THE DEVELOPMENT OF THE THEORY OF
FULL EMPLOYMENT

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THE DEVELOPMENT OF THE THEORY OF
FULL EMPLOYMENT

THESIS

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# TABLE OF CONTENTS

<table>
<thead>
<tr>
<th>Chapter</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>I. INTRODUCTION.</td>
<td>1</td>
</tr>
<tr>
<td>II. KEYNES AND THE CLASSICAL THEORY</td>
<td>7</td>
</tr>
<tr>
<td>The Classical Concept</td>
<td></td>
</tr>
<tr>
<td>The Break with Classical Theory</td>
<td></td>
</tr>
<tr>
<td>The Principle of Effective Demand</td>
<td></td>
</tr>
<tr>
<td>The Propensity to Consume</td>
<td></td>
</tr>
<tr>
<td>The Inducement to Invest</td>
<td></td>
</tr>
<tr>
<td>III. PUBLIC POLICIES AFFECTING EMPLOYMENT</td>
<td>31</td>
</tr>
<tr>
<td>Redistribution and Flow of Income</td>
<td></td>
</tr>
<tr>
<td>Fiscal Policy</td>
<td></td>
</tr>
<tr>
<td>Monetary Policy</td>
<td></td>
</tr>
<tr>
<td>Debt Management</td>
<td></td>
</tr>
<tr>
<td>IV. COMBINED USE OF PUBLIC POLICIES</td>
<td>51</td>
</tr>
<tr>
<td>The American Economic Association and the Douglas Report</td>
<td></td>
</tr>
<tr>
<td>V. PUBLIC POLICIES IN ACTION.</td>
<td>70</td>
</tr>
<tr>
<td>The Council of Economic Advisors Report</td>
<td></td>
</tr>
<tr>
<td>VI. CONCLUSION.</td>
<td>90</td>
</tr>
<tr>
<td>BIBLIOGRAPHY.</td>
<td>93</td>
</tr>
</tbody>
</table>
CHAPTER I

INTRODUCTION

The problem of full employment has been a pertinent one throughout all this nation's history, and only since the crash of 1929 and the resulting depression has a theory seemingly been found that may be the answer to this inherent economic disease. The present theory admits that the system does not run smoothly and to the best interest of all when left alone, but rather that the government must step in and regulate it at different times in order to insure a fully employed society.

The classical theory of employment was totally inadequate because it failed to recognize that the system did not work well if left alone. The economy is man-made and thus is not perfect. It is not governed by natural laws that will work to the advantage of the masses if left alone. Instead, the economy has to be supplemented in times of the downward cycle and to be restrained in boom times. The only agency that can possibly handle the situation is the federal government.

The nation has experienced a change of attitude toward unemployment. The principal reason for this change is the fact that now, in the great urbanized economy, unemployment
affects more people and does so in a faster way. During the whole of the 1800's the country's population was essentially rural. During the periods of recurring unemployment most persons endured its strife by resorting to land that was then available. Such is not the case today. Today more ways must be devised to secure persons in their present jobs and to find more jobs for the expanding urban society. No longer can the risk be taken of letting the economic machine run down as occurred in the 1930's. Its effect on that period is still being evaluated. Hitler's and Mussolini's rise to power were surely not unrelated to the mass unemployment that was felt here and all over the world.

Today the world's economy is even more dependent upon economic success than ever before.

During the past few decades there has been a great extension of control in economic relations. Some of the relations include the regulation of the railroads and other public utilities, controls over food and drugs, the insurance of bank deposits, legislative standards for hours and wages, the social security program, and perhaps most important, the rise of trade unionism. This problem must be constantly attacked with whatever scientific tools are available, one of which is the great mass of statistical data. All folkways, mores, and "mana and taboo" practices must be dropped and procedure must be based on a policy founded on theory. This
theory must be scientific in nature. When one theory will not work and is obviously inadequate, then another theory must be discovered that will better explain the problems and enable the people to follow policies that will remedy the situation. One must realize that the world is ever changing and that all laws are merely statistical, and being statistical, they are subject to change. Out of statistical data one can devise theories and formulate policies. The purpose of this paper is to analyze and to review fundamental ideas and theories of employment and to set forth the policies that can best obtain the goal of full employment.

Full employment is defined as the condition where those who want to work at the prevailing rates of pay can find work without undue difficulty. The term "full employment" is often misunderstood and requires brief explanation. In this present highly dynamic society new industries are constantly developing and old ones are declining. Because of this fact, a high degree of labor mobility must be retained. Likewise, regional population shifts will occur in an expanding, developing economy. In addition, in a democratic society with freedom of occupational choice, some considerable labor turnover is not only inevitable, but, indeed, beneficial. Without this, of course, personal freedom could not be maintained. Accordingly, in a society such as
ours, there will always be a large amount of transitional unemployment and a considerable amount of seasonal unemployment. For these reasons, in an economy as large as this one, it is probable that at "full employment" there would be at any one time between two and three million people temporarily unemployed.

Employment has been related to almost every economic function in either an indirect or a direct relation. Almost all current full-employment and income flow doctrines can be divided into four categories: (1) private consumption expenditures, (2) private capital outlays, (3) current services of government, and (4) government capital outlays on public works and developmental projects. Economic policy guides the manner of control and use of these powers, as well as to what degree they are used. Behind these current policies are theories formulated for the purpose of getting a plan of action. There are, as is to be expected, many schools of thought underlying the present knowledge that influence the manner of dealing with problems of employment. There are two main schools of theory. One follows the general theory of J. M. Keynes and the other follows the traditional theory of classical economics. Keynes' General Theory of Employment, Interest and Money has had more influence upon

the thinking of professional economists and public policy makers than any other book in the recent history of economic thought. This book is a repudiation of the foundations of laissez faire. Keynes, a classical economist for twenty years, broke with its doctrines during the 1930's because he believed the classical theory to be "misleading and disastrous if we attempt to apply it to the facts of experience." This paper concerns itself with the conflicting theories held by these two camps and attempts merely to present them.

Economic policy is a set of rules made by management. These rules govern the ordinary business of making a living. Economic policies are a necessity of time and must be reviewed and modified in an effort to better the people. Government, like business, must have a set of rules to determine its course of action. Economic conduct which is ungoverned by policy leads to problems such as monopoly, inequality and instability of employment and income.

"The making of economic policy consists of bringing together the knowledge which is necessary for changing the rules that govern the choices of individuals in their economic affairs."  

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In continually changing the policies one tries to come closer to what is thought would be an ideal state. Also, the conception of an ideal state is ever changing and for this reason the work of economic policy is never completed.

Economic policy draws on the knowledge gained from an analysis of fact and the ethical judgments that direct the acceptance of the facts as desirable, or otherwise. And if the facts are not desirable they can be changed by methods or the techniques formulated by a policy for action.

The federal government has grown to such a size that its influence on income and employment cannot be overlooked and ignored. Its behavior in regard to fiscal and monetary policies greatly affects the whole economy.
CHAPTER II

KEYNES AND THE CLASSICAL THEORY

The Classical Concept

Classical economists are defined as those who accept traditional or orthodox principles of economics that have been handed down and generally accepted by other academic economists since the time of Adam Smith and David Ricardo.

This theory was readily accepted because people wish to think of things in the realm of natural laws. Individuals wish to believe that natural laws are at work at all times to bring about the best results and that they are set in motion by God to control and regulate mankind even when He is not present. This notion dates back to medieval Europe and was developed with the laissez faire theory by the physiocrats. They related man's position on earth to that of a part in a huge clock and attempted to explain economics with the same set of natural laws that they believed applied to the whole universe. They believed these laws functioned better if left alone and allowed to run their course.

The classical economists viewed the business world as an automatic economy with automatic markets, prices, and wages that were self-adjusting for the good of the community. In the absence of government control or private monopoly
these laws were thought to move and adjust everything so as to bring the system to a state of full employment. Thus there was an assumption of full employment and any disturbance was regarded as merely temporary. If the disturbance persisted, it was attributed to interference by government or private monopoly.

Followers of the classical school in a sense do not admit the problem of employment. They place the emphasis on the use of a given quantity of resources by individual firms and industries and not on the system as a whole. If one industry is booming, it will attract workers away from one that is in a slump. The choice is not between employment and unemployment but merely a choice of where to be employed. Labor for new industry can be secured only at the expense of some other industry, and not from previously unemployed resources. "Classical economics is a study of the alternative uses of a given quantity of employed resources."¹

The assumption that supply creates its own demand is called Say's law of markets and is used to justify the assumption that full employment is the normal condition in an exchange economy. This means that every producer brings his goods to the market for the sole purpose of exchanging them for other goods. Say contended that the only reason

people work is for the satisfaction of consuming. Therefore, whatever is produced represents the demand for another product. The more that is produced, the more demand there will be. As long as production is directed into proper channels, all that is produced can be sold. If production reaches the point of excess, and cannot be sold at a profit, the entrepreneurs will shift to producing things that can be sold, and at a profit. This is a denial of the possibility of general overproduction. Employment of more resources will always be profitable and will give full employment. In this view there can be no general unemployment if the workers will accept what they are "worth". This theory fitted beautifully into the pattern of the eighteenth-century philosophy that natural forces were harmonious and good, and that all would be well if Nature were given a chance to operate freely.

Say's law implies also that human wants are insatiable. This is another reason that markets could not be oversupplied. Human beings can never consume enough to satisfy themselves; they will always want more goods and services and will never hoard money. Hayes says this is not so. "People do not always and forever want more jam on their bread!"

Moreover, Say's law means that there will always be a sufficient rate of spending to maintain full employment. The

classical justification of "normal" full employment rests on the assumption that income is spent automatically at a rate which will employ all the productive resources. However, not all income is spent "automatically" because a portion is saved. However, the part that is saved is no obstacle to spending or employment to the classical analysis because the classical theory assumes that saving is a form of spending, that is to say, by the way of investment. Since saving is in the end spending, then all income is spent either for consumption or for investment. This does not break the income flow and in the last analysis, supply creates its own demand.

The theory of supply and demand plays a large role in forming the core of classical thinking. The classicalists make this theory work as a sort of machine of weights and balances. One example is the flexibility of interest rates in relation to saving and investment. It is "classical" to reason that the rate of interest will work to adjust the amount to be saved or invested. Saving and investing is basic and necessary for an increase in production and consumption. So to reason out this line of thought it would seem that the way to increase consumption would be to see that the rate of interest remained high. "The higher rate of saving will tend to lower the rate of interest, and a lower rate of interest will lessen the incentive to save."

