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INTRODUCTION TO FISCAL POLICY

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DEDICATED TO THE

MEMORY OF MY MOTHER.

Preface

A study of public finance is far short of complete unless the possibilities of using government revenues and expenditures to affect the economic activity of the nation are carefully evaluated. This book has been written with the specific intention of meeting this need. The analyses are nontechnical and can be read and understood by the average student of political science, education, sociology, and history, as well as business and economics. Nevertheless, all of the important developments and possibilities of fiscal policy are concisely and thoroughly treated.

The economic effects of the fiscal activities of the public economy are best analyzed through welfare economics. To the extent that public activities are not related to welfare economics, they are similar to private economic activities and do not justify detailed separate development. Nearly all government fiscal activities change the economic welfare of an individual from what it would be if determined in the market. The purpose of the study of principles to be followed in forming fiscal policy is to make it achieve desirable economic effects—to improve the general welfare.

The public economy never has been and by its nature never can be controlled and therefore judged by the relative prices determined in the market. However, fiscal acts of the public economy must be performed with full awareness that the private economy in the United States is largely governed by profit possibilities as indicated by relative prices in the market. All government fiscal activity in a capitalistic nation must be decided with due attention to the probable effect on prices in the market—that is, price of money or interest rates, price of labor or wage rates, and prices of different categories and types of goods and services.

The analyses in this small volume are aimed at providing the student with a simple and modern discussion of the economic impact of government collection and creation of funds and the

expenditure of these funds for goods and services or debt repayment. The discussions largely revolve around (1) the determination of what are desirable price levels, consumption levels, employment levels, and distribution of national income; and (2) the examination of how prices, consumption, employment, and distribution of the national income have been and can be influenced by fiscal activities. These are treated as the four goals of fiscal policy because, it is believed, their achievement will result in a very efficient level of resource utilization and because they can be greatly affected by fiscal activity.

It is realized that the best plans are no better than their administration. This is also true of fiscal-policy plans. The last chapter of this five-chapter book is devoted to the analysis of the provisions that have been made for the administration of fiscal policy, the efficiency of past administration, and the possibilities for improvement. Special emphasis is placed upon the administration of public expenditures during periods of economic depression and the administration of the great postwar Federal debt.

It is difficult to thank all those who have aided me in the preparation of this volume. All persons whom I contacted during its writing showed the highest degree of co-operation, and I am deeply appreciative of their aid. I am particularly indebted to my colleagues at the Ohio State University, and especially to Mr. Cohen and Professors Arnold, Becker, Calderwood, Coons, Lovenstein, Miller, Patten, and Quantius. In the development of this study, I have been especially aided by the concepts of economics and the techniques of economic analysis that were acquired while studying under Professors C. E. Ayres, Roy G. Blakey, Alvin H. Hansen, and E. T. Miller. I also wish to thank Professor Edison L. Bowers, Chairman of the Department of Economics at Ohio State University, for his patience with me during the period of gestation. For any errors of analysis and fact, of course, I assume full responsibility.

RICHARD W. LINDHOLM

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INTRODUCTION TO FISCAL POLICY

CHAPTER 1

Fiscal Activities Surveyed and Defined

IMPORTANCE OF FISCAL POLICY

Fiscal policy is concerned with the determination of the type, the time, and the procedure to be followed in making government expenditures and in obtaining government revenues. The importance of fiscal policy has expanded and contracted with the expansion and contraction of the effects of state action on the daily activities of citizens. The state was very important in the determination of the activities of citizens of the German principalities in the seventeenth and eighteenth centuries; therefore, fiscal policy was broad and dealt with most of the activities in which the citizens of that period were engaged. Under these conditions a body of theory and administrative techniques was developed, the so-called cameralist school,* by those university professors who were the advisers of the German princes. The English economist Adam Smith (1723-1790) assigned to the public economy, and thus to fiscal policy, only a narrow field of activity.†

* From Latin *camera*, a room or chamber; the advisory conferences having ordinarily taken place in the princely chambers.

† It is sometimes said that the state, according to the economists of the late eighteenth century and early nineteenth century, would perform only the duties of a "night watchman."

Since Smith's time, with the development of the highly industrial civilization of today, the activities of government have expanded in most of the nations of the world. As a result, the importance of fiscal policy has expanded. Modern fiscal policy analyses are largely concerned with the effect of different methods of obtaining revenue and different expenditures on prices, consumption, employment, and the manner in which the income of the nation is divided among the citizens.

The importance of government fiscal activity, and therefore of fiscal policy, is determined by the importance of the public economy in relation to the private economy. The size of the public economy is determined by the effective demand for goods and services arising directly from government purchase and the demand for goods and services arising from the provision of funds through government loans or grants.

Relative Size of the Public and Private Economies

A broad and generalized statement concluded the exploration of what fiscal policy is and the measurement of its importance. It becomes in order, therefore, to appraise the statement by quantitative standards.

A useful measure of the proportionate size of the public and private economies is provided by the number of individuals that each employs. In 1939, the private economy employed 31,308,000 individuals and the public economy 7,828,000; thus about 20.0 per cent of the full-time and part-time employees of the nation were employed in government and government enterprise prior to World War II. During the war year 1944, the private economy employed 39,522,000 and the public economy 17,500,000 or about 30.6 per cent. In 1946, a postwar year, the private economy employed 39,988,000 and the public economy 9,229,000 or about 18.7 per cent. The importance of the public portion of the economy, as measured by the number of persons employed, is slightly less during the postwar period than during the period immediately preceding World War II.°

Another measure of the relative importance of the public and

° *National Income Supplement* to *Survey of Current Business*, July, 1947 (Washington, U. S. Government Printing Office, 1947), p. 37.

private economies is the income originating in each. In 1939, the income originating in private business was $77,850 million and that in government $8,550 million or about 9.7 per cent of the combined income. In 1944, a war year, the income originating in private business was $144,907 million and that in government $34,366 million or 19.0 per cent of the total. In 1946, a postwar year, the income originating in private business was $151,824 million and that in government $23,019 million or 13.1 per cent. This measure of relative importance of the private and public economy indicates an increase in the relative importance of the postwar public economy of 3.4 per cent.*

The validity of the second type of comparison—the national income ratio—is affected adversely by the fact that the amount of national income attributed to the public economy is greatly understated in the statistics because it does not include the contribution of government-owned capital and government-financed contracts. The amount of national income attributed to the public economy is not much more than the total of salaries and wages paid by the public economy, whereas in the case of the private economy the corresponding figure includes profits, interest, inventory adjustments, and the like, as well as salaries and wages arising from expenditures originating in both the public and private economy.

The first comparison—the portion of the total labor force employed by the public economy—is also inadequate as a ratio for appraising the private and public economies. The number of employees of the public and private economies would be comparable only if the government performed by forced account (employed directly the equipment and labor required rather than having the work performed by letting contracts to private firms) all activities that could be economically undertaken in this manner. Forced account type expenditure is relatively unimportant in the United States.

The relative importance of the public and private economies is shown best by the comparison of the total expenditure of the Federal and state and local governments with the gross national product or expenditure. This type of comparison is not perfect because

* *National Income Supplement* to *Survey of Current Business*, July, 1947 (Washington, U. S. Government Printing Office, 1947), p. 37.

it does not indicate the impact of government policy as shown in the type of securities issued to refund the debt, or of government economic policy indicated by other actions of the Treasury or the Federal Reserve System or government lending agencies.

In 1939, the total expenditure of the private economy was $75,023 million and of the public economy $17,270 million. The expenditure arising from the public economy in 1939 was 19 per cent of the total expenditure made in the United States. In 1944, a war year, the total expenditure of the private economy was $107,435 million and of the public economy $103,116 million. The expenditure arising from the public economy in 1944 was about 49 per cent of the total expenditure made in the United States. In 1946, the first postwar year, the expenditure of the private economy totaled $153,379 million and the public economy $50,300 million or 24 per cent of the total. In 1947, the expenditure of the private economy totaled $173,200 million and of the public economy $56,400 million or about 25 per cent, an increase of 6 per cent over 1939.

It is only in the relative number employed that the public economy has contracted since 1939. However, the relative increase as measured by national income and gross national product is much less than commonly assumed.

Two important factors affect a comparison of expenditures of the private and public economy in 1946 and 1947 with those of 1939 and 1944. (1) In 1947 approximately $4,000 million of the gross expenditure attributed to the private economy arose from Federal government loans to foreign nations.* (2) The expenditure data used in this analysis for both 1946 and 1947 include expenditures made to reduce debt and to accumulate surpluses. In 1947 this surplus was $12,900 million. The impact of government expenditures or surplus used to reduce debt and build reserves is very different from an equivalent expenditure as employee compensation or as purchase of goods and services. In 1939 and 1944 government, instead of accumulating a surplus, was experiencing a deficit.†

* This is given in gross expenditure data as net foreign investment. Prior to the active interest of government in foreign lending, this represented the extension of private loans to foreign nationals or governments.

† The total deficit of government in 1939 was $1,867 million and in 1944 it was $51,098 million.

Interrelationship between the Public and Private Economies

The public and private economies are intimately related and the activities of each vitally affect those of the other, even though they can be usefully distinguished for discussion purposes and even though tests of sound action that can be applied to either are not always applicable to the other. The services and functions performed by each economy are necessary for the efficient operation of the other. Their relative importance changes with time, but neither the public economy nor the private economy lives off the other.

From time to time, the initiative for most activity appears to be with one and then the other sector of the economy. During the period of the middle and late 1920's the initiative was with the private economy; during the middle 1930's the initiative was with the public economy; during the late 1930's and early 1940's the initiative was again with the private economy; during the middle 1940's the initiative returned to the public economy; and during the late 1940's it went back again to private economy.

Activity in the public economy is ordinarily prompted by stimuli different from those that affect the private economy. The demand that stimulates activity in the public economy may be labeled group demand and its analogue in the private economy may be labeled individual demand.*

For public group demand to become effective in stimulating a project or activity, the project must be politically acceptable—law, custom, public acquiescence, and the like are involved—and the necessary money must be in hand or obtainable. In a parallel situation in the private economy, political acceptability need not be considered; the desire, plus the purchasing power, is sufficient to make the demand effective. Consider the acquisition of a building by a municipal government and the acquisition of a building alongside it by a department store. Obviously, no sharp line separates the classes of activities. However, generally, it is group

* Group demand as here used means demand for group use, and individual demand means demand for individual use. Consider the demand by a group of children or even a single child for public transportation to a public school as against the demand by thousands of children for bicycles to transport them on private affairs.

activities that are performed by the public economy. Certain activities—fighting wars, for example—are definitely a part of the public economy; but certain other group activities, such as the provision of opportunities for religious activites, are performed within either the public or the private economy.

