The amounts so provided were, at the time of adoption, quite liberal. In Iowa, for example, the sum was the equivalent of a year's expenditure. A century of growth in population and economic development has, however, reduced this fixed amount to relative insignificance. The restriction of borrowing for casual deficits to $250,000 in a state where annual expenditures are at the 150 million dollar level is equivalent to an outright prohibition against all borrowing for that purpose.

In consequence Iowa has had to adopt a policy of surplus financing adequate to cover all possible shrinkage in revenues. Expenditure programs involving substantial capital outlays must go to the voters for approval or be prosecuted on a pay-as-you-go basis.

Borrowing by referendum during the past three decades in the Seventh District states has been limited to three World War I bonus issues (Iowa, Illinois, and Michigan); two World War II bonus issues (Michigan and Illinois); highway issues (Illinois and Michigan); and emergency relief financing in Illinois. Agency and special fund borrowing by these states has only indirectly employed the state credit. While these devices are properly an important aspect of state financial policy during this era, they fall, by judicial interpretation, outside of constitutional debt limitation.

VETERANS BONUSES

The Iowa bonus issue of 1922 is the only successful attempt to follow the borrowing procedure set forth in Article VII, Section 5 of the constitution. This section requires the referral of a proposal to formally use the State's full faith and credit for a specific purpose to a vote of the people. The issue of 22 million dollars was serviced by a special property tax levy and retired in 1943 at a cost to the State of 9.7 million dollars in interest.

In November 1948 a proposal for an 85 million dollar bond issue for bonuses to veterans of World War II will be voted on. The plan contemplates payments of $10 and $12.50 per month of active domestic and foreign service respectively with a maximum of $500. Although this latter issue is, in absolute terms, four times the size of the first bonus, it is directly comparable to the first bonus if related to the yield of the State's tax system then and now. In the fiscal year 1922 tax revenues were 20 million dollars; in 1923, 23 million dollars. The present tax yield, excluding payroll taxes, was 86 million dollars in fiscal 1946 and 112

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[1]Article VII of the Iowa Constitution of 1857 deals with state debt. Its provisions briefly summarized are as follows:

Sec. 1. The credit of the State shall not be given or loaned to any individual or corporation, nor shall the State assume debts or liabilities of persons or corporations unless such obligations were incurred in time of war for the benefit of the State.

Sec. 2. The State may contract debts to supply casual deficits or failures in revenue or to meet expenses not otherwise provided for, but the total of such debt shall not exceed $250,000.

Sec. 3. Losses to the permanent school or university fund of the State occasioned by defalcation or mismanagement of the officers controlling them shall upon proper audit become a permanent debt of the State upon which an annual interest rate of six per cent shall be paid. This debt is in addition to that authorized by section 2.

Sec. 4. In addition to the debt authorized in sections 2 and 3, the State may contract debts to repel invasion, suppress insurrection, and defend the State in time of war.

Sec. 5. With the foregoing exceptions no other debt shall be contracted unless:

(a) it is authorized by law for a single work or a distinctly specified object;

(b) such law imposes a direct annual tax sufficient to pay interest and principal as it becomes due within 20 years from the time the debt is contracted; and

(c) such law receives a majority of all votes cast for and against it at a general election in anticipation of which prescribed notice to voters shall have been given.

Sec. 6. The legislature may, at any time after the approval of a bond issue under section 5 and before the debt is actually contracted, repeal the authorization to borrow. Or if a portion of the debt has already been incurred, it may forbid the contracting of any further debt under that authorization.

Sec. 7. Every law which imposes a tax shall distinctly state the tax and the object to which it is to be applied.

Sec. 8. All motor vehicle registration fees and all licenses and excise taxes on motor vehicle fuel, less the cost of administration, shall be used exclusively for the construction, maintenance, and supervision of public highways or for the retirement of existing or future bonds for highway construction. (This provision was adopted in 1942.)

million in 1947. In other Seventh District states bonus issues have been adopted in Michigan and Illinois; proposals will be submitted to voters in Wisconsin and Indiana. It will be noted from the table below that in terms of 1947 tax revenues Iowa's contemplated bonus borrowing is less ambitious than those in other District states.