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3Dillard, op. cit., p. 19.
However, to tinker with this rate of interest would be anti-
classical because to do so would violate the natural laws
that govern the rate of interest. Interest is viewed as a
reward for saving. Thus, if interest falls, saving will
fall also. Because of the fall in interest rates, money
that was in savings will be diverted to investment. A de-
crease in savings would cause a rise in demand for consumer
goods. The classical theory does not acknowledge that a fall
in consumption, instead of increasing investment, may lead to
a fall in total demand and unemployment. Although this works
out that investment increases as consumption decreases and
seems to be an irrational stand to take, the classical
economists explained that a decision to consume less today is
linked directly with a decision to consume more at a later
date. Even though the classical theory recognized at times
that banks could create money, this was never regarded as a
major obstacle to the savings-investment theory. However,
the whole process of saving and investing to create more
production in order to be able to consume more has lost its
significance as a procedure a nation has to follow to achieve
economic development. The theory recognized that employment
depended on expenditures but refused to accept the fact that
there was not a natural flow of money sufficient to maintain
employment. The followers of the theory deny this because
they refuse to acknowledge that there is any such thing as
involuntary unemployment. They claim, when large numbers are unemployed, that they are voluntarily so and could work if they would accept a lower wage. This calls for a definition of unemployment.

Voluntary unemployment exists when potential workers are unwilling to accept the offered wage, such as those on strike. They could be employed, says Professor Pigou, if they would accept a wage based on real competition. Frictional unemployment exists when men are temporarily out of work because of imperfections in the labor markets. If unemployment exists, then it is voluntary unemployment. According to this theory, the 1932 unemployed workers totaling 15,000,000 and the 7,500,000 still unemployed at the top of the business cycle in 1937, could have worked if they had wanted to bad enough.

It readily appears that this type of theory is not valid. However, its followers contend that these natural laws cannot function today because the government, monopolies, and labor unions have confused everything. These man-made controls keep the natural forces from reducing wages sufficiently to eliminate unemployment. The conclusion drawn by most of the followers of the classical school is that the responsibility for unemployment is on labor itself. The clear classical formula is to adjust the high wages that caused unemployment downward. However, Pigou has conceded that the classicist theory overlooked some aspects in regard to this and said, "Professor Dennis Robertson... has warned me that the form
of the book may suggest that I am in favour of attacking the problem of unemployment by maintaining wages rather than by manipulating demand. I wish, therefore, to say clearly that this is not so." This reversal and deviation away from classical theory by perhaps the most ardent followers of its doctrine are considered by some to be a victory in favor of the Keynesian theory.

Break with Classical Theory

The most important event that finally caused Keynes to break away from the orthodox theory was the financial crisis of 1931.

For twenty years Keynes had followed the general path led by the classical theorists. However, it is evident that he sometimes felt an insecurity in the basic theories when he examined them closely and tried to apply them to reality. Before the depression, he seemed optimistic about finding ways to eliminate the severity of the trade cycle. Later, he seemed doubtful that capitalism could survive. Keynes never did embrace capitalism without reservations but believed it to be a highly productive system if managed right.

During the depression the classical thinkers held the view that personal thrift and reduced government spending

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could bring about recovery. This is to say, traditionally, that accumulated savings would lower interest rates and thus encourage investment. Keynes saw savings as hoarding that resulted in decreased employment instead of increasing investment. This is what made him see that the preference of having money liquidity could have far-reaching anti-social effects.

Possibly the strongest objection to classical theory is found in the notion that unemployment will disappear if workers will merely accept sufficiently low wage rates.

In speaking of the flexible wage policy Pigou says, "This policy, if it could be practically carried out, would in my viewpoint, be a true antidote, within its limits, to slump conditions. It would not abolish, but it would effectively lessen the waste of unemployment." Keynes objected to this policy in both practice and theory. He contended that it is practical to view labor unions, welfare legislation, minimum wage laws and unemployment insurance as an integral part of the modern democratic economic system. Therefore, a theory that cannot work with these things present is not a theory based on the facts of experience. Even if these things could be repealed and a complete authoritarian economy resulted, Keynes contended that employment would not rest on wage bargaining between workers.

and employers but on the degree of effective demand. He does not base unemployment on rigid wage rates and the decline of competition but ties it directly to investment in durable capital goods. The decrease of investment is taken in conjunction with the "stickiness" of interest rates.

During the depression Keynes advocated a protective tariff and repudiated the doctrine that there is a direct relation between exports and imports. The classical thinkers held that to reduce imports would be to reduce exports. This change of attitude in Keynes toward free trade is but another illustration of the break. In the General Theory inequality of income and wealth were seen as the root of unemployment and a great barrier to economic progress. This view is a reversal of the one held in his earlier book Economic Consequences of the Peace. Keynes says that the failure of orthodox doctrine to develop a satisfactory and realistic theory of the rate of interest is a "fatal flaw" in their line of reasoning. It was by substituting a monetary theory of interest that Keynes thought he could explain what determines the level of effective demand and the volume of aggregate employment.

Keynes was the first academic economist of high professional repute since Malthus to attack the doctrine that economic forces of a private property economy tend to bring about the employment of all who wish to work at the prevailing rates. He argued that there could be an equilibrium at
other than full employment. The classicist believed that there could be no equilibrium except when the full employment pulls were eliminated. The fact that "equilibrium" can be obtained at various levels of employment means that one must look to forces other than the "natural" economic ones if employment is to be maintained. These forces, according to Keynes, are man-made devices, such as government spending, control of the rate of interest, a reduction in the inequality in incomes and a move toward socialized investment.

The Principle of Effective Demand

The principle of effective demand is the very heart of Keynes' theory of employment and also a contradiction of the classical view of Say's law.

The place where entrepreneurs can maximize their expected profits is the point of effective demand and relates total employment to total demand. This demand is called the aggregate demand, or that demand brought about by the economic system as a whole. When there is a deficiency in the total demand, unemployment results. According to the classical theory, demand could never fail, with flexible wages and prices, to be adequate to employ all the factors seeking employment. Deficiency in demand could come about only through market imperfections. Keynes formulated his theory by explaining that effective demand manifests itself in the spending of income and that income and employment increase
together. He also saw that out of real income a certain amount was saved, or hoarded, by some people. This caused a deficiency in demand. To make up for this deficiency, and to prevent unemployment, there had to be an amount invested equal to the amount that was saved. If people save out of a given income more than the community wishes to invest, total demand, income, and employment will decline.

At any level of employment actual savings will be equal to investments, and with no change in either, employment will remain the same. If people decide to save less and investment increases, this will bring about higher employment and output that will generate more income which will tend to keep increasing until the amount people decide to save out of their income again equals the amount of investment outlays.

This relation is substantiated by a fundamental principle that as real incomes increase consumption will increase also, but to a lesser degree. Therefore, in order to have sufficient demand to sustain an increase in employment, there must be an increase in real investment equal to the gap between the rise in income and the rise in consumption.

Having defined aggregate demand, aggregate supply must now be defined. There must be a certain minimum amount of proceeds to induce the entrepreneurs to hire a given amount of labor. This minimum price or proceeds that will induce
employment on a given scale is called the aggregate supply price of that amount of employment.

When this is applied to a curve or schedule, the aggregate demand amounts to the proceeds that are expected from production by varying amounts of employment. The aggregate supply schedule or curve amounts to the proceeds required to induce varying quantities of employment increases; these two curves slant upward. However, they will not follow exactly the same course unless the expected proceeds from production equal the necessary proceeds to make the employment profitable for the entrepreneurs. This intersection of the supply and demand schedules determines the amount of employment at any time and is called the effective demand. This is where entrepreneurs maximize their expected profits. If at this point the amount of investment was exactly equal to the amount saved from real income, then it would mean that a state of full employment had been reached. According to Keynes, the typical investment demand will not be adequate to fill this gap and therefore the aggregate supply schedule and the aggregate demand schedule will intersect at a point of less than full employment. At this point it is necessary to induce the employers to offer more employment. But they will not do this unless they anticipate larger proceeds from further production.

At this state the economy is at equilibrium at less than full employment. Furthermore, there is no reason to believe
that investment outlays plus consumption outlays would always tend to equal the cost of a given output. "The maximum maintainable volume of investment is determined by the laws of growth of the economy, i.e., by technologically determined capital requirements of a progressive society which enjoys increasing per capita productivity and a growing labor force." The demand for investment goods is determined by changes in technology and growth of the labor force and would not necessarily fill the gap between the rise in real income and the rise in real consumption. But according to classical theory, "there is some force in operation which, when employment increases, always causes $D_2$ (the demand for investment goods) to increase sufficiently to fill the widening gap between $Z$ (aggregate supply price) and $D_1$ (the demand for consumer goods)." A conclusion can be drawn that Say's law is not valid because consumption in real terms rises less than output or real income, and this widening gap may or may not be filled by investment that depends on the proportionate strength of technological and population growth. Also, it is possible to have an "equilibrium" at less than full employment. In order to achieve full employment it may be necessary to employ additional outlay for investment from some other source.


7 Keynes, General Theory, p. 30.
(possibly the state) to make up for the deficiency in the availability of privately owned capital that has been saved instead of invested.

The Propensity to Consume

After discussing briefly the relation of consumption and investment to total demand and employment in the last part, it is now necessary to review these relationships and see exactly what Keynes' analysis means.

Keynes made the statement that "the volume of employment is determined by the intersection of the aggregate supply function with the aggregate demand function." 8

The aggregate supply function does not involve many (if any) considerations that are not already known. The aggregate demand requires an analysis of the consumption function and investment demand function, or, the propensities to consume and the inducement to invest.

The aggregate demand function, Keynes says, relates the level of employment to the expected proceeds of that amount of employment. The factors underlying the expected proceeds are expected outlays on investment.

The consumption function, the marginal propensity to consume and the multiplier will be discussed in this part of the study and will be followed by the inducement to invest, concluding the chapter.

8 Keynes, General Theory, p. 89.
In approaching the consumption function one sees that it is related to real income or output. In the short run they rise and fall together. Keynes, in advancing the hypothesis that income is a main determinant of consumption, assumes that all other determining factors are given and remain unchanged. Other things remaining equal, the consumption function shows what changes can be expected in consumption from changes in incomes.

If the relation between consumption and income is stated in form of a schedule or table it is easy to see the relation between the aggregate amount consumed at each assumed income level.

If there is any significant change in the "other factors," the amount needed for investment demand to keep the present state of employment will vary.

The "other factors" that can cause the shift and slope of the consumption function are classified as either objective (external to the economic system) or subjective (physiological characteristics of human nature and social practices and institutions). The subjective characteristic is not likely to be subject to short-run changes. These deep rooted behavior patterns determine the slope and position of the consumption function and make it fairly stable. The external factors can cause shifts in the slope or position fairly readily.
The objective factors will be considered first. One of these is the income, or lack of income, that is realized or not realized from windfall gains or losses. A good example is the stock market boom. Today, the increased income of the well-to-do resulting from such gains has undoubtedly raised consumption above the normal relation of consumption to income. If this is true, the consumption function is raised to that extent. Also in time of war, with rationing, price controls, and a limited production of civilian goods, the relation between consumption and income is entirely disrupted. Incomes are up but consumption does not rise in proportion because of heavy taxation, pressure for patriotic saving, etc. Also, the expectation of a cut-back or a price rise will cause people to hasten to purchase and spend more, thereby raising the relation of consumption to current income.