Each of the two economies, in responding to the demands for the provision of goods and services, uses the other's facilities. Because the private economy in the United States provides the larger portion of goods and services, the public economy when it undertakes any important task must rely to a great extent on the private economy. Although the reciprocal dependence of the private economy upon the public economy is not so readily visible, it is nevertheless vital; for one thing, it would be quite impossible to produce any great quantity of goods and services without making use of the educated labor, the highways, and the police protection provided by the public economy.

When and how public funds are raised and spent affects the activities of the private economy. The services provided by the public economy are largely financed, as has been previously indicated, by the levy of taxes and the borrowing of funds from the private economy. Both economies also draw their labor from the same pool. Under modern conditions, the typical situation is that an expansion of one sector of the economy requires an expansion of the other.

An individual making an expenditure for an article at a commercial establishment considers as a fair exchange the transfer of a sum of money for a specifically desired good.

The goods made available through public channels are typically not enjoyed as the result of the individual's ability to purchase them. Also, it is a frequent practice to charge through taxes high prices for the provision of goods and services from which the payer may receive no direct benefit. For example, the wealthy property owners of a city must make large contributions to cover the costs of public education, even though they send their own children to private schools. In the public economy the relationship between contributions, made by particular individuals or institutions, and the goods and services received need bear no very close relationship.

When an individual makes a payment of taxes, the transaction

is not usually an exchange of equals. The taxpayer typically does not receive direct or immediate benefit from the payment. Also, typically, the quantity of medium of exchange is not handed over to the government official because the taxpayer has decided that it is the best possible use he can make of his purchasing power, but rather it is paid into the government treasury because the law requires that it be done. A tax payment is a forced payment from which immediate direct benefits do not arise.

In private finance, the giving up of purchasing power to obtain a particular item of good is considered a voluntary action. The escape available is to keep the purchasing power and forgo the utilities which the good would furnish. But the purchaser does not always have a choice; if an individual refused to purchase all types of food because the prices were too high, he would soon be in the position of either giving up his purchasing power and living, or keeping it and dying. Modern governments in their collection of taxes never offer such harsh alternatives.

The individual consumer does not have a great deal of control over the prices charged for various goods and, after checking the possibilities of using substitutes, is forced to pay the sum demanded, if the particular need is going to be satisfied. (It should also be mentioned that for the vast majority of individuals these needs are usually necessities.)

Although neither the freedom of private economic operations nor the compulsion of public-finance fund raising are absolute, there is a considerable psychological difference between the payment of the typical tax and the completion of the typical commercial transaction.

FISCAL DEVELOPMENT, WORLD WAR I TO WORLD WAR II

Development in the 1920's

Professor Peck, writing in 1924, described the decline of Federal government revenues and expenditures and the expansion of state and local revenues and expenditures.[*] The decline in Federal expenditures and revenues arose from the cessation of hostilities,

[*] Harvey Whitefield Peck, *Taxation and Welfare* (New York, Macmillan, 1925), p. 3.

and the rise in state and local expenditures and revenues arose largely from the demand of the citizens for improved roads and schools. However, although this relationship between Federal and state and local fiscal activity existed, the Federal revenues and expenditures remained greatly above the pre-World War I level.

The interest payments alone on the Federal World War I debt were greater than the total Federal expenditures before the war.* The expenditures of the Federal government during the 1920's were completely dominated by debt requirements.† The total budget of the Federal government averaged only $3,000 million, with interest payments making up a third of the total. In addition, revenues averaged almost $1,000 million above budgetary expenditures, so that the debt was reduced by nearly $8,000 million during the period. Therefore, the total receipts of the Federal government averaged about $4,000 million, interest expenditures about $1,000 million, and debt retirement the same amount. Thus, 50 per cent of the Federal government receipts were made available to Federal debt holders. In nearly all cases, these were persons in the upper income brackets.‡

The Federal tax system at the beginning of the 1920's provided for an excess-profits tax, a moderately progressive personal income tax, and many excise taxes. The first tax bill passed during this period provided for tax reductions, particularly of the excess-profits taxes and the high rates of the income tax.

The excess-profits tax has been used as a special war tax in the United States. The tax is assessed upon profits that are above those considered by the law to be normal. In the case of the tax of the 1920's, it was levied upon corporation profits only and was based largely upon profits in excess of those made prior to World War I. A similar tax was levied during World War II; however,

* Expenditures of the Federal government in 1916 were but $724 million, while interest payments on the Federal debt between 1923 and 1929 varied between $1,055 million and $680 million. William J. Schultz, *Financial Development of the United States* (New York, Prentice-Hall, 1937), pp. 524, 613, 615.

† When reference is made to government expenditures or revenues of a particular year, it is the fiscal year which is being referred to. The fiscal year 1949, for example, includes the last six months of 1948 and the first six months of 1949.

‡ W. J. Schultz, *Financial Development of the United States*, pp. 613–615, 621.

the rates of the World War II tax were higher. This latter excess-profits tax was repealed in 1945, the repeal to be effective January 1, 1946.

Prior to the passage of each of the tax bills adopted during the 1920's, the President and the Treasury recommended strongly that taxes bearing largely on small-income receivers should be retained and even expanded while the taxes bearing more heavily on the higher incomes should be reduced or remain unchanged. This advice had considerable influence on Congress.

The final burden of taxes is very difficult to determine, but certainly as a first approximation it can be stated that taxes on personal income, profits, and inheritances tend to remain upon the persons who make the payment. Also, as a first approximation, it can be stated that the burden of taxes upon goods and services rests upon the persons who purchase and consume the goods and services taxed. The term incidence is used to refer to this person upon whom the final direct burden of the tax rests.*

The Federal government during the 1920's obtained a large portion of its funds from the low-income recipients and made a large portion of its expenditures to high-income recipients. The fiscal activity of the Federal government during this period tended to take money away from persons of moderate means and make it available to the rich. Indirectly, this activity in turn made more funds available for speculation in the security market and contributed to the formation of the investment boom of 1928 and 1929.†

The changing of the portion of the total income of the nation received by different groups is called income redistribution. Income redistribution, when related to fiscal policy, usually refers to the reducing of the portion of total income received by the large-income receivers and the increasing of the portion received by the smaller-income receivers.

At the same time that Federal government fiscal activity was declining slightly, state and local activity was increasing. Also, rather than using revenues to pay off debt owned largely by the

* See pp. 112–124 for further analysis of the burdens of different taxes.

† Also the sinking-fund scheme used brought about a greater reduction of debt during depression than prosperity. See Seymour E. Harris, *The National Debt and the New Economics* (New York, McGraw-Hill, 1947), p. 267.

rich, the state and local governments were obtaining a large portion of their revenues by borrowing from the rich. These new borrowings by state and local governments were actually greater than the debt repaid by the Federal government. What the Federal government gave to the rich in debt repayment, the state and local governments took away in new borrowings. The net effect during the 1920's was that government debt activity was neutral. It failed to absorb any new savings, but it also failed to release funds that might have remained idle.

During the 1920's, the total annual expenditures of state and local government increased from about $5,500 million to nearly $9,000 million. The total impact of state and local fiscal activities was, therefore, nearly twice as great as that of the Federal government. The funds for this great expansion in state and local expenditures were obtained from borrowing, as mentioned above, and from new tax levies.

The gasoline-tax and automobile-license levies developed during this period into important sources of state revenues. Between 1919 and 1929 all forty-eight states adopted a tax levied upon gasoline consumed in use of the highways. Also state inheritance and income taxes were adopted, or the rates were increased to obtain more revenues. However, the property tax remained the most important state and local tax, bringing in more revenues than all other sources combined.

The expanded expenditures of state and local governments were largely for welfare, school, and road purposes. These types of expenditure directly helped all classes but were certainly particularly beneficial to those in the lower income brackets. The tax revenues of state and local government took about an equal percentage of the income of the poor and the rich. The over-all tax burden could be called proportional. However, the expenditures certainly directly aided the middle and lower income brackets more than the upper. Thus, the over-all effect was, perhaps, slightly to increase the quantity of goods and services available to the lower-income receivers. In the 1920's, this was not true of Federal fiscal activity. A tax which takes a larger percentage of the income of the large-income receivers than of the small-income receivers is called progressive. An income tax such as the Federal income tax with steeply graduated rates is this type of a tax.

A tax that takes a smaller percentage of the income of the large-income receivers than of the small is called regressive. A tax such as a poll tax, which is a certain number of dollars and paid by all persons, is a regressive tax. Also, a general sales tax levied as a uniform percentage of price is regressive because the lower-income receivers spend all of their income and therefore pay the tax on total income, while the high-income receivers save a portion of their income and avoid the tax on the portion saved. The total effects of fiscal action are considered regressive if, as a result of the action, the low incomes are decreased more or increased less than the higher incomes. The effects of fiscal action are considered progressive if the low incomes are decreased less or increased more than the higher incomes.

The Federal tax receipts during the 1920's were divided just about equally between excise-tax receipts and income-tax receipts; thus, the impact of the Federal tax system was not progressive as it is today but, rather, proportional. However, the expenditures of the Federal government, rather than being aimed at the poor as was the case with state and local expenditures, were received by the higher-income receivers—over 50 per cent of Federal expenditure was directly related to the debt. Therefore, fiscal activities of the Federal government during the 1920's tended to have a regressive effect; they increased the concentration of income in the upper brackets and intensified the problem of selling all goods produced. The state and local government fiscal activities absorbed savings and tended to equalize the distribution of goods and services. This is very nearly the reverse of relative effect of fiscal activities of the two levels of government during the 1930's.

Development in the 1930's

The period of the 1930's was the first time in the history of this nation that the governments of the United States, and especially the Federal government, entered into a program of spending and taxing aimed at eliminating an economic depression. The fiscal policy of the 1920's had been based on the idea that the nation's economy prospered best if the taxes levied upon profits were low and if every effort were constantly made to reduce government

expenditure and the government debt. The last Federal revenue act passed prior to the great depression of the 1930's reduced the tax on corporate profits from 13½ to 12 per cent, and a temporary additional reduction of the taxes on profits was adopted by a joint resolution of Congress in December 1929—two months after the stock-market crash. However, prosperity did not return. Perhaps there was something wrong with the formula.