	Tax Revenues Fiscal 1947 (Excluding Payroll Taxes)	Bonus Issues Approved or Proposed	Bonus Issues Related to 1947 Tax Revenue
	(Amounts in millions of dollars)		
Illinois	318.6	385.0	1.20
Indiana	135.8	120.0*	.88
Iowa	112.0	85.0*	.76
Michigan	292.7	270.0	.92
Wisconsin	148.7	200.0*	1.35

*Proposed

The Iowa proposal requires an annual property tax levy of the amount certified by the state treasurer as necessary to meet principal and interest obligations. Although such a provision is required by Article VII, Section 5, it does not appear to preclude the use of accumulated surpluses or other sources of revenue to service the bond issue. If other sources are adequate, the treasurer would merely certify that no funds were needed from the property tax. In Illinois the bond issue is being serviced from increased cigarette and pari-mutual taxes and, if these fail to be sufficient, from general sources or a state property tax levy; in Michigan it is serviced from a new tax on cigarettes. If popular referenda are successful in Indiana and Wisconsin, bonuses will be paid out of additional current revenues—in the latter from a new sales tax, in the former from a tax preferred by a majority of voters.

BORROWING FOR HIGHWAYS

In the 1920's the major problem of Iowa government was to get the state out of the mud. It was early apparent that an extensive network of hard roads was essential if not inevitable in the State's economic development. Under the stimulus of Federal aid and the growing yields from highway vehicle licenses and motor fuel taxes such a program was assured a long-run earning capacity ample to justify an unprecedented program of capital outlay.

The major policy issue of highway development did not impinge on its desirability or need but on its timing and on the relative responsibilities of the State and local units of government. The historic division of the road function between the State and its subordinate units favored a continuation of emphasis on local and county responsibility rather than a transference of the funcion to the state. For nearly a decade after Federal aid became available and the Primary Road Fund was created, the activity of the State was limited to planning and general supervision by the State Highway Commission. The prime movers toward greater state responsibility -Federal insistence as a condition to aid and control of the sources of highway user revenue—operated more slowly in Iowa than elsewhere.

Attempts to utilize the State's credit by highway bond issues which would have drastically accelerated the trend toward greater state responsibility were twice thwarted by court decisions. In 1928 the Iowa legislature proposed a highway borrowing under Section 5 of Article VII of the constitution amounting to 100 million dollars. The proceeds were for construction and to retire outstanding issues of county primary road bonds. The bonds were to be issued serially in the years 1929-34 as needed for construction and refunding. Principal and interest payments were to be met from highway user taxes. This issue was approved by a popular vote of two to one in November 1928. The Iowa Supreme Court, however, held the plan failed to conform to constitutional requirements in that (1) the entire issue would not be retired within 20 years of its authorization (i.e., the bonds issued in 1934 would not be retired until 1954 instead of 1949), and (2) the General Assembly could not pledge earmarked indirect taxes beyond a single biennium, and since motor vehicle fees and motor fuel levies were indirect taxes, they did not satisfy the constitutional mandate for a direct annual tax (*State* v. *Executive Council of State* 223 N.W. 737, 1929). Some consolation to the proponents of state borrowing was afforded by the Court's declaration that Section 1 of Article VII did not preclude the State from paying interest or principal on county primary road bonds.

The second attempt to use state credit for highways resorted to the procedure of constitutional amendment. The amendment proposal was adopted by the 43rd and 44th General Assemblies and scheduled for reference to the voters at a special election to be held June 16, 1931. On May 5 the Supreme Court again nullified the effort to use state credit by holding that the proposed amendment did not meet technical requirements in the amending process specified by the constitution. The major objection was that the amendment put a double proposition to the electorate since it both granted to the State power to issue primary road bonds and denied this power to the counties. (*Mathews* v. *Turner*, 236 N.W. 412, 1931.)

The timing of road development in Iowa thus initially was a function of the willingness of individual county units of government to accelerate the program within their respective jurisdictions by the issuance of county bonds. Prior to 1928 little if any financial incentive to this goal was provided by the State. The bulk of highway user revenues was made available for primary road construction and maintenance among the several counties on the basis of area. The size of these allotments was not altered by county borrowing. Moreover, the county was pledged to pay interest and any deficiencies in principal out of property tax revenues. In 1928 and thereafter allotments were made wholly within the discretion of the Highway Commission, and the county primary road debt service was entirely met from state highway user funds. Although legally the debt continued to be an obligation of the county, the State has, since 1928, assumed in fact the responsibility for the management and payment of county primary road debt.