Now, consideration must be given to the factors that determine the form of the function. The "slope" is affected if consumption does not increase as much in real income, that is to say, the gap between consumption and income grows wider. The "level" is determined by the amount of consumption that is taken out of any given income, or the average rate of the propensity to consume at any given income.

Keynes makes the statement that there are motives "which lead individuals to refrain from spending out of their
incomes.⁹ Some motives that he lists are tied to future uncertainties, the desire to invest so as to enjoy a larger income in the future, the enjoyment of independence and power to do things, for the purpose of speculation, and some have miserly tendencies. He also stresses the relationship of business behavior to depreciation and other reserves and calls attention to the way they affect national income. The part that is laid aside for depreciation or is allowed to be written off rapidly distorts the ratio and may be sufficient to cause a slump if investment outlays cannot offset it.

Keynes also says, in relation to lags that might cause a "flat" consumption curve, that consumption is basically fixed by primary needs and a change in real income upward will not raise consumption at once but that the urge to increase consumption in proportion to the new income will be acquired later. Also, if income falls, consumption may not fall readily because of habitual living levels. These levels may be maintained for a time and may be financed from reserves which would prevent consumption from falling proportionally as much as income.

This analysis of the consumption function leads to the conclusion that "employment can only increase pari passu

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with an increase in investment, unless, indeed, there is a change in the propensity to consume."

Keynes' investment multiplier is the coefficient relating an increment of investment to an increment of income. If \( Y \) is income and \( I \) is investment, while \( k \) is the multiplier, then \( k I = Y \). For example, if \$1,000,000 is spent for investment (public works or private outlay) and as a result expenditures on consumption should rise by \$2,000,000, then the total expenditure would increase by \$3,000,000 and the investment multiplier would be 3.

The marginal propensity to consume, large or small, will determine the size of the multiplier. If the marginal propensity to consume is large, so will be the multiplier. Because of this knowledge one is able to attack the problem of the effect of investment on income and to analyze it more accurately. Because of leakages, an original investment will not increase secondary investment so as to absolutely start a chain reaction of secondary investments. For example, a million dollars spent in primary investment will not cause a million dollars to be spent on consumers' goods, nor will that one million dollars be spent on and on until all the factors have been employed. These leakages involve the payment of debt, savings in the form of bank deposits, investment of

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securities purchased from others, and imports. These leakages are also involved when purchase is supplied by excess stocks that are not replaced.

The steeper the consumption function curve, the higher the multiplier, the flatter the curve, the lower the multiplier. The multiplier is determined by the marginal propensity to consume. If, for example, the consumption function lies directly on the 45° line, then the propensity to consume is unity. If it is flat, the marginal propensity to consume is zero. Keynes says that under normal conditions, the marginal propensity to consume will be less than unity.

In view of the above statements, will the total rise in employment be restricted to the increase in primary employment? Keynes says only "in the event of the community maintaining their consumption unchanged in spite of the increase in employment and hence in real income." In the case of a zero marginal propensity to consume, he says, "If, on the other hand, they seek to consume the whole of any increment of income—marginal propensity to consume being unity—then demand will continue to rise until full employment is reached, and thereafter prices will rise without limit."

Thus the secondary (or multiplier) effects of any increase in investment will vary with the marginal propensity

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11 Ibid., p. 117.
to consume. If it is close to unity, small changes in investment will cause large or violent ones in income and employment. If it is not much above zero, very large changes in investment will be needed to produce any substantial fluctuations in income and employment.

Keynes expressed the belief that the consumption function flattens out as full employment is approached. If this were true the multiplier would be relatively larger in the early stages of recovery than at the "later stages of the boom." "The marginal propensity to consume is not constant for all levels of employment, and it is probable that there will be, as a rule, a tendency for it to diminish as employment increases." In other words, when real income increases, the community will wish to consume a gradually diminishing proportion of it.

The Inducement to Invest

The inducement to invest is determined in Keynes' analysis by the business man's estimates of the profitability of investment in relation to the rate of interest on money for investment. The inducement to invest will be strong if the value of an additional capital good exceeds its cost. The value depends on the expected returns over the life time of that capital good and on the rate of interest at which

\[12\] *Ibid.*, p. 120.
these expected annual returns are discounted. The expected profitability of new investment is called the marginal efficiency of capital. This marginal efficiency of capital is the highest rate of return, over cost, expected from producing a marginal unit of a particular type of capital asset. For instance, borrowed money costs an investor 4 per cent while he may receive an 8 per cent return on an investment. This kind of situation may tend to induce an individual to invest for that 4 per cent margin. If 8 per cent is the highest rate of return which can be secured from any type of real investment, the marginal efficiency of capital in general is 8 per cent. Investment will continue as long as the expected rate of return exceeds the rate of interest.

If applied to an investment-demand schedule, the curve of the marginal efficiency of capital and the interest rate schedule intersection would determine the value of an investment within a given period of time.

Investment will be "pushed to the point on the investment-demand schedule where the marginal efficiency of capital in general is equal to the market rate of interest." or, within a given pattern of expectations, determined basically by technological developments, population growth, and in the short run by all sorts of expectations, the volume of investment in any given period of time will be determined

\[ \text{Ibid.}, \text{p. 137}. \]
by the intersection of the demand price of the investment curve and the supply price of the investment curve. As investment increases within a given period of time, the demand price of investment (or value) falls while supply price of investment (or replacement cost) rises. Investment will be pushed to a place where the two will be equal. It is mainly through the investment-demand schedule that "the expectations of the future influences the present." Static economics, says Keynes, has made the mistake of taking account primarily of the current yield of capital equipment. However, this "would be correct only in this static state where there is no changing future to influence the present."  

The rate of interest is the other factor in determining the volume of investment. The rate depends on two things: the liquidity preference and the quantity of money. Liquidity preference refers to the desire of people to hold some of their assets in the form of money. The quantity of money is the amount (coins, currency and bank deposits) outstanding in the hands of the public. Why should one desire to hold money as such? Keynes says that individuals hold money because of fear and uncertainty regarding the future. The desire to hold resources in the form of money is a "barometer of the degree of distrust of one's own calculations and

14 Ibid., p. 145.
conventions concerning the future." In any state of expectation, there is always a tendency to hold certain amounts of one's assets in cash. The rate of interest, says Keynes, is the "premium which has to be offered to induce people to hold their wealth in some form other than hoarded money." 

There are three reasons why people wish to hold money. These include the transactions motive, the precautionary motive, and the speculative motive. The demand for money for the transactions motive refers to the use of money as a medium of exchange. The precautionary motive for holding money arises from the need for meeting unforeseen emergencies that may be needed for additional outlays other than those usually anticipated. These two amounts are relatively stable and predictable. The third, which is important in regard to the rate of interest is the speculative motive. Keynes defines the speculative motive as "the object of securing profit from knowing better than the market what the future will bring forth." In this connection, people are speculating when they hold wealth in the form of money on the chance that conditions will change so they will be able to convert their money into earning assets on better

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16 *Ibid.*, p. 188.

terms at a later date. If there is a fixed amount of volume (money) and a high propensity to hoard, a high rate of interest will result. Given the prospective yield of a capital asset, an increase in the rate of interest will lower the price of the capital asset. Thus toward the end of a boom, the rising rate of interest will tend to retard the rising prices of common stock. As long as the supply (or amount) of money remains fairly constant, the liquidity preference will determine the rate of interest. The interest rate is the price which "equilibrates the desire to hold wealth in the form of cash with the available quantity of cash." 18 The banking system, in control of the supply of money, can exert more influence on the rate of interest than can the liquidity preference of people. Within limits, banks can control the rate of interest. For the government to pursue an easy-money policy during a depression is very important to Keynes' position.

18 Ibid., p. 167.
CHAPTER III

PUBLIC POLICIES AFFECTING EMPLOYMENT

Redistribution and Flow of Income

Redistribution of income is accomplished in a large measure through the progressive income tax structure. The object is to tax the rich and return the proceeds to the poor by way of benefits. In addition there are various other taxes designed to accomplish this same purpose such as the tax on estates and inheritances. "The redistribution of income among income groups can be measured by observing the difference between the amount any group distributes in the form of tax revenues to the government and the amount the government in turn spends in the interests of that group." Viewing the collection from the high income groups and the transfer of it to low income families through benefits and expenditures, it can be readily seen that some individuals will gain, some will break even, and some will lose. It has been the result in England that a large part of the population gained and only a few were losers. The problem of measuring the extent of income redistribution lies in finding the average broken income and determining

the aggregate income gains and losses for persons with in-
comes below and above this income.

In discussing the effectiveness of different types of
taxes, Carter makes certain assumptions as to their nature,
bearing constantly on redistribution. He assumes that
"direct taxes on income and wealth, direct benefits in the
form of government transfers of income to persons, and
specific services performed for persons will be assumed
unsaltable." Incidence will be assumed to be on the per-
son who actually pays the tax or who actually receives the
benefit. Also, indirect taxes on goods and services and
subsidy payments by the government to producers will be
assumed wholly shifted to the final consumer. Incidence
will be assumed, not on the actual payer of the tax or the
receiver of the subsidy, but on the consumer of the taxed
or subsidized article.

The theory behind income distribution is both social
and economic. When wealth is transferred from the rich it
is believed that they, in order to sustain their level of
consumption, will draw on the part that normally would have
been saved. "Consequently, there will be a tendency for a
large part . . . to come out . . . of the tax payers' re-
sources as would normally have been saved; and, if these

\[Ibid., p. 22.\]
resources are not sufficient, for it to be raised by the sale of capital."

The purpose, when viewed in this light, is to capture funds that are being hoarded and to give them to people who will spend them for necessities, thus raising demand. In doing this the community's welfare is increased. Not only is it a mechanical function to improve the economic system but it also eliminates basic wants and hardships of the poor. It builds a stronger, healthier and happier society and increases satisfaction and makes it available to more people.

Transferences can be viewed as having an investment aspect also. For instance, those that are used in the form of industrial training are highly desirable. Then there are those in the form of medical attendance, those that help suffering from temporary sickness without proper medical attention. Transferences used in this manner will tend to increase national income and make for a stronger, more stable economy.

It is generally agreed that a large portion of funds flowing into large incomes in order to increase consumption, should be diverted and made to flow faster into lower income brackets. Also "the need to reduce large incomes is just as pressing as the need to increase small ones."


Since the problem seems to be one of effective demand, it would appear reasonable to find methods of distributing income in such a way that would increase demand. Since most of the demand comes from the masses, a device to direct the flow of income into channels where the propensity to consume is the greatest is of the most importance.

"The perfect instrument for reducing the flow of income to large income is the direct progressive taxation of personal incomes."  The tax brought in from large incomes would supplement the lower brackets by way of benefits. It can not be assumed that the amount necessary to create needed increase in consuming power can be gained from the large incomes alone. The only point of the progressive tax is to overcome the differential flow of income. The amount to be taken from large incomes can not be easily determined because the object is to stop the excess flow of funds into large incomes that amount to oversavings and spurious investment. Ayres says "If we could infallibly detect hoarding and spurious investment, the recapture of those very funds would be sufficient to maintain full production and employment."