The expenditures of the Federal government and the state and local governments expanded slightly during the early 1930's, despite efforts to economize. At the same time, tax receipts began to fall off for all levels of governments. Federal receipts in 1933 were only slightly more than half as great as they had been in 1930, but expenditures had risen by a third. Desperate efforts were made by bewildered men to reduce Federal expenditures and increase Federal taxes. The administration continued to insist that the budget must be balanced, and most congressmen gave lip service to a balanced budget. But both the administration and Congress were unwilling to cut government expenditures; and Congress was unwilling to impose additional taxes upon individuals who were unemployed and upon business firms that were on the verge of bankruptcy. It was at this impasse between belief and reality that the concept of the cyclically balanced budget was born. The idea has recently benefited by an injection of new life in the form of a report of the Committee for Economic Development.* The idea grew out of a need for a compromise between the balanced budget and the existing unbalanced budgets of the depression period. It was an attempt to rationalize the deficits of the period. Briefly, the idea was that budgets would be unbalanced during depressions and governments would expand their debt, but during prosperity there would be surplus of revenues and the debt would be retired. However, the presentation of the idea that debt increase might be good reduced the fear of government debt in the hearts of the people, and they became unwilling to pay taxes to reduce debt during prosperity. The Federal tax legislation of 1948 is an excellent demonstration of the weakness of the idea of a cyclically balanced budget. An idea born of

* See footnote on p. 106 for a brief analysis of the tax program of the Committee for Economic Development.

desperate rationalization is seldom good, and the idea of a cyclically balanced budget is not an exception.

The deficit of the Federal government grew as the 1930's advanced. The revenues of the Federal government were increased during the period to prevent the developing deficits, but the greater demands for expenditures more than absorbed these revenue increases. Federal fiscal activity began to approach World War I levels, and by 1939 Federal expenditures totaled $8,955 million, which was about equal to domestic expenditures in 1918. Federal revenues in 1929 totaled $3,833 million and by 1939 had grown to $6,742 million.* In 1929 over $1,000 million had been available to apply on the Federal debt, while in 1939 the Federal government had a deficit of over $2,200 million. Federal expenditures for goods and services were about three times as great in 1939 as they had been in 1929.

State and local government expenditure also expanded during the 1930's, but this expansion was much less than the Federal. Actually, most of the funds for expansion of state and local expenditure were provided by the Federal government. The use of Federal funds by state and local governments is as old as the nation, but the use of these grants, called grants-in-aid, expanded greatly during the 1930's. State and local average government annual expenditure expanded by about $1,000 million from 1929 to 1939, and the average annual increase of Federal grants-in-aid to state and local governments was about $850 million during the same period.

The social-security program, providing payments to the aged, the unemployed, and the handicapped, was established in the 1930's. By 1939 these new undertakings had expanded the expenditures of the Federal government by over $1,000 million and had expanded state expenditures by an even greater amount. A large portion of these expenditures was not actually made to individuals but was used to increase the totals of social-security funds and to increase the quantity of savings available for the purchase of Federal government debt. In addition, the Federal government expanded its expenditures on flood and erosion con-

* Data used in this analysis were taken from the *National Income Supplement* to *Survey of Current Business*, July, 1947, pp. 21–23.

trol. The Federal government also entered more actively into highway and public-building construction. The Federal expenditures to aid agriculture and housing also became much more important.

The types of expenditures expanded by the Federal government during the 1930's directly increased the scale of living of the people in the lower and middle income brackets. At the same time that expenditures of the Federal government became more closely related to the human welfare, the revenue system became more progressive. Thus, Federal fiscal activities began to increase the scale of living and decrease the savings of the citizens of the nation. In other words, the impact of Federal fiscal activities became progressive in its nature.

The large-scale use of borrowed funds made it possible for the Federal government substantially to increase real incomes of the lower income brackets without decreasing the real income of any individual. This relationship was possible because, as a result of government borrowing, large quantities of the factors of production that were unemployed became employed and produced goods.

The Federal tax revenues were expanded during the period by reintroducing and raising the rates of some of the excise taxes. The reintroduction of legal alcoholic beverages expanded the revenue of all levels of government. The Federal taxes on personal income and corporation profits were also increased. The general tax applicable to corporation profits was raised to 19 per cent in the Revenue Act of 1938. In 1936, the Federal government experimented with a tax on the undistributed profits of corporations, the purpose of which was to increase purchasing power through an expansion of corporate dividend payments.*

The state and local governments were greatly in need of additional revenues during the 1930's. The receipts from their established taxes had declined sharply. In order to get the money required for normal operation, many states introduced a general retail-sales tax. This tax has since developed into the most important source of state revenue. New taxes were not introduced by

* In 1948, Great Britain is utilizing a tax on distributed corporate profits in order to decrease the quantity of purchasing power arising from corporate dividend payments.

ocal governments; however, state aid to local government ex- panded, and in some states the property tax became exclusively a source for local revenue.

FISCAL DEVELOPMENT, WORLD WAR II AND AFTER

Size of War Fiscal Activity

The fiscal requirements of World War II necessitated a tremendous expansion of Federal revenues and expenditures. The attendant prosperity increased state and local revenues, but the rationing of raw materials and the shortage of labor reduced state and local expenditures. Although Federal tax revenues expanded greatly during the war and remained high in the postwar period, expenditures expanded much more rapidly and the gross Federal debt increased from $42,968 million in 1940 to $269,422 million in 1946 or $226,454 million.* At the time of this unprecedented expansion of the Federal debt, the debt of state and local governments was being reduced. However, the total reduction of state and local debt was very small compared to the Federal expansion.†

In 1944, Federal expenditures alone were $95,559 million. This is greater than the gross national product of the entire nation for any year prior to 1941. During the years 1942 through 1945, Federal expenditures averaged nearly half the gross national product. The fiscal experience of World War II vividly shows that it is during these periods that the relative importance of the public economy, and particularly the Federal portion, expands. Also, the war experience of a gross national-product increase of over 100 per cent shows that government fiscal activity can increase tremendously the productivity of the economy. Government fiscal activity, which never quite succeeded in its efforts to utilize fully the productive resources of the nation in the 1930's,

* The gross per-capita debt increased from $325.62 in 1940 to $1,907.70 in 1946. *Annual Report of the Secretary of the Treasury for Fiscal Year Ended June 30, 1947* (Washington, U. S. Government Printing Office, 1947), p. 356.

† State debt reduction from 1941 to 1946 amounted to $1,276 million or 5.1 per cent of the 1941 total. From the *Book of the States, 1948–49,* vol. 7 Chicago, The Council of State Governments, 1948), p. 247.

finally achieved its goal during World War II. But during the 1940's the pump was primed to overflowing and inflation resulted.

Government Revenue Sources during the War

The Federal government provided all of the funds for financing World War II and for the international postwar reconstruction. Table 1–1, given below, briefly summarizes Federal fiscal activity during the five war years. The large portion of the financing done by expanding government debt was unfortunate. Certainly in 1943 more than slightly over one-fourth of Federal expenditures should have been obtained from taxes. During the entire five-year period,

TABLE 1–1. Federal expenditures, taxes, and deficits during World War II, 1941–1945 (in billions of dollars).

Year	1941	1942	1943	1944	1945	Total, five years
Federal expenditures	14	34	80	95	100	323
Federal taxes	8	13	22	44	46	133
Federal deficit	6	21	57	51	54	190

Source: *Report of the Secretary of the Treasury for the Fiscal Year ending June 30, 1945*, p. 87.

Federal borrowings were $57,000 million greater than tax receipts. About 60 per cent of the funds to finance World War II (1941–1945) were obtained by an expansion of the Federal debt. The great fiscal advantage of the Federal government over state and local governments in borrowing operations was demonstrated during World War II. Despite the fact that Federal debt was increasing at an unprecedented speed, the average rate of interest paid decreased. This ability of the Federal government always to obtain all the funds wanted is important in financing a war and is also very important in making Federal fiscal activity paramount during a depression.

War-finance policy has largely revolved around the determination of the correct portion of war expenditure that should be financed from tax levies and, on the other side of the same shield, the portion of total war revenues that should be obtained from

loans. The more popular statement of the problem has been loans versus taxes; this, however, provides an incorrect emphasis. All major wars must be financed by the use of both loans and taxes, and the relevant discussion is related to the portion of each to be used.*

Merely because a war is financed partly by loans does not mean that the generation fighting the war is able to shift a portion of the economic cost to future generations. Most of the economic costs of war consist of the overtime put in by regular employees, the productive activity obtained from individuals temporarily drawn into the labor market, and the private consumption forgone. The hour of leisure lost or the steak that was not consumed will never be enjoyed. The scale of living of generations living after the war will suffer particularly in those nations where destruction is severe or where a foreign debt has been accumulated.

The Federal government expanded its tax receipts largely by enacting a war excess-profits tax on corporate earnings and by increasing the rates of the individual and corporate income taxes. In addition, many new excise taxes were imposed and the rates of the old excise taxes were increased. Pressure to enact a Federal sales tax was resisted. These special rates and taxes, with the exception of the excess-profits tax, were largely continued until the spring of 1948. The excess-profits tax was repealed by Section 122 (a) of Revenue Act of 1945. The rates of the individual income tax were reduced and personal exemptions increased in the Revenue Act of 1948. The excise-tax rates in 1948 were still practically unchanged from their wartime levels.

The expenditures of the state and local governments during World War II decreased by an average annual amount of $1,000 million. For this reason and because of the increased revenue receipts, a number of states reduced the rates of their income taxes. Also, the trend continued toward making a larger portion of the property tax available to local governments. Very few new state or local taxes were assessed. State and local governments during this period did not obtain net revenues from borrowing, instead state and local government debt was decreased.

* A. C. Pigou, *The Political Economy of War* (New York, Macmillan, 1941), pp. 72–86.

Postwar Fiscal Trends

World War II has expanded the importance of the public economy and particularly the relative position of the Federal government. This expansion has arisen because of (1) the necessity of making interest payments on the large Federal debt, (2) the great increase in the number of veterans and expansion of veteran benefits, and (3) the need for greater armed forces plus the reconstruction requirements of the world. These factors, in addition to a substantial price rise, have combined to bring about a fourfold increase of postwar Federal expenditures over the prewar level. State and local expenditures have also risen sharply in the postwar period.* The principal cause in this case has been delayed public improvements due to war scarcities and the general price rise of war-induced inflation. In addition, state expenditures have increased to provide education for the veteran and to pay state bonuses.

Interest payments on the Federal debt are expected to remain approximately the same for a number of years after 1948. Any debt reduction taking place is likely to be compensated for by a rise in interest rates, as a larger portion of the Federal debt is transferred to private savers. The approximately $5,000 million paid annually as interest on the Federal debt is paid largely to persons in the upper income brackets. The studies of the Board of Governors of the Federal Reserve System show that, despite efforts to spread the Federal debt among all portions of the population, the debt remains largely in the possession of the large-income receivers. The data given in Table 1–2 (p. 21) show the manner in which the Federal debt was held directly by individuals in 1947.