The first borrowing for primary roads occurred in 1920. By December 1, 1927, twelve counties issued a total of 27.9 million in bonds. The bulk of borrowing was made during

1928 through 1931, but intermittent borrowing continued until 1938. In 1939 the General Assembly prohibited further issuance of county primary road bonds. Of the 118.2 million bonds issued, 90.9 were retired by June 30, 1946, at a total interest cost of 47.4 million. A total of 5.1 million of property tax revenue was spent by counties of which 1.8 million was for principal payment.

In addition to the long-term obligations, counties issued certificates in the years 1922-26 anticipating allotments of primary road funds. These were retired as allotments became payable. When the State ceased to allot funds on an area basis, the practice of issuing certificates against the primary road fund was discontinued. A total of 12.2 million dollars of certificates was issued, but the amount outstanding at the end of each fiscal year never exceeded 3.6 million.

The growing yield from the user taxes and Federal aid afforded more and more flexibility in a state-wide construction program, while the cost of debt service due to refunding operations in the middle 1930's came well within the fiscal capacity of the earmarked revenue structure. By 1950 the entire primary road borrowings will have been liquidated, and an additional eight million dollars annually will be available for other programs.

DIRECT AND INDIRECT OUTSTANDING INDEBTEDNESS OF THE STATE OF IOWA 1920-47

(Amounts in millions of dollars)

Fiscal Year Ending June 30	Total	Direct Debt			Indirect Debt			
		Total	Long-term[1]	Short-term[2]	Total	Long-term		Short-term[5]
						High-way[3]	University[4]	
1920	1.7	.2	—	.2	1.5	1.5	—	—
1921	4.4	.1	—	.1	4.3	4.3	—	—
1922	8.3	*	—	*	8.3	7.1	—	1.2
1923	23.4	11.2	11.2	—	12.2	8.6	—	3.6
1924	37.1	20.9	20.9	—	16.2	13.0	—	3.2
1925	36.7	19.8	19.8	—	16.9	14.9	—	2.0
1926	37.5	18.7	18.7	—	18.8	16.9	.1	1.8
1927	45.4	17.6	17.6	—	27.8	24.1	.2	3.5
1928	63.5	16.5	16.5	—	47.0	43.1	.2	3.7
1929	79.2	15.3	15.3	—	63.9	60.7	1.4	1.8
1930	102.6	14.2	14.2	—	88.4	86.1	1.3	1.0
1931	113.6	13.2	13.2	—	100.4	96.8	1.2	2.4
1932	112.6	12.1	12.1	—	100.5	96.3	1.2	3.0
1933	109.4	11.0	11.0	—[6]	98.4	95.0	1.2	2.2
1934	103.5	10.3	10.3	—[6]	93.2	90.7	1.2	1.3
1935	99.6	9.2	9.2	—	90.4	86.6	1.2	2.6
1936	95.5	7.7	7.7	—	87.8	86.4	1.2	.2
1937	91.7	6.6	6.6	—	85.1	83.4	1.7	*
1938	87.4	5.5	5.5	—	81.9	79.8	2.1	*
1939	81.7	4.4	4.4	—	77.3	74.7	2.6	—
1940	74.6	3.3	3.3	—	71.3	68.8	2.5	—
1941	66.5	2.2	2.2	—	64.3	62.2	2.1	—
1942	59.0	1.1	1.1	—	57.9	55.7	2.2	—
1943	50.9	.1	.1	—	50.8	48.7	2.1	—
1944	43.5	*	*	—	43.5	41.7	1.8	—
1945	36.2	*	*	—	36.2	34.6	1.6	—
1946	28.3	*	*	—	28.3	27.2	1.1	—
1947[7]	20.8	*	*	—	20.8	19.8	1.0	—

[1]Consists of indebtedness for World War I bonus payments.
[2]Includes warrants outstanding issued in anticipation of revenues for capitol grounds extension (1920-22).
[3]These are county issues for construction of state primary roads.
[4]Consists of loans made for dormitories at the state colleges and university, for the stadium at Iowa State University, and the Memorial Union Building at the Iowa State College (Ames).
[5]Issued by counties in anticipation of revenues of the State Primary Road Fund, and warrants issued in anticipation of revenues to the State Sinking Fund for Public Deposits. County road warrants outstanding are as of November 30.
[6]During fiscal years 1933 and 1934 due to large amounts of funds in closed banks, the treasurer issued approximately 14 million dollars in stamped warrants. Amounts outstanding at the end of these fiscal years are not available.
[7]Subject to revision.
*Less than $50,000.