However, the danger that arises in the use of a highly progressive tax structure is its effect on investment. The

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5 Ibid., p. 106.  6 Ibid., p. 109.
undistributed profits tax and capital gains tax are said to be more dangerous to investment expansion than the progressive tax policy "because corporations are more likely to assume the risks of forward-looking, anticipatory investments by expanding corporate surpluses. . ." 7

The capital gains tax is said to be the same burden on individual investors as the undistributed profits tax is on corporations. The problem centers around the proper use of taxes in order to effectively redistribute income and at the same time remove those taxes that hinder the normal flow of private investment.

"Broadly speaking, the rise of the great modern corporation has profoundly affected both the channels through which savings flow and the character of investment activity." 8 Investment is now largely a function of the corporation rather than of individuals. To finance their investments, corporations have a fund of "quasi-automatic" savings in the form of depreciation and depletion allowances and corporate surpluses. The savings of millions of individuals are channeled through these corporations and end up in one of these accounts and thus some of the large incomes escape the progressive income tax altogether.

8 Ibid., p. 384.
Hansen points out that corporations are more and more taking over the investment outlays of this country and that they finance these investments largely by internal sources such as that mentioned above. For instance, in the period 1925-1929, 82 per cent of total investment outlays by corporations came from internal sources. In the period 1936-1937, this was increased to 92 per cent. This trend seems to indicate that real investments are coming increasingly from corporations and from internal sources. It is evident that for this reason the progressive income tax is missing a very large part of savings and has very little to do with curtailing real investment. Hence, it can be considered as a method primarily designed to redistribute purchasing power with little or no effect on real investment. So, attention should be directed to a tax that could reach this great amount of savings when it becomes too large and in effect amounts to hoarding.

"Under conditions of less rapid extensive growth, American corporations may... tend to retain too large a proportion of earnings." A tax structure in order to prevent tax evasion by wealthy individuals could be reached by an amendment of the individual income tax that would require each stockholder to include in his taxable income his pro rata share of the undistributed profits of

\[9^{\text{Ibid.}, \text{ p. 389.}}\]
corporations. "It may also be necessary to prevent corporations from piling up undue idle balances in their excessive desire for corporate security by taxing those undistributed profits (after making reasonable allowances for liquidity) which are not invested in plant and equipment."  

There is also an increasing tendency for large fortunes to be held in tax-exempt bonds. There is "a tendency for the percentage of estates held in tax-exempt securities to increase as the size of the estate increases." Assuming that one can legislate a tax program that will reach these accounts, the main question is whether it will be effective enough to supplement the demand and redistribute income necessary to keep that demand sufficiently high. The answer is probably yes, but it necessarily has to be a constant attack.

Allan Fisher divides means for redistributing consumption power into two groups. They are the "direct" method and what he calls the "radical" method. The direct method is what can be done by taxation, that is, allowing income to seek its natural market channels and then taxing away what is possible and distributing it among the poor by way of benefits. There are two objections to this method when it is used alone: (1) It must be repeated endlessly since

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it has little effect on the causes of inequality and (2) the high taxes it requires can limit the production of the economy.

Fisher seems to favor the "radical" method because it seeks to reduce inequality by extending educational opportunities and thus striking at the very heart of the cause. Both of these methods should be utilized to reach the desired result.

In addition to directing more income into those small brackets where less is saved, there is no serious objection in creating income where none exists at all. This would mean providing income for those who are not gainfully employed, such as infants, young people preparing for future jobs, housewives, the sick, cripples, and the aged.

There are two alternative methods that could be used to achieve a redistribution of income. These methods are through wages and prices. In addition to these methods, the income tax plays an important role. When wages increase, the problem is to keep prices from rising also. If prices could remain stable and if wages were allowed to rise, the result would be one of shifting profits into wages and thus squeezing the profit margin. The government could maintain stable prices either by subsidies financed by

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12 Grampp and Weiler, Economic Policy, p. 275.
income tax or by direct price control. If the economy was one of full employment accomplished by progressive taxation and some budget deficit financing, there would be a problem of sacrificing investment because of raising consumption demands. In a fully employed economy consumption increases only at the expense of investment. In order to keep this investment adequate enough for progress, an additional amount of income tax should be imposed to keep the consumption from rising. Kalecki says by this extra amount of revenue, i.e. the part which is needed for the subsidies, the budget deficit will fall. "The increase in wages with prices maintained at a constant level will cause a shift from the 'budget deficit' policy to the 'income tax system'."

The other method, the reduction of prices by direct control, accomplishes the same purpose, the shifting of real profits to real wages. Its administration is more difficult because not all industries have a wide profit margin. Both methods should be used together. The extra amount of income tax can be used to offset the rise in consumption and can be used to reduce the deficit. Here all methods are used. The progressive tax, price controls, and deficit financing. These methods must be used carefully in order

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to keep private investment from falling. If private investment is unaffected the cutting of profit margins will make the task of government expenditures to secure full employment a much easier job.

Even if these methods are used successfully there may still develop pools of unemployment in certain localities. How then can these depressed areas be helped and brought upon an economic plane with the rest of the country?

Entrepreneurs often locate their plants where the private cost is lowest. However, in many industries it has been admitted that these private costs do not vary a great deal with location, while there may be a wide variance in social cost. In other words, capital is highly mobile.

Most industries consider the accessibility to market when deciding on a location, however this is only a minor consideration since transportation has been greatly improved.

There are two ways of securing jobs for people in a depressed area. The government could inquire from the entrepreneurs the location of new industrial plants and then move labor to the site and assist in training labor. This, obviously, entails a great personal hardship on the people. This hardship could be avoided by using the second method. By this method the government plans the location of new enterprises and directs them to the populated areas where there is unemployment.
Where it is extremely difficult to detect which areas will be affected, the government can make use of public-owned industries and spread them equally over sections of the country where it may not be possible to induce private industries to locate. By combining the two methods, pools of unemployment can be eliminated. The main purpose in directing the location of plants is to enable the government to take into account the social costs—a factor with which the private entrepreneur is not concerned.

Fiscal Policy

There are three types of fiscal programs that can be applied to an economy that has cyclical fluctuations of income and employment. These programs are outlined in a recent report of the Committee for Economic Development entitled "Taxes and the Budget."

The first plan is that of a balanced-budget program; the second is CED's plan of "built-in flexibility"; and the third is the managed compensatory program.

The balanced budget could be carried out on two bases: one comprising fixed public expenditures over the cycle, and the other consisting of increased expenditures in boom years as tax revenues rise and reduced expenditures in depression years as tax revenues fall. The latter is in accordance with past practices.
"If the expenditures were fixed over the cycle, tax rates would be lowered in boom years and increased in depression." This is done to make revenues just sufficient to balance the fixed budget. However, in seven depression periods, a balanced budget has been impossible because in depression times there are emergency demands raising expenditures and lowering revenues from income.

Second, the CED has prepared a budgetary program called the "stabilizing budget policy." It calls for fixed public expenditures over the cycle based on social needs in accordance with the values placed on public services by a democratic society.

Also, it calls for fixed tax rates that are adjusted to bring the budget into balance when about 93 per cent of the labor force is employed. Here full employment is assumed to represent 96 per cent and up. At full employment the fixed rate would provide about three billion dollars in surplus (cash budget). When employment falls below 93 per cent a deficit will occur. A deficit in this case would be desirable, since deficit financing reduces private spending less than tax financing. In boom years budgetary surpluses are desirable because an excess of taxes over expenditures tends to curtail excessive private spending. This is an important advance in

fiscal thinking but the problem is much bigger than the CED seems to realize. The CED is assuming in a sense that the cycle is a rare thing and that prosperous times will continue indefinitely if proper guiding forces are chosen. This is almost the same as repeating Say's law. "Built-in flexibility" is highly desirable as far as it goes, but it is not an adequate stabilizer in the dynamic economy. The CED's suggestion overlooks the consumption function and the role of continually changing forces such as new discoveries, technological developments, physiological responses by entrepreneurs, etc. This is evidenced by the following statement:

The recommendations of this report are presented in the belief that, if they are combined with appropriate measures in other fields, economic fluctuations can be confined to moderate departures from a high level. Yet it would be foolhardy to ignore the possibility that we may again confront an economic crisis of great magnitude—either severe depression or major inflation. Some extraordinary action must and will be taken if such a crisis appears. An emergency congressional reduction or increase in tax rates (perhaps with a fixed, automatic termination date) would then be one of the most effective and least dangerous of the available courses. 15

To put a compensatory program into action quickly, with flexibility, is impossible unless long-range plans and preparations involving improvement and development projects, housing

and public works are constantly kept up to date. If this is not done, then once a depression comes, the government will be forced into wasteful expenditures for lack of something constructive to do.

But long-range expenditure programs are not enough. Another very interesting and important anti-cyclical weapon is a flexible tax system. The idea as expressed by Hansen seems to be very practical and powerful. "The modern fast-moving economy, with its tendency toward violent fluctuations, cannot be managed effectively on the basis of an unchanging tax structure fixed for two or more years or worse yet over an entire cycle."

The program calls for Congress to empower the executive branch with the power (within limits established by legislation) to adjust basic income-tax rates. This program would produce a quick timing and adequate flexible tax structure. A good guide post that could be provided by Congress would be the use of various schedules of rates according to the changes in the volume of unemployment. In addition, the President could include his decisions in his Economic Report to Congress, stating the reasons for any such actions.

16 Hansen, op. cit., p. 181.
Monetary Policy

The use of monetary forces is limited mostly to times of prosperity. In times of depression or stagnation the monetary authority can do very little. It might not even be called upon to create additional credit facilities considering the prevailing liquidity of the banking system which results from the process of self-deflation during the depression. Monetary policy cannot enforce investment. It can, to a degree, control the money rate of interest, but not the rate of profits. "Only in times of prosperity, when excess reserves of the commercial banks have gradually been absorbed, can the monetary authority begin to influence the extent of credit expansion." The monetary authority seems to be blamed always for slowing down the expansionary process in its fight against inflation. Either that or it is blamed for letting the situation get out of hand. Moreover, it is not always free to raise the rates of interest in order to check inflationary expansion. "Increasing rates of interest are equivalent to a fall of security prices and may be opposed by the public, the banks, and the Treasury alike."


18 Ibid., p. 437.
Even if interest rates were pushed higher and higher, their effect on investment and consumption outlays would probably not be substantiated, and when the measure did take hold it would probably shatter confidence (through the effect on the securities markets) and precipitate a collapse.

Moderate monetary measures by themselves are relatively ineffective, while drastic measures may easily turn the economy into a tail spin. Monetary policy could be used with fiscal and other controls in fighting inflation and deflation alike. Perhaps the most effective use of monetary forces is the continuing restriction and easing of credit.