The payment of bonuses and pensions to the veterans of World War II is different from that of any previous war; because payments are made to a so much larger portion of the total population. Individuals with veteran status constitute about one-third of the working population. Until about 1975, the provision

* State expenditures rose from $5,421 million in 1940 to $6,402 million in 1946 (Council of State Governments, *Book of the States, 1948–49*, vol. 7, p. 257). State bonus payments made and contemplated total about $2,500 million. The greater part of the funds to make these payments is being borrowed.

TABLE 1–2. Holdings of United States savings bonds of spending units in early 1947, by income groups.

Amounts of liquid assets held	Percentage distribution of spending units within income groups				
	All spending units	Under $1,000	$1,000 to $2,999	$3,000 to $4,999	$5,000 and over
None	44	75	47	28	13
$1–$499	32	19	37	36	21
$500–$1,999 ...	18	4	13	30	34
$2,000 and over.	6	2	3	6	32

Source: *Federal Reserve Bulletin*, vol. 33, no. 7, July, 1947, p. 797.

of benefits to the veterans of World War II will be largely a matter of veterans providing aid to veterans. Despite the fact that veteran payments may be only transfers from one veteran to another, this aid will be channeled through government provision of funds and government expenditure, and will mean an expansion of the public economy. Table 1–3, given below, provides an estimate of veteran expenditures in 1950 and 1960. In 1948, veteran services and benefits of the Federal government totaled $7,500 million; it is expected that this amount will be reduced substantially in the near future. It is doubtful that this reduction

TABLE 1–3. Estimated Veterans' Expenditures in 1950 and 1960
(In millions of dollars at 1940 prices)

Class	1950		1960	
	Minimum	Maximum	Minimum	Maximum
Total	1,930	2,430	2,130	2,730
Pensions	1,310	1,768	1,548	2,148
Veterans' insurance.	115		205	
Hospitalization	151		219	
Education and training	200	242	—	—
Administration and other	154		158	

Source: J. P. Dewhurst and associates, *America's Needs and Resources* (New York, Twentieth Century Fund, 1947), p. 483.

will become an actuality if a serious economic recession should set in.

Individuals from the various income levels are veterans in approximately the same proportion as they are of the total population. Therefore, expenditure made to veterans will have the tendency to decrease the income of the upper-income receivers and increase the income of lower-income receivers. This is the reverse of the effect of interest expenditure. If the Federal revenue system remains as progressive as in 1948, veteran expenditure will tend to equalize the income distribution of the nation.

National-defense expenditure has decreased rapidly since the cessation of hostilities in 1945. National-defense expenditure during 1947 totaled $14,451 million and by 1948 had been reduced to $10,401 million. The expenditure in 1949 will be greater than that of 1948. It appears that national-defense expenditure will remain at a much higher level than during the period between World War I and World War II, when it averaged less than $1,000 million annually. A tenfold increase in national-defense expenditure is so great that it will noticeably reduce the total quantity of goods and services available for private consumption. However, national-defense expenditure will have little effect on the distribution of income among the citizens of the nation.

The expenditure for international affairs and finance has expanded tremendously in the postwar period since 1945. The period immediately after World War I was also one of international government expenditure, although at that time it was called international lending. The loans made at that time after negotiated reductions totaled $11.6 billion; accumulated interest has increased them to about $15 billion. In 1933, the Federal government formed the Export-Import Bank to extend international loans. Loans outstanding of the Bank total less than $2,000 million. Early in the summer of 1946, a loan of $3,750 million was granted by the United States to Great Britain. The Greek-Turkish Aid Act of 1947 provided an expenditure of about $400 million in 1948 and 1949. The Economic Co-operation Act adopted by Congress in the spring of 1948, together with similar subsequent legislation, will require expenditures to a total of $7,354 million in 1949. This type of an expenditure tends to raise prices very quickly. The quantity of goods has been de-

creased and the quantity of purchasing power available for expenditure has been increased. During the middle 1930's, the large importations of gold into the United States, in exchange for goods exported, had a similar effect on prices. The difference which made the latter policy more desirable was that prices were too low during the 1930's and an increase was desirable, while in postwar United States prices are already too high.

In addition to the expansion of Federal expenditures that has arisen directly from World War II, an expansion has also taken place in the provision of highways, airports, education, and housing. Federal aid in the provision of these facilities is becoming increasingly important. The development has taken place because of (1) the proven superior efficiency of the Federal government in collecting revenues and (2) the desire to provide more nearly uniform facilities throughout the nation. The fiscal activities of the Federal government in the post-World War II period will be even more dominant than they were after the great expansion of the 1930's. Federal expenditure has proved to be like a snowball; each increase provides the basis for greater additional increases in the future.

MEANING OF TERMS

In fiscal-policy analysis and description, economic terms and concepts are used. Although the meaning of these terms is generally understood, it is necessary to define them more precisely in analyzing possible fiscal-policy activities. These terms are: full employment, oversaving, investment, consumption, deficit finance, multiplier and acceleration effects, consumption function, national income, and efficient resource utilization.

Full Employment

Full employment is usually considered only in relation to the employment of labor, and it is assumed that when labor is fully employed other resources are also completely utilized.* It is

* Joan Robinson, *Essays in the Theory of Employment* (London, Macmillan, 1937), p. 15: "Conditions of full employment obtain when no one employer can increase his staff without reducing the staff of some other employer."

usually justifiable to make this assumption, for the available supply of labor is the basic determiner of the quantity of production. The experience gained during World War II has emphasized this fact. Of course, it is quite possible that other productive resources—through patent regulations, monopoly control, or inefficient management—are not being fully utilized even though labor is being completely utilized. Despite the importance of these factors in certain instances, it is reasonably accurate to consider full employment of labor and maximum productive effort as being identical.

The concept of full employment excludes the requirement that the full abilities of the working population must be used. Also, full employment does not require that every person be employed for the accepted normal number of hours per week. The conditions of full employment can be met even though a portion of the laborers able and willing to work at the prevailing wage scale and working conditions are temporarily unable to find employment. This latter type of underutilization of labor resources is frequently called frictional unemployment.

Frictional unemployment arises from labor turnover—that is, laborers temporarily out of employment while moving from one job to another. The term perhaps can be broadened sufficiently to include laborers being trained for a new type of job and those seasonally unemployed. Thus, in an economy as large as that of the United States, the conditions necessary to meet the requirements of full employment would exist with two to three million laborers temporarily unemployed.

The term "disguised unemployment" is used to refer to laborers that are employed but are engaged in activities that are generally recognized as being unproductive or are engaged in duties below their abilities.* The mass armies of Western Europe and China are excellent examples of disguised unemployment. Disguised unemployment frequently arises from the political necessity of providing work for all or at least for the vast majority of the able-bodied men and women of the nation. In the United States, there was a type of disguised unemployment in addition to reported statistical unemployment during the depression of the

* J. Robinson, *Essays in the Theory of Employment*, pp. 82–101.

1930's. This arose from the employment of highly trained men in positions far below those that they were capable of filling.*

The provision of full employment has become closely associated with a high standard of living. The attainment of full employment has been frequently advocated as the most important economic goal.

The analyses of the preceding paragraphs indicate the weakness of the term as an economic concept. The maintenance of full employment with a large amount of disguised unemployment does not mean that the quantity of enjoyable goods and services is maximized. Actually, the term "full employment" is much more meaningful as propaganda, than as an economic, goal. The shortcomings of the term were indicated during the Congressional hearings of 1946.† The legislation finally passed provides the executive branch of the Federal government with sufficient economic information to enable it to pursue a policy aimed at full employment.

Investment

Investment activity is carried on by both the private and the public economy. Investment as a fiscal-policy concept is concerned largely with factors determining size of private investment and economic effects of public investment.

Investment, in the private economy, means the purchase of newly produced buildings, machines, inventories, residences, and the net foreign balance. These are capital goods which increase production or discharge utilities over a rather long period of time. The term "net foreign balance" refers to the amount that foreigners buy in this country over the amount that we buy in foreign countries. This latter type of investment was formerly made nearly entirely within the private economy, but during the middle 1940's it has been largely a public activity, and in addition in 1948 it meets few of the requirements of an investment—for example, the Economic Co-operation Act. Also during World War II many additional factories and other productive facilities

* An excellent discussion of the nature of unemployment is in the *Monthly Labor Review*, vol. 64, no. 1, January, 1947, pp. 1–10.

† See the discussion of full-employment legislation on pp. 187–193.

were financed by the public economy. The development of public-housing programs and government lending for residence construction is another example of the expansion of the public economy into areas of private investment.

Public investment, as shown above, can be and often is of the same type as private investment. In addition, public investment includes expenditures for highways, public buildings, dams, and the like, which are seldom purchased by members of the private economy. Sometimes other government expenditures—such as those for battleships, education, and health—are also considered investment expenditures. The justification for including a battleship is that it is certainly a good which will be used over a period of time. The justification for including education and health expenditures is that they certainly increase productivity over a period of time.

A private investment is made because of expected future returns over the cost of investment. Public investment is, or under ideal conditions would be, determined by the social values expected to arise from using funds in that particular way rather than in some other manner.

The term "investment" is not used here to refer to the purchase of securities or the purchase of homes or productive facilities which have already been produced. This type of investment is called financial investment; it does not lead to an increase of production but merely means that the bank account of one person has been increased and that of another reduced. Under certain circumstances—for example, if the security were owned by a commercial bank and the new owner were a private individual—the account of the purchaser is reduced but a compensating increase in the account of the seller does not take place.

Consumption

The meaning of the term "consumption" has been partly developed in our definition of investment. The purchases which are not investments are consumption expenditures. Consumption, defined in a positive fashion, is the use of economic resources by ultimate consumers.

The use of resources in consumption can take place in a number

of ways. The resources can be utilized through the market as purchasable goods and services. The resources can be utilized in the home through self-production and consumption. Or consumption can arise through the medium of government provision of goods and services.

Consumption through the medium of government provision or public consumption varies from consumption through the market place or private consumption. The variation arises principally from the way that the quantity and the manner of resource consumption is determined. If consumption is determined by the market place, each consumer has as many votes as dollars (units of purchasing power); if determined through government action, each consumer has his own vote and as many votes as there are other individuals also desiring that type of consumption. Thus resource use in the private economy will be determined to a great extent by the *number of dollars* favoring a type of consumption, while government consumption will be determined by the *number of individuals* favoring a certain type of consumption.

Oversaving

The goals of fiscal policy are closely related to the economic concept of oversaving that has been developed since J. M. Keynes' *The General Theory of Employment, Interest, and Money.* Although the idea of oversaving—merely too much saving—is simple, the measurement of oversaving is so complicated that it requires more economic data than are available. The problem of determining the quantity of oversaving is closely related to the general problem of money flow.* Stated differently, oversaving exists when savings arising from a given level of income are greater than investment expenditure.