THE STATE SINKING FUND FOR PUBLIC DEPOSITS

The State's credit has been indirectly employed to insure bank deposits of the State and local governments. Depositories for public funds in Iowa are designated by local governing bodies. In the years when the State levied a property tax substantial amounts of deposits of state funds were customarily left in the hands of county treasurers. Thus both state and local funds were widely distributed in Iowa banks. Depressed agricultural conditions and declining farm land values in the early and middle 1920's led to many bank failures. To cope with the ensuing shock to the finances of the State itself and the local units of government and to safeguard operating balances from loss and temporary embarrassment, the Iowa General Assembly of 1925 created the State Sinking Fund for Public Deposits. From this fund the state treasurer was directed upon certification of the State Banking Commission to make timely restoration to local governments of amounts frozen in closed banks.

The funds to meet these claims were derived from liquidation dividends and from the diversion of all interest payments on public deposits to the Sinking Fund. As it was expected that liabilities would accumulate more rapidly than these sources of revenue could liquidate them, provision was made for the issuance of state anticipation warrants. The statute authorizing their issuance required that the warrants should be labeled an "obligation of the State Sinking Fund for Public Deposits only." A ceiling for the total of warrants outstanding was set at 3½ million dollars, but this limit could be extended by executive action. In 1934 the revenues of the Sinking Fund were further augmented by earmarking the yield from a newly enacted malt beverage tax. The prohibition of the payment of interest on demand deposits contained in the Banking Act of 1934, and first effective on public deposits August 24, 1937, denied this source of revenue to the Fund. A system of semi-annual assessments against public balances was adopted as a substitute measure. These assessments continued through the fiscal year 1940. This was also the last year that revenue from the beer tax was allocated to the Fund.

During its entire history from 1926 to date the Sinking Fund for Public Deposits received from interest payments 13.7 million dollars, in assessments on public deposits 2.3 million dollars, in liquidation dividends 16.6 million dollars, and in beer revenues 7.8 million dollars. Together with earnings on investments in Government securities in recent years total receipts of the fund have been 40.4 million dollars. In the same period the Fund has paid claims for deposits by the State and local governments in closed banks aggregating 35.7 million, incurred interest costs on the anticipation warrants of one million dollars, and transferred two million dollars to the General Fund.

The Sinking Fund still exists to fulfill the function for which it was originally created, although the coverage of the Federal Deposit Insurance Corporation lessens to a marked degree potential liabilities. The Fund has been virtually dormant since 1940 when its major revenues were

cut off. No claims have been paid since 1942, and liquidation dividends have declined from a $500,000 level in 1941-43 to $77,000 in 1947. A balance of 1.75 million dollars nearly all of which is invested in securities of the Federal Government is available for future operations.

The total of borrowings through the issuance of anticipation warrants from 1927-35 was 22 million dollars, but the amount outstanding at any one time was seldom in excess of 3.5 million dollars. All warrants were retired by 1939. In 1933 an effort was made by the General Assembly to authorize the borrowing of 20 million dollars from the Reconstruction Finance Corporation to be used to replenish the depleted cash resources of the Sinking Fund. The Iowa Supreme Court held such borrowing to be contrary to the constitution unless approved by a vote of the people as required by Article VII, Section 5.[2]

INSTITUTIONAL DEBT

It is common practice among states to differentiate the method used to finance capital expenditures for regular educational facilities from that used for such subsidiary enterprises as dormitories, recreational facilities, and athletic plants. While both types of expenditures are ordinarily regarded as proper functions and responsibilities of the state and can be financed directly, because earnings from subsidiary enterprises can be readily segregated, the states generally prefer to finance them as independent undertakings and without state appropriation.