A highly essential means of controlling inflation is the maintenance of a surplus of government cash receipts (other than borrowing) over cash payments. Cash taken from the public by taxes in excess of cash payments to the public has the effect of reducing private expenditures. When these surplus cash funds are used to retire bonds held by the commercial banks, the effect is to reduce demand deposits; and when used to retire bonds held by the Federal Reserve Banks, the effect is to put a continuous pressure on member-bank reserves. "The continuous pressure on reserves, incident to the use of Treasury cash surplus to retire securities held by the Federal Reserve Banks, is much to be preferred than the 'jerky method' of raising reserve
requirements." In short, moderation is the word to apply to the use of monetary controls.

Debt Management

Another important force that can be used for economic stability is the debt. In general, the debt increases when there is a budget deficit and decreases when there is a surplus. The timing and amounts of these surpluses and deficits have important effects on stability.

The distribution of the debt between the Federal Reserve System and private holders is determined by monetary policy. By the purchase or sale of government debt, the Federal Reserve Banks can raise or lower the reserves held by commercial banks and thereby expand or contract the ability of the commercial banks to make loans. In this way the debt can be used with monetary policy to influence the cost and availability of credit.

The composition of the debt—the maturities and other terms of the securities that go to make up the debt—are determined by debt management. Debt management affects the amount of interest the people have to pay each year to service the debt. Some kinds of debt cost more interest than others. However, reducing the interest on debt is not the primary purpose of debt management.

Today, the non-marketable portion of the debt is 37 per cent. Before the war it was only 8 per cent of the total. However, the larger part of the debt consists of marketable securities that mature from 90 days to 30 years. At the end of 1953, 44 per cent of the privately held marketable debt was coming due. This is the outstanding feature of the debt today.

The Treasury Department is charged with managing the debt. It is authorized to issue securities for any amount of debt at any given time (subject to limits by Congress on total amount of outstanding debt at any given time). The Treasury Department can also buy securities. The real limit set on the Treasury is the market for securities.

The composition of the debt can be changed (other than by time) by deliberate debt retirement. The Treasury can retire securities before maturity by offering different securities in exchange. Or, the Treasury can buy debt in the market for its own account or for the account of government trust funds.

The Treasury's main instrument for changing the composition of the debt is, however, the choice of the new debt issues it makes. Each year the Treasury must issue enough securities to pay off the securities that are retired plus the amount of deficit or minus the amount of surplus in the government accounts for that year. Within the limits of
its choice of terms, the Treasury debt managers deliberately change the composition of the debt with these new issues.

To some extent the Federal Reserve Banks also have a hand in debt management. The character of debt bought or sold by the Federal Reserve Banks automatically changes the composition of the debt held by private investors. But the order of change is not nearly so great as that which results from Treasury operations.

Flexible management of a large debt for the sake of economic stability is a new thing in the United States. Before the war the debt was much smaller than it is now and the possible effects of debt management were correspondingly less important. Between the war and the spring of 1951, debt management and monetary policy "were harnessed to the task of stabilizing the prices of government securities, particularly long-term government bonds."  

This type of policy effectively neutralized both monetary policy and debt management as anti-inflationary weapons. The Treasury could not issue securities that were unattractive at the pegged interest rate. Nor could the Treasury raise the interest rate without abandoning its declared policy of stabilizing the prices of government bonds. Debt management 

as a means of promoting stability throughout the economy was hamstrung.

When the "pegged" bond price policy was abandoned in the spring of 1951, both monetary policy and debt management were freed for more effective use. The freedom to permit interest rates to vary restored to the Federal Reserve Bank its power to restrict credit when it was wise to do so. Before this time monetary policy was neutralized because the pegged bond price policy prohibited the Federal Reserve Bank from tightening credit conditions. Any tightening of credit tended to depress the prices of government securities, which, under the prevailing policy, required the Federal Reserve Bank to buy. But by buying, the Federal Reserve Bank automatically supplied the commercial banks with greater reserves which in turn eased the supply of credit. However, the Treasury recovered its initiative in issuing securities and by offering appropriate interest rates to make the chosen securities salable, thereby becoming effective.
CHAPTER IV

COMBINED USE OF PUBLIC POLICIES

Credit and monetary policies and fiscal and debt management policies are interrelated means available to the government for combatting inflation or deflation. The policies are impersonal in nature and operate through market mechanisms, and in doing so are appropriate for use by governments of private-enterprise countries in their efforts to encourage orderly economic growth.

Credit and monetary policies affect income and expenditures of the private part of the economy through their influence on the volume of money, on capital values, interest rates, availability of credit, and on the purchasing power of the dollar. Fiscal policies affect national income by regulating the amount, character, and timing of government spending and the amount, type, and timing of taxes collected. All of these, in turn, affect expenditures by individuals and businesses. Methods of public borrowing and management of the debt, which may be considered as an aspect of fiscal policy, are closely related to credit and monetary policies. With public debt so large a part of the capital market, types of government securities and the terms of their offering have
significant effects on the market for non-federal obligations and on the cost and availability of credit generally.

These policies are most effective when they operate to supplement each other in promoting stable economic progress. In a period of inflationary pressures, buying power can be reduced by fiscal action through reducing government expenditures and increasing taxes. Debt management policies may be directed toward moderating the financial liquidity of the economy. Credit and monetary action may curtail demand for goods and services by businesses and individuals. Thus, it may be possible to curb inflation through heavier taxes, through methods of borrowing and refinancing public debt, through credit restraint, and through varying combinations of these measures, or in some instances through one type of policy alone. In an inflationary period it is unfortunate if the restrictive effect of higher taxes is offset by expansive credit and monetary policies, or if restrictive credit and monetary policies are offset by expansive fiscal policies or debt management policies.

Each of these policies has its own advantages and disadvantages. As a rule, credit and monetary policies are more flexible, within limits set by statute, and can change sharply and quickly if conditions so require. Credit and monetary policies, especially as effected through general instruments of policy—discount rates, open market operations,
and reserve requirements— are also less subject to pressure from private-interest groups than are fiscal policies. Operating as they do through the money markets, the credit and monetary authorities are in close and constant contact with the changing moods and temper of the financial and business community. They are thus in a position to feel early the impulses of changing trends and to adapt promptly or even reverse their policies in response to current forces. So, credit and monetary policies are especially sensitive means of counterbalancing destabilizing developments in their incipiency.

Fiscal measures are often very slow in formation. A lot of time is necessarily absorbed in the legislative process—in the initial formulation of programs, in their consideration and in final enactment. More time may be required in the execution of such programs. Fiscal policies in their detailed formulation are also more complex, more controversial, and more directly related to distribution of income than are credit and monetary policies. This is one reason why fiscal policies are more difficult to use as a means of economic regulations than are monetary policies.

It is almost impossible for the government to vary its whole program of expenditure and taxation promptly according to the requirements of economic stability.

Taxes on payrolls and sales can, however, be effectively manipulated and timed accordingly. When considering
taxes as a stabilizing agent it is probably unnecessary to think of them in terms of revenue. So, when such a tax as a payroll tax is collected, it should be placed in a fund which could later be drawn on and expended.

The payroll tax could be applied at an advancing rate during the last half of an upswing period and made more progressive as the peak of the boom approached. As soon as it is evident that a turning point has been reached, the tax collections should cease entirely. Then once it appears that a recession is definitely under way, the surplus funds previously collected could be drawn on and poured back into the income stream. Actually the funds would not have to be stored but it is simpler to think of them as being stored.

The payroll taxes deducted from wages could be returned to the wage earners to help maintain labor incomes and the taxes that were assessed against employers, could be returned to aid in the maintenance of current wages. This is actually a deferred wage payment loan, wages being withheld in the prosperity phase and returned with interest in the depression phase.

In the same manner the sales tax when "applied in the last phase of the upswing, would act as a drag on the rise of consumption expenditures," with proceeds used for relief.

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Using these methods it would be possible to check an undue expansion of consumption in a boom period and stimulate consumption in a depression.

The question arises whether progressive taxation should be used instead of the payroll and sales tax. Because the progressive tax abstracts from savings directly and consumption indirectly there is good argument for both types. The only trouble with using the progressive tax is that it may reduce investment as well as consumption and serve to check the very thing that is stimulating the boom.

If private investment outlays are inadequate and the economy is engaged in a condition of long-run chronic unemployment, the main emphases should be on raising the consumption function. "Consumption is necessarily the ultimate end of economic activity." To raise the consumption function to a permanent level, a policy of redistribution of income by highly progressive taxation, coupled with income-creating governmental expenditures, must be used. "Raising income tax rates would tend in the direction of making the newly created income more nearly self-perpetuating." To the extent that our tax system could be shifted away from regressive taxes bearing on consumption to progressive taxes on that part of the income stream which flows into the

\[ \text{Ibid.}, \ p. \ 299. \]
\[ \text{Ibid.}, \ p. \ 299. \]
savings channel, private consumption expenditures would rise.4 "A major reform of our whole federal, state, and local tax structure, designed to reduce consumption taxes, would be of crucial importance in any program aiming to enlarge the outlets for private investment."5 However, other policies may be considered so important at times as to outweigh considerations of economic stability in governmental decisions. The conduct of war is the most striking example of such a situation. Aid for the post-war reconstruction of Europe is another example of much more moderate proportions. Also, in instances in which long-range products have been already undertaken, it may be impractical or wasteful to bring them to a halt before completion even though continuing them may have destabilizing tendencies. In such situations, credit and monetary policies need to be restrictive, with as much aid as possible from debt management policies, so that private spending will not be unduly stimulated.

Credit and monetary policies are commonly viewed as being more powerful in combating inflation than they are in combating deflation. The occasions when this has been true have followed booms which seriously distorted the economy. This is one reason why avoidance of depression requires restraint of excessive expansion during the preceding boom. Credit and

4 Ibid., p. 398. 5 Ibid., p. 399.
monetary policies can be effective in combatting tendencies toward deflation as well as inflation when there is a marginal loan demand by credit-worthy borrowers. Under such circumstances, availability of credit to meet their demands for loans is dependent upon the state of liquidity of lenders generally and particularly of commercial banks. Thus, tendencies toward deflation can be significantly influenced by credit and monetary action. In periods of depression following excessive over-expansion, banks and lenders generally may not be willing to lend freely even if they are made liquid by credit and monetary policies. This may happen when potential credit-worthy borrowers feel that borrowing would not be profitable and when either lenders or borrowers feel unable to incur the risks. In these conditions, fiscal action may be required to revive business activity.