The problem of oversaving lies in the flow of money payments becoming inadequate to maintain an existing level of economic activity. At first glance, all saving may appear as money not spent for goods or services; however, on closer examination, it is seen

* By money flow is meant "who has paid and who has received how much on account of various types of transactions or objects of payments." From "Tracing Money Flow through the United States Economy," by Morris A. Copeland, in the *American Economic Review*, vol. 36, no. 2, 1946, p. 31.

that savings are often spent for goods and services used for production purposes rather than consumption. Oversaving arises when there is a greater quantity of money *not* spent on consumption goods than *is* spent on investment goods—that is, more is saved than is invested. This relationship brings about a reduction in the money flow and a consequent decrease in economic activity. On occasion, the amount of savings not spent on new investment goods has been called hoarding.

The requirement in a dynamic economy is not, however, just the maintenance of a particular size of income flow. The flow must be constantly expanding. This expansion of the size of the flow is necessary if the ever increasing quantity of goods and services is not to be sold at continually lower prices. A socialistic economy might be able to endure continually falling prices, but a capitalistic economy certainly cannot. The problem of a desirable quantity of saving is really nothing more than maintaining the proper-sized income stream and also providing for any desired expansion.

The quantity of the money flow is determined by the amount of money and its velocity. If there is no reason to expect an increase in speed of money flow, it is necessary to have an increase in the quantity of money.* In the past, the increase in money has taken place largely through investment that was in excess of voluntary savings.† If savings available for investment are as great as the need for investment, this method of bringing about the expansion of money flow has been destroyed. Thus oversaving may in many instances be nothing more than the elimination of the shortage of voluntary saving which existed in the past. This shortage made necessary a desirable increase in the quantity of money through expansion of bank deposits. Oversaving, then, has become the term used to express an inadequate flow of money income, and the concept includes in addition an explanation of why this flow is inadequate. It is also quite possible that over-

* An increase in the flow of a liquid can be accomplished by increasing the size of the pipe or increasing the pressure. Similarly, the quantity of money flow can be expanded by an increase in velocity of money turnover or amount of money.

† Voluntary saving refers to income received but not spent for consumption. Forced saving is the bidding of factors away from consumption good production by increasing the quantity of money.

saving may arise from a decrease in speed of money flow as well as a decrease in the quantity of money; in fact, the former is the way in which it first appears.*

The acts of saving and investing usually take more time than the single act of spending for consumption. Even if every dollar saved is immediately set aside for the purchase of capital goods, the machinery of saving and spending is slower than that of merely spending. The same applies to taxes collected, unless expenditures are made in anticipation of tax receipts.

A result of a large quantity of voluntary saving is that investments can be made without any increase in the quantity of money, or with a smaller increase than would otherwise be necessary. For this reason, voluntary saving makes investment possible without the danger of inflation. Also, savings may produce conditions of deflation. The amount of savings is correct if the money flow with the existing quantity of saving is of the correct amount to maintain what is generally considered a desirable level of economic activity. If the savings are insufficient, inflationary tendencies will develop.

Logically, emphasis regarding the cause of insufficient money flow could be changed and placed upon consumption or upon the institutions having the power to increase the quantity of money. However, the emphasis has been placed upon savings and investment. This has been true because it has been the change in the relationship between these two economic phenomena that has created the new problems regarding the maintenance of an adequate flow of money. Another reason for this is that our economy is business directed. The decision to invest is determined by profit possibilities, and the persons who do the saving also do the investing and receive the profits.†

* Actually a common definition of saving is that it is that part of disposable income (earned yesterday but disposed of today) that is not spent on consumption.

† Oversaving is related to investment opportunities. The reduction of investment opportunities is related to the concept of the mature economy. See George Terborgh, *The Bogey of Economic Maturity* (Chicago, Machinery and Allied Products Institute, 1945) and Alvin H. Hansen, *Full Recovery or Stagnation* (New York, Norton, 1938).

Deficit Finance

Deficit finance is frequently used when referring to government fiscal activity related to the provision of full employment. The term means that the government obtains an important portion of its revenues by borrowing from individuals and commercial banks. When the government enters into borrowing activities, the budget is said to be unbalanced. What is meant is that the budget does not provide for tax receipts equal to expenditures. If the government obtains its revenues from borrowing, it is likely to bring about an increase in the effective demand for goods and services—that is, aggregate demand. This increase arises because the government has an additional quantity of money to spend but the quantity of money spent by individuals is not necessarily reduced. The borrowing of money from individuals often means that savings that would otherwise be idle, and thus bring about unemployment, are now used by the government and full employment is maintained. The refusal of the private economy to go into debt makes it necessary for the public economy to increase its debt—practice deficit finance—if deflation is to be prevented.

Deficit finance has been used by governments for many years in the financing of wars. However, it was considered an undesirable emergency measure that should not be resorted to unless the nation was in danger of being conquered by a foreign enemy. During the period of the 1930's, the obtaining of government revenues in this manner was seen to be a weapon that could be used to fight the internal enemy of depression and unemployment. It is in this second use that deficit financing is discussed in this section.

The Multiplier and Acceleration Effects and the Consumption Function

The multiplier, as used in fiscal policy analysis, relates to the increase in private consumption expenditures which arises from an increase in government expenditure. It is usually assumed that the government expenditure is made in the provision of additional capital goods—for example, a public-works expenditure. The concept of the multiplier is only concerned with the increase in

consumption expenditure that arises when the original government investment becomes income to individuals in the form of wages, profits, or interest. The portions of the original government expenditure which are drained off in savings and idle holdings of cash do not become a consumption expenditure and are called leakages.* The concept of the multiplier includes not only the original increase in private consumption expenditure that arises from the government investment but also the total increase in private consumption arising from the government investment. The additional leakages at each stage reduce the quantity of private consumption-expenditure increase. The multiplier is said to be infinite if the leakages are zero, or if none of the income is saved, and one if 100 per cent of the government expenditure is saved. If the multiplier is assumed to be between two and three, the disposable income of individuals within a rather short period would increase by two or three times the government expenditure. This phenomenon is just as true of private investment activity as it is of government investment activity.

The accelerator principle is used in fiscal policy to describe the induced investment that arises from increased consumption expenditure. Thus the full effect of an additional government investment expenditure includes both the multiplier and accelerator effects.† The addition to national income that is provided by the accelerator leverage is determined by the relatively large expansion in investment that may arise from an expansion of consumption. This bunching of investment caused by the acceleration principle arises because a small expansion of consumption will bring about an immediate demand for a number of new machines. This will be the period of boom. However, if consumption does not continue to expand, the number of new machines demanded and produced will decline quickly. This will be the period of depression.

The accelerator will have an important effect if the industries producing consumer goods are operating at capacity when the

* For a good analysis and description of different kinds of leakages, see Henry Hilgard Villard's *Deficit Spending and the National Income* (New York, Farrar & Rinehart, 1941), pp. 238–257.

† Alvin H. Hansen, *Fiscal Policy and Business Cycles* (New York, Norton, 1941) and Gottfried Haberler, *Prosperity and Depression* (Geneva, League of Nations, 1940).

increase in demand arises.* Under these conditions, immediate orders for new machines must be placed to meet the demand. Also, the accelerator action will be more important if businessmen think the increase in demand for their goods will be maintained and may expand in the future.

The concept of propensity to consume, or the consumption function, refers to the portion of the income of an individual or an income group that is spent for consumption purposes. Keynes concluded that as the income of a community increased and decreased the amount of consumption also increased and decreased, but not as rapidly.† This relationship existed in the United States until the post-World War II period, when private savings decreased despite an expansion of income.‡ The propensity to consume is high if a large portion of income is spent on consumption and a small amount saved or invested. It is low if the reverse is the situation. The propensity to consume is high if the annual income of the individual or income group is low and low if the annual income is high. The portion of a particular level of income that will be consumed is considered to be constant.§ If the propensity to consume of the different income levels is constant, (1) it becomes possible to forecast the multiplier effect of particular expenditures, and (2) it becomes possible to estimate the quantity of savings that would arise from different levels of national income with a certain type of income distribution.|| The general formula for calculating the multiplier from the marginal propensity to consume is:

$$\text{multiplier} = \frac{1}{1 - \text{marginal propensity to consume}}.$$

* The acceleration of investment in the United States arises when the Federal Reserve Board Index to production capacity approaches 0.85, disappears when it drops to 0.80.

† John Maynard Keynes, *The General Theory of Employment, Interest, and Money* (New York, Harcourt, Brace, 1936), p. 114.

‡ In 1946, personal income was $177.2 billion and personal savings were $14.8 billion. In 1947, personal income increased to $196.8 billion but personal savings decreased to $10.9 billion.

§ Keynes corrects for the secular drift and thereby provides a constant consumption function over time by stating his consumption function in terms of wage units. The use of wage units largely corrects for price and productivity changes.

|| The marginal propensity to consume determines the multiplier. "If the

The multiplier is the reciprocal of the fraction that expresses the proportion of any given income increase that people consume at a given rate of interest.

National Income

The term "national income" is used very frequently and has become the basis for the formulation of most economic plans. Although the term is now very common, its accurate measurement in the United States started in 1929 and the national income data of most nations are still not much more than informed guesses. In those countries where data for accurate measurement are available, disagreements still continue regarding the inclusion of particular items in the total—for example, the concept of national income used by the United States Department of Commerce has been recently revised upward by the inclusion of imputed rent of owner-occupied dwellings and corporate profits prior to payment of corporate-profit taxes.*

There are a number of terms which relate to the income of the nation. Briefly, the more common terms and their definitions are as follows:

National income is the aggregate earnings of labor and property that arise from the current production of goods and services by the nation's economy. Thus it measures the total factor costs of the goods and services produced by the economy. Earnings are recorded in the forms in which they accrue to residents of the nation, inclusive of taxes on those earnings. As such, they consist of the compensation of employees, the profits of corporate and unincorporated enterprises, net interest, and the rental income flowing to persons.

Gross national product or expenditure is the market value of the output of goods and services produced by the nation's

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consumption psychology of the community is such that they will choose to consume, e.g., nine-tenths of an increment of income, then the multiplier is 10; and the total employment caused by (e.g.) increased public works will be ten times the primary employment provided by the public works themselves. . . ." J. M. Keynes, *The General Theory of Employment, Interest, and Money*, pp. 116–117.

* See *Federal Reserve Bulletin*, Sept., 1947, vol. 33, no. 9, pp. 1105–1114, for excellent brief discussion of national income and product statistics.

economy, before deduction of depreciation charges and other allowances for business and institutional consumption of durable capital goods. The nation's economy in this context refers to the labor and property supplied by residents of the nation. Gross national product comprises the purchases of goods and services by consumers and government, gross private domestic investment, and net foreign investment.