In Iowa the 1925 General Assembly authorized the State Board of Education to borrow funds for the construction of dormitories at the institutions under its jurisdiction by pledging the improved real estate as security. Ensuing principal and interest obligations were to be retired solely from earnings of the property, from profits of similar property at the same institution, or from private bequests. Separate corporations have been organized to construct the memorial unions at the State College (Ames) and the State University and the stadium at the State University. These borrowed money, made the necessary improvements, and leased the property to the university which meets the equivalent of principal and interest requirements out of operating earnings. When the debt is retired, title to property reverts to the State. In some states the earnings of subsidiary enterprises are supplemented by state appropriations. However, this is not the practice in Iowa.

In the last ten years the greater portion of the outstanding indebtedness resulting from agency borrowing has been for dormitories. While the current outstanding obligations are nominal, it is anticipated that as a result of record enrollment in state universities and colleges additional loans of this type will be made in the near future.

Agency borrowing in Iowa up to the present time has been confined to state educational institutions. The recently adjourned General Assembly authorized the State Armory Board to borrow money for the construction of armories, and thus made possible an extension of this general technique to another agency. There is an important distinction, however, in that the earnings of the Armory Board are derived from rentals paid out of state appropriations. This method of finance has come into common use to provide facilities for national guard units without recourse to appropriations or direct borrowing for construction.

It has been pointed out in other articles in this series that many state courts recognize a distinction between borrowing by the State and its agencies even though they may be its creatures. Thus, state appropriations may be used for the service of debt without making the debt a legal obligation of the State. The creditor's security is limited by statute to the physical assets acquired with the proceeds of the loan and the future earnings of the improved property. In the case of loans for local armories the physical assets while for a specialized use are of such character that they are suitable for community centers. Where the property pledged is a stadium or a dormitory, no doubt the moral prestige and standing of the borrower is an added assurance to the legal safeguard.

SHORT-TERM BORROWING

In 1913 the General Assembly adopted a 10-year program of enlarging the site on which the capitol and other structures housing the state government were located. The expansion was to be financed by an annual property tax levy yielding between 1.5 to two million dollars during the period. The Executive Council was authorized to purchase land whenever it became available with funds from the annual tax levies, or if these were not sufficient, the Council could issue warrants in anticipation of future levies. Such borrowing, when reviewed by the court was held not to constitute a debt under Section 5 of the constitution, provided warrants issued were limited to the anticipation of revenue for a biennial period.[3] The theory advanced was that one legislature could not bind its successors and, hence, could not guarantee continuity of policy beyond a biennial period. This required that anticipation notes be limited to a similar period. A total of 1.5 million dollars was issued in warrants, but, except for June 30, 1914, when the amount outstanding was $675,000, the warrants outstanding were usually less than $200,000.

In the years prior to World War I the state treasurer was compelled to mark warrants presented for payment at times when cash balances were inadequate to meet obligations as "unpaid for lack of funds." These warrants were then sold, and interest, not exceeding five per cent, was paid on them. During 1916-18 an average of one million dollars was outstanding at the end of each of the fiscal years. With increased revenues during the 1920's this practice was not used again until the 1930's. In fiscal years 1933 and 1934 the treasurer stamped approximately eight million dollars of warrants against the General Revenue Fund and six million dollars of warrants against the Primary Road Fund. This was primarily due to the fact that State balances were frozen in closed banks. By November 1933 almost all of these warrants were redeemed from current collections and from liquidations of assets in closed banks.

[2] *Hubbell* v. *Herring* 249 N.W. 430 (July 18, 1933).

[3] *Rowley* v. *Clark*, 144 N.W. 908 (1913).

FARM INCOME CONTINUES HIGH

(*Continued from Inside Front Cover*)

dollars. This rate may be compared with total domestic exports valued at two to four billion dollars during most of the inter-war years. The world dollar shortage and declining exports are treated in the accompanying article in this issue entitled "World Dollar Shortage Hits U. S. Exports." The expected further decline in exports may have an impact on farm prices and farm income in two ways.

Traditionally, at least during the inter-war years, agricultural exports accounted for 20 to 40 per cent of total exports. But during the peak period of exports in recent months agricultural exports have totaled only about one-eighth of the value of all exports. In other words, in spite of high levels of total dollar values of agricultural exports, the levels of industrial and other non-agricultural exports have reached even greater relative magnitudes. If exports of such commodities are to continue to decline sharply, the indirect effect on farm prices and income could be a curtailment of civilian domestic demand. It is estimated that upwards of 3.5 million of the 60 million employed in this country are producing directly or indirectly for export. If the gap of curtailed exports is not filled by backlogs of domestic demand for the amounts of reduction, some unemployment and slackening production can be expected. The effect of this would be to lessen somewhat the domestic demand for farm products. Such a change would be most likely to be felt in the so-called luxury items, such as fruits and vegetables, top quality cuts of meats, and some dairy products.

