CENTRAL BANKING, FINANCIAL AND CREDIT RESPONSIBILITIES
OF THE GOVERNMENT'S ROLE IN OUR ECONOMY

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Other members of the panel have been asked to discuss rather detailed regulation of specific behavior that is permitted or enjoined. My assignment is to analyze the much more general problem of the role of Government in promoting the kind of environment in which individual decisions are made.

A basic economic goal of every Government is the maximum utilization of its human and other resources. Societies differ, however, with respect to the relationships that they feel should exist between the Government and the individual and, consequently, on how specific goals are to be determined and achieved.

In dictatorships the State is supreme and the individual is subservient to it. Essentially, the leaders decide who is to produce how much of what goods and services and for whom. They determine the division of time into work and leisure, the allocation of resources to specific investment and consumption purposes.

In democracies the State is the servant of the people. Our own economic goals, for example, are expressed as follows in section 2 of the Employment Act of 1946:

"... Federal Government shall use all practicable means ... in a manner calculated to foster and promote free competitive enterprise and the general welfare ... to promote maximum employment, production, and purchasing power."

The difference in basic philosophies is reflected in the differing role that money plays in the two systems. In choosing among alternative goals
and alternative ways of achieving them, even a dictatorship is concerned with costs. Since the factors of production — land, labor, capital — are not directly commensurate, some unit of account is needed. Money serves this purpose, even in a dictatorship. It also performs some auxiliary function of allocations within the limits determined by the general economic plan.

In democracies, on the other hand, money is the basic instrument of economic freedom through which individuals make their preferences known. Within very wide limits, each individual has freedom to choose how he will earn his money income. Through the democratic process of the secret ballot, citizens elect representatives to determine how and how much shall be allocated to common purposes through the Government — and it may be considerable. Again, within wide limits, the individual is free to spend the remainder of his money income as he sees fit. He may also borrow to supplement his income, may save for the future, and may sell some assets and buy others as he sees fit to secure a maximum of welfare. This is a continuous process. Decisions of today are not only influenced by those of the past but condition the choices of the future. In the process, individuals direct the use of resources to those purposes for which they spend money and away from those for which they do not.

Democratic societies want their economic system to achieve maximum utilization of resources while maintaining a maximum of individual economic freedom. Unfortunately, there is no inherent reason why the total of all the individual decisions to buy or sell, to borrow or lend, to consume or invest, to hoard or spend will add up to the exact amounts that are needed to utilize available resources.

What is desired is some mechanism that will induce individuals of their own volition to adjust their behavior so as to produce the desired total result. Fiscal and monetary policies are vital parts of such a mechanism.
It is customary for economists to describe the operation of these policies in terms of their effects on aggregate demand. It is not too difficult to do this in very general terms.

If the governmental and private sectors of the economy try to purchase more goods and services than can be produced at existing prices, their efforts will tend to increase prices rather than real output. It would seem appropriate, therefore, for the Government to curtail its own demands and to induce the private sector to do likewise by extracting more taxes. It would also seem appropriate for the monetary authorities to discourage expenditures by making credit more expensive and more difficult to secure. Although the public would react by using its cash more efficiently, it also would be induced to postpone some of its purchases. These combined operations would tend to remove the inflationary pressure.

If, on the other hand, there are unused human and material resources, it would seem appropriate for the Government either to utilize some of them or to induce the private sector to do so by reducing taxes -- or perhaps by combining the two. It would also seem appropriate for the monetary authorities to encourage additional purchases by making credit cheaper and more plentiful. These combined operations would tend to stimulate aggregate demand and thus bring unused resources into production.

We have built into our fiscal system some automatic stabilizers that tend to operate in keeping with these principles. Certain expenditures, such as unemployment compensation, tend to rise as business activity falls. Federal revenues -- based as heavily as they are on taxes of private income at high corporate rates and steeply graduated individual rates -- tend to rise rapidly during expansion and to fall rapidly during recession. But these stabilizers do not do the whole job.
When we move to deliberate changes in fiscal policy designed to affect aggregate demand, we encounter formidable obstacles. One obstacle is the budget process itself. In January, after several months of preparation, the President will submit to the Congress the budget for the fiscal year 1965, which will begin on July 1, 1964 and end on June 30, 1965. This means that estimates must be made a year and a half to two years in advance! An illustration of what can happen during this interval is afforded by experience with the budget for the last fiscal year. In the proposed budget, as submitted in January 1962, the President estimated receipts at $93.0 billion and expenditures at $92.5 billion, for a surplus of $0.5 billion. As it turned out, expenditures did equal $92.5 billion, but, primarily because economic activity was not as great as anticipated, receipts amounted to $86.5 billion, or $6.5 billion below projections.

A second obstacle arises from our legislative process. We are witnessing an illustration at the present time. The Congress has been working on a tax bill since its early days. At the present time, some ten months later, no one knows whether a tax law will be passed, or if passed, what its content will be.

Even if we were able to surmount these technical and institutional obstacles, we would still be confronted with extraordinarily difficult ethical problems in fiscal policy. Fiscal policy is inevitably concerned, not only with aggregate demand but also with the distribution of burdens and benefits between the public and the private sectors, within the private sector, and between the present and the future.

Permit me to give a single brief illustration. Obviously the mere size of the budget, irrespective of its balance, largely determines the distribution of real resources between the public and the private sectors.
The tax structure, in turn, has great influence on the distribution of the burden within the private sector and between the present and the future. Assume, for example, that the Government relies exclusively on personal income taxation to raise its revenue. The current standard of living and the rate of growth will be greatly affected by whether the tax is assessed on a uniform or a graduated basis. Obviously, if a uniform rate is selected a larger proportion of the taxes will be paid by those with lower incomes. Now it is an understandable fact that people with lower incomes consume a larger fraction of their incomes than do those with higher incomes. Such a tax, therefore, will tend to reduce current consumption and to increase saving and investment. For our people as a whole it will tend to increase the rate of growth and our future standard of living at the expense of our current standard of living. A steeply graduated tax, on the other hand, would tend to increase our current standard of living and reduce the rate of increase in that standard. The point I want to make is that at full employment levels, consumption and investment are alternative ways of using real output. We cannot use identical goods and services for both purposes. Tax policy has a great influence on what the distribution will be. Procurement and expenditure policies also affect, directly and indirectly, specific investments and consumption.

Monetary policy also is confronted with combining multiple goals, which vary from time to time. For several years the problem has been to devise a policy that would encourage greater utilization of our human and material resources without aggravating our balance of payments.

Unfortunately, despite much talk of affluence, we do not have enough resources to achieve all our goals. Fiscal and monetary policies can do much to promote maximum utilization of those we have "in a manner calculated to foster and promote free competitive enterprise and the general welfare."