Net national product or expenditure comprises the purchases of goods and services by consumers and government, net private domestic investments, and net foreign investment.

Personal income is measured as the sum of wage and salary receipts, other labor income, proprietors' and rental income, interest and dividends, and transfer payments.

Disposable income is the income remaining to persons after deductions of personal tax and other payments to general government.

Efficient Resource Utilization

The efficient use of resources is their use in the fashion that will maximize the quantity of net utilities and also their use by the user offering the highest price. In economic theory, it has usually been assumed that the use of resources in the manner dictated by price relationships will also maximize the net utilities that could be obtained by the production of goods and services with the available resources. Public finance does not provide for the allocation of resources in any manner other than that dictated by the price relationships. Rather, the old price relationships are changed by changing the distribution of income through the collection of taxes and borrowing, by direct purchasing of goods and services by the government, and by affecting the quantity of monopoly in the private economy.

If the assumption is made that any distribution of income other than that determined in the traditional market place decreases the efficiency of resource allocation, then all activities of the public economy reduce the efficiency of resource allocation. However, in order to accept this assumption it is necessary to admit that the distribution of income indicated by Table 1–4 (p. 35) provides the consumption demand that would bring about the most efficient

TABLE 1–4. Aggregate income and savings of United States consumers,* by 15 income levels, 1935–1936.

Income level	Number of families and single individuals	Aggregate income (millions)	Savings		
			Amount (millions)	Per cent of income	Per cent of total savings
Under $500	6,710,911	$ 2,061	$–800	–38.8	–13.4
$500–$750	5,771,960	3,615	–382	–10.5	–6.4
$750–$1,000	5,876,078	5,130	–254	–4.9	–4.3
$1,000–$1,250	4,990,995	5,589	–97	–1.7	–1.6
$1,250–$1,500	3,743,428	5,109	95	1.9	1.6
$1,500–$1,750	2,889,904	4,661	196	4.2	3.3
$1,750–$2,000	2,296,022	4,214	245	5.8	4.1
$2,000–$2,500	2,958,611	6,572	587	8.9	9.8
$2,500–$3,000	1,475,474	4,005	482	12.0	8.1
$3,000–$4,000	1,354,078	4,599	742	16.1	12.4
$4,000–$5,000	464,191	2,045	434	21.2	7.2
$5,000–$10,000	595,908	4,092	1,218	29.8	20.4
$10,000–$15,000	152,682	1,747	679	38.9	11.4
$15,000–$20,000	67,923	1,175	473	40.2	7.9
$20,000 and over	110,135	4,645	2,360	50.8	39.5
All levels	39,458,300	59,259	5,978	10.1	100.0

* Includes all families and single individuals but excludes residents in institutional groups.

Source: National Resources Committee, *Consumer Expenditures in the United States, 1935–36* (Washington, 1939), table 8, p. 48. Taken from Temporary National Economic Committee, Monograph No. 37, *Saving, Investment, and National Income,* by Oscar L. Altman, p. 17.

use of the nation's resources. This could be assumed only if it is believed that the additional desire to work arising from poverty combined with very high prizes for success increases productivity more than poverty and idleness of the rich reduces production efficiency. In addition, the increased utility obtained by making available additional units of goods and services to those in the lower income brackets must be assumed to be not much greater than the utility obtained by making available similar quantities of goods and services to high-income receivers. The writer does not believe these assumptions can be made.

The determination of the most efficient utilization of resources is necessarily a combination of uses in the manner that maximizes

quantity of goods and services and net utilities. It is not impossible to arrive at rather definite conclusions of the manner of resource use that will maximize the quantity of goods and services, but the determination of the quantities of particular goods and services that will maximize net utilities is quite another thing. The assumptions made when national income data are compared to determine utilization of resources from one period to another are that techniques have remained constant and that the relative prices placed upon different goods and services correctly determine value of the good or service to the nation. The value placed upon different goods and services is largely determined by income distribution; and, with the very unequal income distribution existing in the United States, it is very doubtful that relative prices correctly measure relative values.

Fiscal policy, by the provision of incentives through public expenditures aimed at greater human efficiency and through the prevention of unemployment, can become an important element in the provision of production efficiency. Each of the goals of fiscal policy must be judged on the basis of whether its attainment will enhance the use of resources. The fiscal-policy goals analyzed in the following chapters were selected largely because they are believed to be the most vital in their effects on the maximization of resource utilization.

CONCLUSION

The governments of the United States and the world have always, by fiscal action, affected the quantity and type of economic activity. In many cases the effect was opposite from that which would have been desirable for the advancement of the general welfare of the nation. Too often in the past the fiscal action was determined by small pressure groups, with the legislative bodies and general population both apathetic and ignorant of the probable results of the action.

The increased relative importance of government expenditure and money-raising activities necessitates that fiscal policies be determined under the bright light of public scrutiny and that the average citizen be aware of the probable effects of different procedures. The fiscal activities in the United States during the

quarter of a century 1923–1948, which have been briefly outlined in this chapter, are excellent testimony to the undesirableness of fiscal action adopted when policy is not determined on the basis of the results of fundamental economic research made available to legislative bodies and the general citizenry.

QUESTIONS AND PROBLEMS

1. Define fiscal policy; by the use of examples differentiate between fiscal policy and monetary policy. What are some of the difficulties related to separation of fiscal and monetary policy?
2. Compare the fiscal developments of the post-World War I period with those of the post-World War II period.
3. What is the relative size of the public economy? How has the growth of the public economy affected fiscal policy?
4. Why were the fiscal activities of the Federal government during the 1920's important in determining fiscal activities of the Federal government during the 1930's?
5. Give the principal causes of the growth of government expenditures during the post-World War II period. What do you think will be the trend of government expenditures during the next twenty years? What types of expenditures will show the greatest change? Why?
6. A decrease of government expenditure and a sales tax were advocated by the experts of the Treasury in January, 1933. Why, in your opinion?
7. Define full employment. Why might a government be tempted to disguise unemployment as employment? How can you tell if disguised unemployment exists? Why is the determination important?
8. Define oversaving. Can you think of any reasons why the problem of oversaving became important during the 1920's? Why didn't businessmen and economists in the 1920's realize that savings were too great, and realizing this, put into effect fiscal policies that would reduce savings?
9. Show how the concepts of oversaving, investment, and consumption are related. Which of the three do you think is most basic? Why?
10. What is the relationship between the consumption function and the multiplier? Why is it important to know the size of the multiplier?

CHAPTER 2

What Modern Fiscal Policy Includes

FISCAL POLICY AND PUBLIC-FINANCE CONCEPTS

The Laissez-Faire Attitude toward Public Finance

Those who believe in a minimum of government activity in the economy consider government fiscal activity as worsening economic conditions rather than bettering them. This attitude is based upon the idea that the removal of the basic causes of the difficulty is prevented by fiscal intervention of the government. For example, government coddling is considered to make the depression continue and become worse, because the economy is not permitted to arrive freely at an equilibrium from which sound recovery could start. The exception to the general opposition toward government fiscal activity of the laissez-faire economists is that the flexibility of economic life and freedom of movement of the factors of production should be encouraged.* This attitude toward government fiscal activity is completely out of touch with

* The New Deal as a conscious and deliberate matter began in 1924 under the Coolidge administration. See "The Road Back to Full Employment," by Benjamin M. Anderson, in *Financing American Prosperity,* edited by Paul T. Homan and Fritz Machlup (New York, Twentieth Century Fund, 1945).

the realities of the world in which we live. Government expenditures and taxes aimed at breaking up the inflexibilities arising from modern technological methods would be a waste of government funds and, in addition, would destroy the efficiency of the private economy. The business of government in the foreseeable future will be to control and increase the efficiency of huge concentrations of capital and great labor organizations, and not to tear them into parts.

The Interventionist Attitude toward Public Finance

The interventionist believes that "the invisible hand" (the allocation of resources through prices determined in unregulated markets) of Adam Smith is inefficient and must be supplemented by government activity. The interventionist believes that sufficient economic data are now available and that the science of economics has developed to the point where it is possible actively to improve the economic conditions arising from the transactions in the market place. An important portion of these positive actions is the revenue-raising and revenue-expenditure activities of government.

Also, the interventionist does not believe that an activity should be carried on by the private economy merely because such has been the case in the past or because the relative size of the private economy should not be decreased. Rather, the determination of whether a particular type of activity should be carried on in the private economy or in the public economy must be based upon the relative efficiencies of the two economies. This sort of attitude has determined that valley developments such as Tennessee Valley Authority be made with public expenditures and that the atomic-energy development program remain a public activity. The traditional attitude that government should only perform the duties of a night watchman is completely abandoned.

Two Types of Government Fiscal Activity

All government fiscal activity affects the quantity of purchasing power available to the different portions of the private economy.*

* Potential purchasing power consists of current income received plus assets possessed. The portion of income and assets actually used to purchase goods and services is the purchasing power.

Also, all government fiscal activity affects the types of goods and services that will be consumed and produced. However, fiscal activity may be divided into two broad categories on the basis of the relative amount of voluntary fluctuation possible. The amount of voluntary fluctuation is important if government economic activity is expected to provide needed purchasing power when private economic activity begins to falter. Although the idea of public economic activity varying with fluctuations in the private economy possesses many undesirable features, it remains basic in the consideration of government fiscal action aimed at providing an efficient utilization of a nation's productive resources.

Expenditure for public works, farm relief, unemployment compensation, low-interest small security loans, and welfare are the principal types of government expenditures that can be rather readily varied depending on the amount of water the private economy is putting into the trough of total purchasing power. Government expenditure for courts, law enforcement, administration of legislation, interest on debt and war are examples of expenditures that cannot be readily varied. This type of division places international expenditure in a doubtful category. Experience in the middle 1940's seems to indicate that it is similar to war expenditure. International and war expenditures of the United States can be controlled only if we follow a conscious policy of aggression or if we refuse to be affected by developments in other nations. Neither of these possibilities appears very likely.

Government revenues can also be separated on the basis of their variation between periods of prosperity and depression. In the case of revenues, the flexibility arises largely from the difference in the variation of the size of the base upon which the tax is levied during periods of high income receipts and low income receipts. Tax collections based on profits vary greatly in what is usually considered a desirable manner, while tax collections based on real estate change very little. Also, taxes levied upon luxury items vary greatly, while taxes levied on necessities such as cigarettes, gasoline, and food change much less. The taxes that bring in large quantities of revenue during prosperity and small quantities during depression are generally considered to be the more desirable because they help to keep the water trough

of purchasing power full, when needed, and prevent it from overflowing, when that type of action is required.