The second way farm incomes and prices will be affected by declining exports is, of course, the direct slackening in demand for agricultural commodities as such. Reductions will not only affect prices proportionally but may be expected, in view of the high levels of farm exports, to have multiplied effects on the level of farm prices. Studies indicate that even in the inter-war years when agricultural exports were only a fraction of recent levels a change of one billion dollars in exports was associated with a change of more than 1.5 billion dollars in cash farm income. It seems reasonable, therefore, to assume that in the light of recent and current rates of agricultural exports and the generally tight domestic supply situation any given percentage decline in these exports may carry with it a decline possibly twice as great in prices.

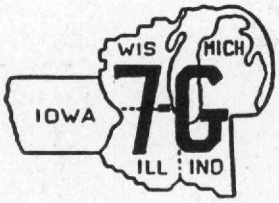
Naturally, such magnified effects on prices would not be expected to occur for *each* exported commodity. The declines might be more or less, depending upon whether a particular commodity experiences a declining export volume, upon the relative importance of the volume of exports in the total moving into consumption channels, and on the relative supply and demand situation within this country.

Turning now to estimates on the relative importance of exports of various commodities to total supplies or production, it may be seen that some commodities are much more "exposed" to price changes from export changes than are others. Based largely on rates of export for the first quarter of 1947 and partly on estimates for the total to be exported for the year, such calculations indicate that for the grains and grain preparations 1947 exports will be at the following rates or proportion of total supplies moving into consumption channels: wheat, more than one-third; rice, more than half; corn, nearly one-third (note that this is corn moving into consumption channels, *not* production); oats, about one-fourth; and barley, more than 10 per cent. For cotton and tobacco the rates are about 38 per cent and 30 per cent of production, respectively. At somewhat smaller rates are the following commodities: food fats and oils (excluding butter), 10 per cent; fruits, seven per cent; meats, three per cent; dairy products, three per cent; eggs, four per cent; and poultry, 0.5 per cent. In the case of dairy products the estimates show that about 0.5 per cent of the butter and 15 per cent of the cheese supplies moving into consumption channels will have been exported during the year. It is further estimated that well over 10 per cent of the dried milk and condensed milk production will be exported during 1947.

It may thus be seen that sharp reductions in export demand for cotton, tobacco, wheat, rice, and to some extent other grains, fats and oils, cheese, and condensed and dried milk might be expected to have price-lowering effects considerably out of proportion to the amount of reductions. To what extent and in what order of priority these food exports may be hit by reductions remain in part unknown, but there is already evidence, particularly with regard to Great Britain, that cotton, tobacco, meat products, eggs, cheese and dried milk, as well as fruits and their preparations are most likely to feel first and most the probable reductions. The world food situation continues apparently to be such that the highest priorities will continue to be placed on grains and grain preparations. When it is remembered that Great Britain in the first quarter of this year took from one-fourth to one-half or more of our exports of such commodities as cotton, tobacco, meat products, dairy products, fruits, and nearly all of the eggs exported, it is obvious why the dollar "crisis" should be of concern to farmers and other agricultural interests. For some of these commodities the proportions of supplies exported, as shown earlier, are relatively small, and therefore, the price reducing effects may be minor and possibly delayed at least temporarily in the face of the domestic demand situation.

But the British crisis is generally regarded as only the beginning, to be followed later by further aggravation from developments in France, Italy, and probably other countries. It seems probable now that the greatest impact of declining exports on American agriculture will come via the indirect effect of declining non-agricultural exports on domestic economic activity. It should not be inferred from these points discussed here and elsewhere in this issue that there is any notion that exports will vanish within a few months or the immediately foreseeable future. But even a modest fractional reduction, a strong probability, could set off some substantial economic declines in this country. Whether this happens depends upon steps taken by this country to meet the situation, and if it does happen on a substantial scale, the short-run outcome will depend upon the magnitude of domestic needs to take up the slack and the speed with which adjustments can be made internally to take up such slack.

SEVENTH FEDERAL



RESERVE DISTRICT