By restricting the volume of credit and the money supply during inflationary periods, credit and monetary policies can restrain excessive growth in civilian demand for goods and services and thereby contribute to the prevention of deflation and depression. The most important reason for curbing inflation is to avoid the inequities that usually develop during inflations in the distribution of income as between those whose incomes are relatively fixed and those whose incomes respond readily to inflationary pressures. Inflation fosters distortions in the economic structure as between products and segments of the economy that change slowly in
response to inflationary pressures and those that adjust quickly. In addition, inflation encourages over-expansion by consumers and businesses in order to anticipate future requirements and to protect themselves against price increases. This process commonly leads in many lines to the building-up of excess capacity and stocks with the consequence the opportunities for sound borrowing later by businesses and consumers may be reduced. It is these distortions, over-commitments, and excessive expansions of capacity and stocks which characteristically develop during inflationary periods that lay the ground work for declining and even panic markets and subsequent deflation and depression.

Fiscal policies can attack the problems of combating deflation and depression directly by increasing public expenditures or lowering taxes, or both, so as to cushion or offset the decline in the total volume of private income and expenditures in the economy. In inflationary periods, fiscal policies can contribute greatly to stability through reduced government expenditures and higher taxes.

There are limitations, however, on the stabilizing effects of fiscal policies. During inflation, for example, total spending will not decline as a result of fiscal action if the dollars taxed away are replaced by credit dollars. There are, moreover, strong pressures against raising taxes, and it is always possible that by the time taxes have been
raised, total incomes will have risen further. Also, some increases in taxes may tend to dampen incentives to efficient production or to encourage extravagance, thus adding to inflationary pressures. On occasion, higher tax rates may be partially offset, at least temporarily, by efforts of business and labor to maintain the levels of their incomes after taxes through price and wage increases. Other complexities with respect to fiscal action may be encountered during deflation.

Methods of public borrowing and management of the public debt can be a helpful complementary tool of countercyclical government policy. To the extent that government securities are sold to and held by non-bank investors, the government's needs are financed by the long-term savings and short-term funds in the economy. To the extent, on the other hand, that government securities are sold to banks, new funds are likely to be created and the money supply increased, unless banks correspondingly reduce other types of credit. If government securities are purchased by Federal Reserve banks, the result is to increase the supply of reserves available to banks and to provide the basis for a multiple expansion in bank credit. The effect of sales to commercial banks and reserve banks hence tends to be inflationary. The types, maturities, and yields of securities offered are important in determining what types of buyers will acquire them and, consequently, have an effect on general economic stability.
Appropriate fiscal policies, appropriate debt management policies, and appropriate credit and monetary policies can all contribute to economic stability. The exact combinations of policies which will be most desirable at any particular time will depend greatly on circumstances and the practical feasibility of action in one field or another. They are re-enforcing instruments of public policy.

With respect to other public policies to combat inflation and deflation, such as price and wage controls and direct government lending, their relation to credit and monetary policies depends on the circumstances and the nature of the policies at the time. Similarly, other public policies or programs not specifically designed to combat inflation and deflation, such as allocations of materials, welfare measures, promotion of housing construction, and veterans' benefits, may at any particular time contribute to or impede credit and monetary policies and other policies which are directly focused on combatting inflation or deflation.

As a rule, the best stabilization policies are those which operate as generally and impersonally as possible through the price mechanism, with a minimum of direct intervention in the customary operations of markets. For this reason, as well as because they affect directly the volume of spendable funds and the money supply, fiscal measures, including debt management policies, and credit and monetary measures are considered primary instruments of government stabilization policy.
They deal directly with the causes of inflation and deflation. While direct controls may be needed at times to forestall cumulative run-ups in prices and wages and to channel resources to special purposes, notably defense, these controls do not affect the basic inflationary forces and, in the absence of appropriate fiscal and debt management policies and appropriate credit and monetary policies, are not likely to achieve stability.

The American Economic Association and the Douglas Report

In the theory of orthodox public finance the government used expenditures and taxes to secure particular objectives such as construction of a highway or provision of compulsory education. Their effect upon the economy as a whole was not thought to be important. The classical writers assumed full employment and thought additional government spending would bring inflation and overlooked the important fact that it would add to aggregate demand. Fiscal policy, said Keynes, should emphasize the effects of government expenditure and revenue upon the total economy and be used deliberately and consciously as "a balancing factor" to secure economic stability. "Fiscal policy," is therefore, "not concerned with particular types of spending to secure limited objectives, or with particular taxes; it is not concerned with budgetary administration or debt management in so far as they are
techniques for orderly government housekeeping."

Because of the valuable declarations of beliefs on policy by the American Economic Association on economic stability there follows a reproduction of the synopsis presented by that body.

1. Economic instability has characterized the American and other advanced economies. A study of American business cycles indicates that the output of durable goods fluctuates more than the output of non-durable goods and that the output of capital goods fluctuates more than the output of consumer goods.

2. The total income created by production is equal to the value of goods produced. But the aggregate demand is not necessarily equal to the value of goods produced.

3. The decisions of firms and households to spend are influenced not only by the flow of income but also by monetary factors. Many economists believe that the variations in bank credit amplify the fluctuations in output, employment, and prices.

4. Rules of fiscal management require (a) that government tax revenues should be higher relative to government expenditures in periods of high employment than in periods of substantial unemployment and (b) that money and credit should be relatively tight in periods of high employment and relatively easy in periods of substantial unemployment.

5. At present, tax rates and expenditure policies are such that the federal government tends automatically through its effect on the flow of income to limit the fluctuations in output, employment, and prices.

6. To insist on an annually balanced budget would destroy the effectiveness of automatic

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stabilizers implicit in the federal government's present tax and expenditure system.

7. When automatic stabilizers are not adequate, the government may stabilize employment and prices by (a) changing tax rates and tax structures, (b) changing expenditures on public works, and (c) expanding or contracting government activities.

8. Open market operations, and other quantitative controls, are particularly effective in checking credit expansion and hence in limiting inflationary developments. They are not so effective in checking deflationary developments.

9. There is disagreement among economists on whether the Federal Reserve should use open market operations to support the bond market or to check inflationary developments. It cannot do both simultaneously.

10. Wage induced inflation, if it develops, would pose a dilemma for fiscal and monetary policy. If monetary fiscal means are used to combat this type of inflation, unemployment would result. Hence, the choice: inflation or unemployment. This is a major unsolved problem.

Out of this report came no agreement about the role of monetary policy and there was no agreement about the proper remedy for inflation. In general it was just a statement of problems, but the same year another report was submitted and it contained some very interesting statements in regard to policies affecting employment. A brief reproduction of a report made by the Douglas Committee follows:

1. Federal expenditures and taxes are now so large that the federal government inevitably affects in one way or another the course of prices, output,

7Grampp and Weiler, Economic Policy, p. 22.
and employment. Since monetary-fiscal policies can seldom be neutral, they should be employed in such a way as to make a positive contribution to economic stability and growth.

2. Reliance on monetary, credit, and fiscal policies is more consistent with the maintenance of economic freedom than is reliance on a system of direct controls contrived to achieve the same result.

3. Acceptance of the principle of the annually balanced budget would require that the government raise taxes during depressions and lower taxes during inflations, thus having a perverse effect on economic stability.

4. The revenue-expenditure system should be designed so that in normal periods—periods when unemployment is at its practical minimum and prices are relatively stable—federal revenues should show a small surplus; and when unemployment develops, the surplus will shrink to a deficit.

5. If the Federal Reserve follows the policy of supporting the bond market to keep interest rates down, the Federal Reserve is powerless to restrict credit in general: any person who sells a government bond can force the Federal Reserve to create new money.

6. A restrictive monetary policy can contribute so substantially to the avoidance of inflation that it should be used, even if the cost should prove to be a significant increase in service charges on the federal debt and a greater inconvenience to the Treasury in the sale of securities.

7. The restoration of a free convertibility of money into gold would be neither a reliable nor an effective guard against serious inflation. And during deflations, it could seriously complicate the problem.

There is a widespread agreement among economists that federal taxes and expenditures are now so large that the

\[ \text{Ibid., p. 54.} \]
government cannot be indifferent to their effects on total employment and income: they can be used either as a stabilizer or destabilizer in the economy. There is also agreement on the appropriate rules for the government to follow in the management of its fiscal and monetary affairs in order to contribute effectively to the stability of employment, income, and prices. During periods of high employment and rising prices, government revenues should be greater than government expenditures, and during periods of substantial unemployment government revenues should be less than expenditures. There is also a general agreement that money should be relatively tight in periods of high employment and easy when employment is substantially low.

A report by the Subcommittee on Monetary, Credit, and Fiscal Policies of the Joint Committee on the Economic Report of the eighty-first Congress (commonly referred to as the Douglas Committee) and the American Economic Association report, "The Problem of Economic Instability" had for its purposes the task of showing to the public the extent of agreement among economists about stabilization techniques and an inquiry into the role of fiscal and monetary policies as a means of achieving full employment and stable prices.

Both committees would rely as much as possible, on what they called "automatic" or "built-in stabilizers." These built-in stabilizers affect the flow of income without a
year-to-year change in tax rates and other fiscal programs. Tax rates and expenditures are adjusted so that the government will balance its budget at "full employment" or when unemployment reaches an amount of, say, 4 per cent. Then when a recession sets in tax revenues will decline and unemployment compensation payments will rise, so that the government will contribute to creating a larger aggregate demand or total spending power. This also works contrariwise. Also, the progressive income tax is a built-in stabilizer. Tax revenues rise more than do incomes. Both committees recommended that efforts be made to increase the scope and effectiveness of built-in stabilizers.

They also decided against an annually balanced budget as a rule for fiscal management. They said to insist on a balanced budget would require giving up whatever contribution the built-in stabilizers could make to stability.

In regard to taxation, a transfer of income from poorer to richer by regressive taxation, with the proceeds used to pay the interest on the federal debt, has restrictive effects on consumption; the opposite process has expansive effects. This restrictive effect on consumption will mean an expansive effect on savings, while an expansive effect on consumption means a restrictive effect on savings. However, the effect of the fiscal system on redistribution is limited because the current level of federal spending is high and because the tax system cannot be made more progressive quickly.
If in times of unemployment there is a need for federal expenditures' expansive effects there can be different results depending on the method used. The way government finances these expenditures can affect their multiplying value. For instance, if the money for expenditure is not taken from anyone, that is, manufactured, the expansive effect will be greater than if it is provided by taxation. It is generally held that expenditure funds should not come wholly from taxation because this would mean a reduction in the size of the multiplier and a smaller increase in gross national product and employment.

In regard to the question of whether fiscal policies should be used solely for the purpose of managing the economy it can be seen that it has already been used very effectively as a stabilizer. The opinions of professional economists are at present strongly favorable to the proposition that economic stabilization through fiscal policy is one of the important functions of government. "Taxes should never be imposed for the sake of the tax revenue." Spending should be for particular purposes, but in depression even "harmful" spending "may be better than doing nothing to increase employment."

There are various theoretical practices that have been suggested by which government could attempt to guide the

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economy to a state of equilibrium and high national income. Some policies that could cause contraction and expansion in a desired time are:

1. Varying taxes and expenditures simultaneously such as a balanced increase, or decrease, of taxes and expenditures.

2. Holding expenditures constant and varying only tax rates in order to produce a deficit during depression and a surplus in prosperity. Part of this might be effected automatically by built-in flexibility owing to the fact that a decline of national income might cause decreased tax collections and increased government expenditures for relief and form price supports. An increase in national income might have the opposite effect.