The possibility of flexible government revenues is greatly affected by level of government. The Federal government can always borrow all the funds it requires. Therefore, it could greatly reduce its tax revenues without affecting expenditures. The state and local governments find it impossible to do this. As a result, the Federal government possesses much greater flexibility of revenue source. The state and local governments find it very difficult to borrow during the same period that members of the private economy find borrowing difficult. This is also the time when the water in the purchasing-power trough is getting low, but the state and local governments find it impossible to increase it by lowering their taxes and increasing their borrowings. However, this is exactly what the Federal government can do and did do during the 1930's.

All fiscal activity, and particularly fiscal activity which can be varied with the amount of private economic activity, is concerned with the determination of all fundamental economic relationships. The fundamental relationships of our economy can be stated in a number of ways, but the following four groups include most of the important economic relationships affecting efficiency of economic activity: (1) the values or prices of goods and services, (2) the portion of the income of the economy that is spent on consumption goods and services, (3) the degree of employment of labor, and (4) the manner in which the national income is distributed. The analysis of the effect of government revenues and expenditures upon these four relationships is the basis of the major portion of this book. They are discussed in relation to the effects upon them of (1) different methods of obtaining government revenue, (2) various government expenditures, and (3) administration techniques.

The Four Goals

Two legitimate questions arise at this point: (1) Why are these particular relationships related to fiscal activity? (2) Why are these particular relationships selected for discussion?

The first question can be answered satisfactorily very quickly. These concepts are related to the economic activity of the nation, and fiscal activity is such a large portion of the total that it necessarily affects any economic relationship. Total economic activity is affected by what happens to the various portions. The effect on all economic activity is certain to be great when the part that is concerned is approximately a quarter of the total. Because of this relative importance of fiscal activity, it is justifiable to assume that any economic relationship is related to fiscal activity.

The second question—Why are these particular relationships selected for discussion?—requires a much more detailed answer. In fact this chapter is principally concerned with pointing out the fundamental importance of the four relationships and determining the desirable level of each as an achievement goal of fiscal policy. At this time, therefore, only a brief answer that will serve as a frame of reference can be given.

The achievement of a *desirable price relationship* is given as the first goal of fiscal policy. In a market economy (and the economy of the United States is a market economy) the types of activities encouraged and the total quantity of economic activity are largely determined by prices. The all-powerful economic planner of a market economy is "price." If the planner "price" gives a nod of encouragement through a higher relative value stated in dollars, that type of activity expands; if the planner "price" disapproves through a lower relative value stated in dollars, the activity contracts.* If the planner "price" disapproves of all activity, the value of all activities as stated in number of dollars is reduced; approval of greater activity is shown by an increase in the general value as stated in number of dollars. This system of economic planning through prices breaks down when the planner "price" attempts to bring forth a general increase of activity, all the resources of the nation being already fully employed. The result of this attempt is inflation, and it may cause an actual decrease of productive activity. Certainly any effects of fiscal activity on prices are of paramount importance because of the central position occupied by prices.

* In the past, lower agriculture prices tended to increase quantity produced. Agriculture under the present government controls-and-subsidy program will react to price in a manner similar to other industries.

The achievement of a *desirable level of consumption* is the second given goal of fiscal policy. Consumption is frequently considered the end result of all economic activity. Also, it is frequently considered the cause of all economic activity. Whichever point of view is accepted, and they are actually very closely related, consumption is of prime importance in our economic system. The previous discussion of investment and saving also emphasized the dynamic part played by consumption in modern business-cycle analysis. Certainly any effect of fiscal activity on consumption levels is of paramount importance.

The achievement of a *desirable level of employment* is the third given goal of fiscal policy. The quantity of productive employment in a modern industrial nation largely determines the scale of living. Also, the development of unemployment in the past has created dissatisfaction with free enterprise and the market method of determining economic activity. As a result, a type of political totalitarianism has on occasion been adopted to control the economy in a way that is considered to be more democratic and efficient than that arising under free private enterprise dictated by the demands of the market. During the 1930's a large portion of the fiscal activities of all the great industrial nations of the world was directed toward the provision of a desirable level of employment. Also, most writers have analyzed fiscal activities on the basis of their effect upon employment.

The achievement of a *desirable distribution of income* is the fourth given goal of fiscal policy. This goal is much more fundamental than the other three. To a great extent, the efficiency of any economy is determined by the manner in which the fruits of that economy are divided. The income distribution existing in a market economy determines the manner in which the goods and services produced by that economy will be divided. The distribution existing is largely determined by the manner in which economic control is divided. It is still true, especially in the United States, that economic activity is controlled by those with investments in particular undertakings, and that investments are owned by those persons who have saved, and that savings are largely made by persons with high incomes. As a result, the type of income distribution is important in determining who will control the economy. Also, income distribution directly affects prices,

quantity of consumption, and quantity and stability of employment. There appears to be no more important economic goal than a desirable income distribution.

Because fiscal activities affect all aspects of daily life (economic, social, political, and technological), the goals of fiscal policy must be as numerous as the aims of all the various individuals and groups of the nation. Also, because the aims and desires of individuals and groups change, the goals of fiscal policy are also constantly changing. Apparently a very important aim of contemporary fiscal policy in the United States is to establish and maintain political democracy and capitalism in the countries of Western Europe. The effects of attempting to achieve this temporary fiscal goal are felt throughout the United States economy. However, the major economic effects of the goal will be reflected in price levels, consumption, employment, and income distribution.

Another goal of fiscal policy has been frequently related to an expansion of the birth rate existing in a nation. Before World War II, this expansion was a goal of Italian and German fiscal activity, and it remains a goal of British and French fiscal activity. The high personal exemptions allowed by the Federal income-tax law and the splitting of income between husband and wife are examples of the same aim in the United States. The goal in this case is largely achieved through income redistribution provided by reduced tax burdens and of subsidies and payment according to number of dependents. If all the various possible goals of fiscal policy are examined, it is seen that they are largely achieved through action on one or all of the four goals chosen for the core of the analyses of this book.

The Keynesian Revolution

The important variation that has developed in the understanding of fiscal activities is that government revenue-raising activities and expenditures are regarded in relation to the above or very similar goals of fiscal policy. Prior to the development of fiscal policy, taxes and expenditures were largely made in a manner that was expected to have the least possible effect on general economic activity, with some consideration given to effect

on investment. The important consideration was that the administration cost should be low. In addition, since the 1930's, these identical activities have been determined in relation to their effect on prices, consumption, employment, income distribution, and allied economic relationships. Another example is the close relation between fiscal activities of the Federal government during World War II and the reduction of prices, consumption, and the efficient allocation of labor and raw materials.

The idea that government could and should influence the prices of goods and services, the amount of consumption, the degree of employment, and income distribution—through its collection of taxes, borrowing, and purchase and sale of commodities and labor—has been rather generally accepted since the depression of the 1930's. The importance of government fiscal activity in accomplishing these goals was a result of J. M. Keynes (1883-1946) and his pioneer work, *The General Theory of Employment, Interest, and Money.* The emphasis that Keynes placed upon fiscal policy is so important that the changed attitude toward government fiscal activity previously referred to is sometimes called the Keynesian revolution.

It is not difficult to see the more obvious reasons why fiscal policy is assigned an important role in the determination of prices, consumption, employment, and income distribution.

Prior to the depression of the 1930's and the book by the late J. M. Keynes, most economists, statesmen, and business leaders accepted without much question the conclusions of the economic writings of the great classical economists (David Ricardo 1772–1823; John Stuart Mill, 1806–1873; and Alfred Marshall, 1842–1924) that labor would be continually fully employed and that the techniques and natural resources of the nation would be used in the most efficient manner. The depression of the 1930's showed that this adjustment did not automatically take place. The experiences of the same period showed that the controls assigned to the central banking systems, largely related to interest-rate determination, of the leading nations were not adequate to bring about this most efficient adjustment.* It was, therefore, a very natural result that fiscal policy should be considered as a method of making the required adjustment.

* See p. 46 for brief list of powers of central banking systems.

The effectiveness of fiscal powers in accomplishing a desired aim is greatly implemented if the government's monetary powers and administrative powers are adequate and are co-ordinated with the manner in which the fiscal tools are being used.

Other Government Economic Powers

Monetary Powers

Monetary powers determine the government's ability to control the flow and quantity of money and credit. This power can affect the direction in which the economy will move and the level of economic activity. These ends are also primary goals of fiscal policy.

The conventional tools available to the Federal government, within the framework of the term "monetary policy," are the powers possessed by the Federal Reserve System (the central bank of the United States) and the Treasury to vary the quantity of money. The Federal Reserve System can affect the flow and the quantity of money and credit by (1) open market operations, (2) changing legal reserve requirements, (3) changing the rate of interest that it charges, (4) changing the restrictions on installment purchases, and (5) moral suasion. Nevertheless, in the past the Federal Reserve System has been unable either to decrease or increase money and credit at times when it was generally agreed that it would be desirable to do so if monetary policy were to accomplish the goals set down for it. Failure to *decrease* money and credit has stemmed usually from political influence; inability to *increase* the quantity of money and credit has been due usually to the lack of response in a relatively free or unplanned market economy.

The actions of the Treasury have been largely passive. At times, particular pieces of legislation have made it possible for the Treasury to pursue an active monetary policy—for example, the provision for the gold stabilization fund in the 1930's and the power to sterilize gold imports; usually, however, Treasury policy-making activity related to quantity of money has been fiscal rather than monetary in its nature.

The Federal government through its fiscal tools—its methods of raising revenue and its expenditures—also affects quantity and

flow of money and credit. The ability of governments to do the same thing more indirectly is included within modern monetary powers and is usually accomplished through the banking system. This overlapping of the type of activity included in the meaning of the terms "monetary policy" and "fiscal policy" means that some of the relationships discussed in public finance under fiscal policy would also be discussed in money and banking under monetary policy. For example, the term "monetary policy" is perhaps best suited to include government debt transactions. Nevertheless, because government capital-account activities are always so closely related to current expenditures and receipts, it becomes in practice very difficult to analyze separately capital and current transactions; for this reason, fiscal policy is more frequently used than monetary policy to include an analysis of government debt transactions. Basically, obtaining money by borrowing is just another source of government revenue.*

Police Powers

The state through its police powers can negatively control directly and completely all economic activity through prohibition. During World War II the control of the economy was largely accomplished through the use of police powers. The prevention of inflation and the stimulation of the production of certain goods was to a great extent accomplished by the police powers possessed by the Office of Price Administration and the various agencies controlling raw materials. The ability of the government to raise taxes and to assure the acceptability of money is determined by the effectiveness of its police power. If the Bureau of Internal Revenue did not have the ability and power to arrest and fine persons who violated the Federal income-, estate-, and gift-tax legislation, the laws providing for these taxes would mean very little. Also, it is by the use of its police powers that a government makes certain pieces of metal and paper legal tender, and it is by their use that it compels banks to keep certain quantities of reserves, and so forth.