3. Holding tax rates constant and varying government expenditures, thus producing a deficit in depressed times and a surplus in prosperous ones.

Also, in addition to these, corporations might be required to set aside reserves during good times to become available for investment during slumps. If they failed to invest this amount the Treasury could take it as a forfeiture.

Together with any or a combination of these accelerated depreciation could be used as a stimulus to investment in bad years. The state might also contribute half to all additions to private payrolls. This would encourage employment without the expansion of public works and do away with the demoralizing effects caused by it. This is considered by some to be a short cut to socialism and if one

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goes this far it would be just as bad as going all the way. Of course, it is bound to cause a great deal of controversy and confusion but it is still another proposal to be considered.
CHAPTER V

PUBLIC POLICIES IN ACTION

Having discussed the theory behind the public policies and how it can be used, the next logical subject for discussion is to see how the government has employed these policies in actual practice and to see how well they have worked. The best way of doing this is to follow the post-war years in the economic report to the President.

The Council of Economic Advisors' Reports

The Council of Economic Advisors was set up by the Employment Act of 1946. Each three months its report to the President is sent to Congress as an economic review of the country and of administrative policies.

According to Nourse, there was an early need for reform in the organization. He said that during his tenure with the Council that it "fell apart into somewhat unrelated guerilla operations in response to the particular and sometimes temporary interest of single Council members and strong individuals within the staff." It has been

said that the CEA spread itself too thinly and failed to concentrate on the major issue of economic stabilization.

In its first report to the President the CEA gave, indirectly, a justification for its broad approach. It criticized what it dubbed "the Roman doctrine" of an external remedy—that the economy as a whole—"may be kept on a reasonably even keel merely through the intervention of central government in the monetary and fiscal area." It would, said the Council, "be very simple indeed if we could rely on fiscal policy as a panacea; but why limit ourselves to a single remedy—and a crude one at that—when we can muster a set of remedies fitted to the whole range of particular situations?" Nourse said the vital complaint on this is that the CEA has never mustered the "set of remedies" or analyzed "particular situations."

Also, during its first report the CEA seemed to think because of the cooperation of industry, agriculture, labor, state and local governments and an exchange of opinion and knowledge between these would lead them to pursue a wise social policy and would lead the government merely into a complementary role. In the first report Nourse put great emphasis on voluntary price reduction. Also in the second report there was an appeal to management and labor to act

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in the short-run so as to serve their long-run interests. "Economic stabilization can be achieved without our private enterprise system only if management accepts the responsibility for a more stable practice in planning its investment and operative programs." The reason must have been because otherwise the swings might be too big for government to regulate and compensate.

The change in the use of fiscal policy came most notably in the reports of 1943 and 1949. The President recommended "a cost-of-living" tax credit of 40 dollars for each taxpayer and each dependent. To offset this decrease in government revenues, corporate taxes were to be increased sufficiently to yield an equivalent amount." The administration said it feared inflation in January of 1949, and the report recommended new taxation to raise four billion dollars, mostly by additional corporate taxes, but also by higher taxes on estates and gifts. Also, OASI benefits were to be increased substantially, the minimum wage was to be lifted from forty cents to seventy-five cents an hour, public assistance and the housing programs were to be expanded.

Seeing the downturn in the economy in 1949, the President called for a three-billion dollar civil works program for 1950

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compared with two and one-fourth billion dollars in fiscal 1949. This, with expenditures in excess of three billion dollars by state and local governments added to private construction, he believed, would "maintain the construction industry at a high level of activity and thus strengthen the whole economy." 5 He said, although the situation then did not call for immediate expansion of public works, it would be dangerous to neglect "the precautionary preparation of measures which might be needed if the business downturn" became more serious. He said that these preparatory measures by themselves would serve to keep confidence up and reduce doubts of businessmen concerning future investment. Thus, in the report after the first serious slump or business downturn since the war, is seen the role that federal policy on public works was beginning to play.

In earlier periods just after the war, federal spending was kept at a minimum so as to keep down inflation. It is now seen that the opposite was needed in fighting off a recession.

This necessity was not possible under a balanced budget system because the greater spending would have to be financed principally from taxes and this in itself would hurt the


6Ibid., p. 11.
investment-policy businessmen. "We had no surplus," said the President, "because we lost about five billion dollars from untimely tax reductions in the height of inflation." So, in the face of these difficulties, a deficit had to be accepted. The committee said that a plan of action should be prepared in case it was needed to support economic expansion if the "force of the market alone should fail to provide the needed uplift." This is a far cry from classical thinking. It was the thinking inspired by Keynes and is the policy of the present administration although it is that of a conservative party. Also, the committee made it very clear what the government's responsibility was when it declared it would encourage banks to make loans if investment incentive fell at any rate at all.

Also, if this proved to be inadequate, "government must take some direct responsibility for stimulating and supplementing private activity." A year later and during the early stage of the Korean war there was no immediate cause to use these policies. In view of a prospective war and shortages, investment and incentive (also because of big government cost-plus contracts) soared among businessmen and government spending was

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not needed as it was thought it might be. Again the govern-
ment tightened up in all places and was afraid of inflation.
Housing credit, public works, loan programs, and investors
of supplies and equipment were caught in this restrictive
policy. A new tax program was put into effect. There were
no reductions that were thought needed for business recovery.
In fact it was advised that the corporate tax be raised to
a total of 70 per cent.

This was advised so as to balance the budget (or show
a surplus) in inflationary times. In the July, 1950, re-
port appeal was made to the businessman not to hold back on
production because of fears that capacity would become ex-
cessive for peacetime use. They were told that "the govern-
ment's obligation to resist aggression is no clearer than our
obligation to maintain full prosperity at home when peace is
made secure." This statement reassured the business man
that the government was ready and able to stand behind him
in peace time and secure demand for his products. Here the
administration seemed pretty sure of itself in being able to
manage and guide the economy to a high degree of employment
and income.

This report characterized the period from early 1946
to late 1947 as an expansion phase. In that period

9 Council of Economic Advisors, The Midyear Economic Re-
employment and personal income surged upward. Unemployment dropped below two millions and investment climbed steadily. Despite a large degree of pessimism in the country, the economy grew stronger and stronger. First, because of previously held back consumer and production demand, then by an increase in the export business in rehabilitating war torn countries. As demand declined, capital investment by business expanded, home building increased, and the economy continued to move forward. Without public assurances the policies of private investment could not have been extended far enough to permit the easy home financing that was the backbone of the rise. From the period from late 1947 to the beginning of 1949 was called the climax of inflation. Business investment at first increased much more rapidly than did the output of industry. This increased the spendable income of consumers and together with war-time savings and the international situation demanding large outlays caused a tremendous inflationary force.

By midyear 1947, because of the tremendous demand and limited supply, wholesale prices rose longer and further than they did after World War I.

The government was to stand its test of preventing a serious collapse resulting from a mostly uncontrolled inflation when in early 1948 the bottom dropped out of the grain market much as it did in 1920.
The government's policies prevented a collapse of the 1920 kind by limiting the changes of prices per day. Changes in prices in a single trading session were held to a narrow range, 10 cents per bushel in the case of wheat. For several trading days wheat dropped the limit and finally leveled off at 74 cents a bushel below that of a month earlier. This restrictive control prevented the complete demoralization of the market.

Also the farm support program halted a market break in farm prices and prevented the fear in the business world that an agricultural collapse was in the making and would cause a general deflation. These factors help to explain why there was no major break in industrial production and employment.

In spite of the government surplus and debt-retirement policy, inflation ran its course. But due to the improved banking and credit structure and some powers held by the government used to damper buying and credit, the recession was more controllable when it did come.

The first seven months of 1949 were characterized as the recessionary phase. This stage was mostly caused by a general decline in the prices of farm goods and the general refusal of people to consume the production at prevailing price levels. The general price level outran the incomes and buying habits of consumers. Because consumption
expenditure dropped in the last part of 1948, businessmen, already with a tremendous inventory, with their confidence shaken began to reduce their orders for new goods to prevent further inventory expansion. Production was cut back. In each of the four successive months, beginning with March, 1949, the industrial production index dropped five points. The drop of thirty-four points from November, 1948, to July, 1949, was more than 17 per cent, wiping out the entire increase in the index of industrial production since the spring of 1946. This was a tremendous thing. One, and possibly the most important, reason the decline did not go further was that there were new factors in the business structure and in the program of government policy.

There was a slight increase and the economy showed signs of pulling itself out of the recession when in June, 1950, the industrial production hit 199, four points above the previous post-war peak. Unemployment had dropped to 3.4 millions and real incomes of consumers were increasing.

With the coming of the Korean War prosperity began a rapid climb and the government formed three broad conclusions in regard to public policy. These were, first, that they should be designed to bring about a quick increase in production; second, they should insure that defense requirements and essential civilian needs have priority over other uses and hoarding would not be tolerated; third, that they should provide against the threat of new inflation. It
urged that monetary policy be one of restriction with terms tightened on loans insured or guaranteed by the government, and recommended further legislation to tighten both private and government lending policies.

After the Korean outbreak cost of living increased 9 per cent, and wholesale prices rose by 16 per cent. With this rise, more than half the families of the nation had no income gains between 1950 and early 1951, and almost one fifth suffered actual declines. Due to higher taxes, credit restraints and an application of a price and wage control policy early in 1951 an easing of the inflationary pressure came and a reasonable stability of prices was reached.

The President recommended, because of inflationary forces due to an expected rise in income and no considerable rise in consumer goods supply, that direct price and wage controls be administered. The Wage Stabilization Board was to prevent total payroll increases, provide incentives for increased productive effort, and minimize wage pressures of a kind that might require increases.

He also recommended that ceiling prices be placed on goods and not raised except to provide adequate production incentives to business. This was administered by the Office of Price Stabilization.

About mid-1951 all these anti-inflationary measures began to take effect and there was a lull in inflationary
pressures. By this time, however, military production had continued to rise. In the second quarter of 1950 it took 6 per cent of GNP, 8 per cent in the fourth quarter of 1950, and 10 per cent in the second quarter of 1951. With this increase the council expected the number of people gainfully employed to rise, hours of work and overtime payments to increase, and wage rates to creep upward even under an effective wage stabilization program.

In the face of these facts the council recommends stronger restraints over business investment and consumer spending. "The most recent declarations and surveys of business intent reveal that affirmative policies must continue to be used to bring the total of private investment downward toward a less inflationary level."

During the first half of 1952, the private and public aggregate demand held production high, and also kept income at a rising level. The leveling off, and in some cases, decline, in employment and in the average work-week in industries manufacturing goods for consumers and the slow rise in total production, reflected a period of slow upward trend dominated by general stability. However, it seemed to be an uneasy stability. There were mixed beliefs concerning a new inflation or a renewed recession.

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Money was made a little easier in the second half of 1952 mostly by lending on government securities and also a few credit controls were either eased or suspended. Regulations requiring minimum down-payments and maximum maturities for mortgage loans on new houses and commercial construction, and the terms of government-insured loans on new or old houses was made easier in June. The Congress terminated the powers that the Defense Production Act had over controls on consumer credit and said that no future program of voluntary credit restraint could be approved under this act.

The CEA's view as to how revenues were to be raised to pay for increased expenditures was a strong reliance on taxes. This shows, even though inflation controls were eased, that they were still afraid to resort to borrowing as a means of financing the defense budget. Borrowing is an inadequate way to finance because it does not distribute the bill effectively and is highly inflationary while taxation is a very effective means of controlling inflation. An Excess Profits Tax that was passed in 1950 was still in effect and was due to expire in June of 1953. The high income tax imposed in 1951 was due also to expire in December, 1953. The deficit for the year of 1953 was estimated to be around ten billion dollars and the President was pressing for a strengthening of the tax program.
"Particularly in a full-employment economy, taxation helps to protect the purchasing power of the dollar."¹¹ Taxation should be the "last inflation control measure to be relaxed, since it is a basic measure and the most effective one for long-continued use."¹² This is true especially when the government is running a deficit and there is no other non-inflational way to pay for it. There really was no other choice under the circumstances.

The President said that it is the responsibility of the government "to plan its operations so that they will make the greatest contribution, in the long run, to economic stability and growth."¹³ When possible, he said, the government should suspend the operation of controls and limit itself to the use of fiscal and credit policy, along with other regulatory and protective programs. Also, the people, while striving vigorously to avoid inflationary movements, should realize that their primary purpose is full production and employment and its fair distribution. The President believed the monetary policy could contribute greatly to the stability of prices.


It is the function of monetary policy to control the expansion of credit, so that the total moneys supplied will be commensurate with the needs of the economy, avoiding on the one hand excessive credit creation which might lead to speculative abuses, and avoiding on the other hand contractions in the money supply which would interfere with production, employment, and investment. 14

Institutions have given the people somewhat of a reactionary resistance and provide arrestors to the cumulative shrinking of demand. Also, there are "built-in" stabilizers such as unemployment compensation, farm price supports etc. Keynes noticed, as did the Council, that consumers resisted a decline in their living standard by cutting their saving rate sharply. This was true during the 1949 setback. Although these institutional stabilizers help, they are no substitute for positive anti-deflation policy. The Council saw that a possible shortage of total spending might show up around 1955 or 1956. It says that private outlays are more desirable than public because they are more "flexible and free-wheeling." The matter of raising investment and consumption is their answer, "but we can scarcely be content with the principle that any additional demand will do." 15 An increase in total demand comes from an increase in total production and an increase in production is brought about by an increase in investment according to Keynes.

14 Ibid., p. 21. 15 Ibid., p. 10.
At any rate the report continues by asserting that a current deficiency in total private demand might call for emphasis on either consumption-stimuli or investment-stimuli and that investment and consumption must grow together or one will sooner or later have to pause for the other to catch up. If investment outruns consumption to an appreciable degree there must be a time when consumption expenditures rise to take care of this additional output. If this adjustment does not come and is forestalled by a new investment, then total demand is weakened and the problem is only postponed and deepened. The relation of this problem to fiscal policy is interesting. For instance, a rise in prices relative to wages, other things being equal, increases before-tax business earnings relative to before-tax personal income. Now a shift in this direction tends to favor investment rather than consumption; conversely, a rise in wages relative to prices tends to favor consumption. A policy of a consumer-oriented tax reduction or an increase in government transfer payments to individuals might be needed to raise consumption relative to investment. Also, the Council suggests either a wage and salary increase or a price reduction as a means of shifting the types of incomes desired.

The contraction in the economy that took place the latter part of 1953 was caused by an imbalance between production and sales. After the steel strike production moved rapidly upward. In fact, consumption exceeded the increments of
disposable income. In spite of rising personal income and production, inventories began to pile up. Inventories rose from four billion dollars in the first quarter of 1953 to seven billions in the second quarter. Production was cut again and unemployment resulted.

In examining the structure of the labor force in the first quarter of 1950 and January, 1954, a relationship can be seen between the two. For instance, the total of unemployed in 1950 appears to be about the same as the total number of men in the armed forces. And the total of unemployed in 1954 appears to be the same as the total of unemployed in 1950. Over the four-year trend unemployment seems to have decreased at about the same rate as the armed forces have increased—of course not exactly, but there is a relationship. The two have simply exchanged places in regard to a shift in the labor force.

During the first part of 1953 the government pursued a tight money policy and the Federal Reserve System raised the discount from 1 3/4 to 2 per cent. This discouraged member banks from borrowing at the Reserve Banks. The Treasury harmonized its policy with that of the Federal Reserve System by seeking to obtain funds from investors other than banks. This general tightening of monetary policy brought a restriction of sales. Characteristically, the credit restriction had more effect than was desired. Monetary policy is dangerous and should be handled with great care.
The trouble is, when applied slightly, it has little or no effect and when carried to the extreme its effects are too great for the desired situation.

Early in May and July the Federal Reserve Bank increased its holdings of U. S. government securities and thereby increased member banks' ability to extend credit. Also, in June the reserve requirements were reduced from 24 to 22 per cent in reserve banks, and from 14 to 13 per cent in the country banks. This released funds available for private credit and eased the tension in the money market.

The situation is described by the Council in the following manner:

The road of reasonable full employment without price inflation is narrow. There is always the danger that our economy, by moving a little too far to one side of the road, will enter the zone of inflation, or by moving too far to the other side, will slip into a zone of contraction. 16

Fiscal policy is less flexible than that of monetary or debt management but can be used as a main stabilizer in the economy. For instance, when trade and employment were slipping, the Treasury announced it would not attempt to extend the Excess Profits Tax and the high personal income tax when they expired. This gave new confidence to the

businessmen and consumers. Also used as an aid to the economy is the power of the administration to extend housing credit under the FHA. This was a new way to increase credit and stimulate economic conditions. For instance, on a house costing $12,000, the required down payment could be reduced from $2,400 to $600, while the amortized period could be extended from twenty-five to thirty years.

The savings rate was very high during the period from 1950 through 1953. During this period an average of 7.3 per cent was saved compared to 4.5 per cent in 1929 and an average of 4.3 per cent in 1947-1950. This would suggest that there would be no justification for a rising debt unless there was an unequality of income distribution. Then there was heavier borrowing to finance houses and all sorts of durables. During 1953 payments of interest and principal on mortgages and consumer goods rose to 15 per cent of disposable income.

Public works were recognized by the Council as being a very important aspect in bringing stability. It could be designed and executed to be accelerated in such times and restrained in boom times. "If it should become necessary, outlays for federal public works could be stepped up by one half or more within a year." In recent years public works

17 Ibid., p. 103.
have accounted for about one third of total new construction. One can begin to see the importance of this kind of expenditure. At least it is needed and is not throwing money and resources away. The backlog of federal, state, and local public works is counted in the tens of billions of dollars. The federal program has available countless numbers of useful projects and plans that could be expanded if there was need for this additional outlay. A large part of this could be accomplished without legislation.

A tax structure review was suggested by the Council so as to remove barriers that might dampen business incentives. Among these were: the carry-back of losses should be extended from one to two years; elimination of the double taxation of dividends; treatment of research and development expenses should be clarified; accumulation of earnings needed for expansion should not be penalized; and, to encourage business income from foreign investment. All these programs show a desire by the government to encourage private outlays while steadying the background with a set of devices that would help keep the economy in the middle of the road.

The Council says it has learned several lessons as a result of the latest encounter with the business cycle. These are as follows:

First, that wise and early action by government can stave off serious difficulties later. Second, that contraction can be stopped even when governmental expenditures are declining, provided effective means are taken for building confidence. Third, that
monetary policy can be a powerful instrument of economic recovery, so long as the confidence of consumers and businessmen in the future remains high. Fourth, that automatic stabilizers such as unemployment insurance and a tax system that is elastic with respect to national income, can be of material aid in moderating cyclical fluctuations. Fifth, that a minor contraction in this country need not produce a severe depression abroad. Sixth, that an expanding world economy can facilitate our own readjustments. 18

This pre-view of how close the different agencies of the government watch the reported statistics and the various tools that they use in certain situations gives one the feeling that perhaps an adequate theory has been found, one that is not disastrous if applied to reality. Perhaps it has been influential in the near past but there is no way of determining just how much it has actually helped. At any rate one now realizes that there is something that can be done about employment and proceeding from that belief one may be able to modify and change the present theory when it shows signs of weakness.

CHAPTER VI

CONCLUSION

This paper has pointed out that in the near past the responsibility of maintaining full employment has either been assumed by or placed on the central government. The first task of public policy is to make the system function so as to provide opportunities for employment and to provide it in such a way that society will profit socially and economically.

How the government should use the various measures relating to its budget depends, in the final analysis, upon one's judgment with respect to the socially desirable distribution of wealth and income. The tax revenues should in any case be drawn as far as possible from sources which impinge lightly on consumption, for only if they are such will they have an income-generation effect. The tax method of financing, even though the rates are progressive, is at best more restrictive in effect than loan financing—in other words, has a smaller income-generating effect—and this is all the more true of the increments of taxes collected. These two facts favor the more conservative policy of financing apart from borrowing.

The problem of eliminating the drag caused by taxes on consumption, necessitated because of the need to raise
revenue for social services can be eased by a modification of the federal grant-in-aid program and by the assumption by the federal government of certain responsibilities now carried wholly or in part by the states.

The main purpose of a managed compensatory monetary and fiscal program is to raise the consumption function which can be done by

(1) a change in the proportion of the various distributive shares in the national income, (2) redistribution of income through the tax system and social service expenditures, (3) provision for more adequate "security" in order to narrow that motive for saving, (4) increases in community consumption, and (5) elimination of as many monopolistic forms and practices as possible. 1

To accomplish this end the government must maintain a stable price level by the use of monetary and fiscal methods and price subsidies. Paying federal, state, and local employees higher wages and salaries and encouraging a rising wage-salary rate trend over the whole economy would help raise the consumption power of the nation considerably. In addition to this there is need for a flexible long-range expenditure program and a flexible tax system in order to help raise consumption and to smooth out the effects of the business cycle.

In order to raise demand there must be employed a many-pronged attack that will result in a stable, progressive economy. This task can be done only through deliberate governmental measures to raise the buying power of the lower income groups and the propensity to consume on the part of the nation as a whole.

The recent uses of the measures discussed in this paper seem to indicate that there now is an adequate theory to handle the problem. Exactly how effective it has been or will prove to be in the future cannot be measured. There is still the possibility that this theory may not be sufficient to counteract a depression, if and when one gets underway. The question of the sufficiency of this theory remains an unanswered one.
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