* "Compulsory lending would have immobilized spending power as effectively as taxes, would have been more equitable, and also would have protected work incentives better than taxes." Speech by Louis Shere, Director of Tax Research, U. S. Treasury, given April 15, 1948, before Graduate Economics Club, Yale University.

The fiscal policy and to a considerable extent the monetary policy of the nation are further reduced in effectiveness by the inadequacy of the police powers. A state is often unable to co-ordinate its fiscal, monetary, and police powers in a manner that could bring about desirable economic relationships. There are perhaps not more than ten countries that can utilize these powers in a manner that will bring about tolerably efficient control of economic activities. Post-World War II experience has shown that even in the United States an emergency is required for their effective use.

PRICES

General Price Level

Fiscal activity can change the relationship between the quantity of purchasing power and the quantity of goods and can thus change the general level of prices. Fiscal activity can also change the relative prices of different goods and services and affect the quantity of particular goods and services produced and the manner of resource utilization.

The maintenance of a desirable general level of prices means, in a capitalistic system, that prices must not fall so much that debt burdens are greatly increased or inventories greatly decreased in value, and that prices must not rise so much that fixed incomes are greatly decreased in value or that a general hoarding of goods exists. The general level of prices is, of course, also greatly affected by monetary policy. However, it has usually been monetary activity dictated by fiscal requirements that has brought about a major change in the general price level.

A large portion of the economic difficulties of the 1930's arose from the severe fall in the general level of prices. The debt of agriculture became particularly burdensome as a result of sharp price declines. The sharp decline in inventory values that arose from the sharp fall of general prices also contributed to the intensification of the depression of the 1930's. The sharp rise of general prices during both world wars brought forth maladjustments in economic planning and income distribution and later caused serious economic problems.

The data of personal holdings of liquid savings of 1945 and 1946 presented on page 66 and the data of Federal savings bonds in

1946 and 1947 given on page 128 show the effects of personal reserves of the very great increase in the general level of prices during the postwar period. The decrease of these liquid reserves has reduced the ability of the people of the nation to purchase the goods and services produced at a most efficient level of production. The general level of prices best serves the needs of a capitalistic society if it is rising slowly; fiscal activities can and should be utilized to attain this ideal.

The stability of general prices is associated with economic stability. The most common test of the degree of economic stability is price movements. However, stable prices are largely the result of stable economic relationships and not the cause. Thus fiscal activities, to the extent that they maintain desirable economic conditions, have contributed to price stability. Also, fiscal activities can be used directly to affect certain crucial prices in a manner that will aid in preserving economic stability in a free-enterprise society.

Either by a general rise (inflation) or by a general fall (deflation), prices can have a tremendous effect on the economy; that is, in addition to their function of allocating resources. The desirability of economic stability has always been recognized. However, the agreement has not been complete; there have been some that have considered violent price fluctuations desirable. This latter group believes that instability and insecurity provide a major portion of the basis for the progressive nature of our culture.

The theory of boom (inflation) and bust (deflation) determined government fiscal policy prior to the 1930's. It was assumed that the government could do little to prevent high prices and could do even less to prevent low prices. This meant that the government could do little to prevent the great economic wastes and maladjustments arising out of inflation and deflation. In fact, the theory was that the inefficiencies arising from great price fluctuations were less than those to be expected if prices remained stable. The arguments (shake-out necessary to eliminate inefficient firms, high prices necessary to eliminate surplus of money, and so on) presented in 1946 for the removal of price controls are evidences that the boom-and-bust theory is far from dead in the United States.

Particular Prices

The relative price obtained by an industry or a particular producer is affected by (1) the price that possible users of the product are able to obtain for the resources they possess, which is greatly affected by income distribution, and (2) the degree of bargaining advantage or monopoly possessed.

An increase in demand caused by change of income distribution would increase prices under either competitive or monopoly conditions. The increase in the demand for certain types of products and services caused by a change in income distribution brings about a transfer of resources through relative prices.

The manner of use of the resources of a capitalistic nation is determined largely by relative prices. If the price that can be obtained for the goods or services of a certain type of activity is high in relation to another type of activity, the first type of activity will be greatly encouraged and the resources of the nation will flow in that direction. For example, if the price that can be obtained for resort hotels in Florida is high and the price that can be obtained for worker's cottages is small, building materials will flow toward and be used in the construction of Florida hotels and not of worker's cottages. The use of resources in a capitalistic economy is determined to be most efficient if used in the manner dictated by relative prices. Although in many instances relative prices do not bring about the most efficient use of a resource, neither does the alternative of rationing and price controls, as an abundance of experience after World War II proved. In addition, rationing and price controls utilize a large quantity of resources in their administration. To the extent that fiscal activities can control prices so that prices do a better job of allocating resources, fiscal policy has eliminated a weakness of the price system and the apparent necessary inefficiencies of an administrated economy.

In a capitalistic economy, prices determine the relative portion of the national income received by the different factors of production. The price that a laborer obtains for his services determines his income and the portion of the national product that he can command. The same is true of the capitalist and the entrepreneur. By determining the portion of total income going to different

groups, these same prices also largely determine the general types of goods that will be produced.

If the price obtained by labor is relatively high, the portion of productive facilities used to produce consumer goods will be increased. In the past, this relation has usually been characteristic of a depression period. If the return of the capitalist and entrepreneur is relatively great, the production of producer goods will expand. In the past, this has usually been a prosperity period. Desirable price relationships would exist if the prices obtained by the two groups were such as to provide a stable relative distribution of productive factors.

The prices paid for different products will also have a great effect on the manner in which natural resources—such as fertility and mineral deposits—are utilized. The determination of prices that will prevent the waste of natural resources would be another advance in the provision of more goods and services.

Public finance activities can directly determine particular prices by relative tax burdens and the payment of subsidies. The levy of taxes can discourage the production of certain goods and, as a result, tend to influence the flow of resources toward the production of other goods bearing a lighter tax burden.

Relative prices of particular groups of goods determine the prosperity and efficiency of the different portions of the economy. Low prices for cotton, tobacco, and peanuts would prevent southern agricultural areas from obtaining the necessary fertilizer, machines, and labor required for efficient production. The relative price of a particular good or group of goods largely determines the quantity of resources that will be used in its production. Industries producing goods and services with high prices attract productive resources, and industries producing a product selling at low prices are forced to relinquish resources.

Effect of Monopoly

If a good is produced under monopoly conditions, the price will be higher and the quantity reduced. This reduction in the quantity of the good produced would mean that the factors used in its production would be decreased. Usually this results in a decline of the price of the factors and a subsequent increase of their flow

into competitive areas where quantity restrictions do not exist. The flow of these raw materials away from the area that had become monopolized and toward the areas still under competition would mean, under most circumstances, a reduced efficiency of resource use.

The effect of monopoly in the production of a good is to increase the price of the good produced and reduce the price of the raw materials required in its production. This effect tends to make the raw-material or resource owners combine to resist the pressure on their prices. A probable effect of this reaction would be reduced production throughout the economy and the great possibility of idle resources. High taxes on monopoly returns can reduce the bad effects of the distribution of income and inefficient allocation of resources arising from monopoly.

A monopolist producer uses a smaller quantity of raw materials and therefore produces a smaller quantity of goods, because his profits are maximized when prices are higher and quantity less, than is the case with a competitive producer. The monopolist could be induced to produce the same quantity of a good as a competitive producer if his profits would be maximized at this quantity of production. The government can induce a monopolist to expand production to this point through the payment of a subsidy per unit of output. The excess profits which the monopolist would receive as the result of this large subsidy could be mostly taxed away by the assessment of a lump-sum tax. The levy of the tax as a lump sum would not change the fact that maximum profits would be obtained when producing the same quantity of goods as a competitive producer.*

The monopolist can be induced to increase production by the payment of a subsidy, in the same way as he is induced to increase production when consumers become willing to buy a larger quantity of the products produced at a higher price. The

* This relationship between a per-unit subsidy and taxation of profits has been mentioned by a number of economists. *Taxes Without Tears,* Donald Bailey Marsh (Lancaster, Penn., Jaques Cattell, 1945), discusses the idea very completely, pp. 99–151. "The criterion for a subsidy to induce the monopolist to expand to the optimum is that the subsidy per unit of output shall be equal to the difference between marginal costs and marginal receipts at the desired output (that is, the output where marginal costs equal price)"; p. 137.

change in the demand changes the output and the price at which profits are maximized. A per-unit subsidy by the government has the same effect on production levels as an increase in demand. The difference in the effect, if the subsidy can be largely reclaimed by a lump-sum tax, is that a change in distribution of income is not necessary and the higher prices do not become a part of the costs of some other producers. The object of the subsidy is to change the point where profits are maximized from low output to capacity output.

A monopolist could also be induced to produce up to the point where the additional cost per unit equaled selling price (point of optimum production) by merely reducing tax rates. The tax rates would induce this type of production if they were lowered as the output of the monopolist approached more closely the point of optimum production as determined by relative prices.

CONSUMPTION

The Quantity of Consumption

The importance of the maintenance of the correct quantity of consumption in the preservation of the proper balance between savings and investment was pointed out in the definition of oversaving. If the portion of national income used to purchase consumption goods is too great, the quantity of saving and new investment will be insufficient to make use of the new technical developments and also replace worn-out capital goods. If the portion of national income intended for consumption is too little, intended saving becomes greater than intended investment, and as a result national income falls, bringing about a decrease of employment and inefficient utilization of resources. In addition, the quantity of consumption is related to the provision of the necessities required for an efficient labor force. The consumption level of food, shelter, clothes, medical care, and education of the humblest family must be adequate to maximize productive activity of its members. This correct level of consumption is vital to an efficient economy and is particularly vital to a capitalistic economy because of the relationship between quantity of savings and investment.

During the 1930's, consumption levels fell so low that all the

goods and services consumed could be produced with over a fourth of the persons desiring work unemployed. However, this low level of employment was only in part directly caused by the decrease of consumption; it was to a great extent caused by the operation of the acceleration principle and the very nearly complete cessation of expenditure for investment. The consumption expenditures in 1929 totaled $78,761 million and private gross investment $15,824 million; in 1933, consumption equaled $46,346 while investment was but $1,306 million. The dollar value of consumption decreased by 41 per cent, investment by 92 per cent.* The tremendous decrease in investment arose because, with consumption decreasing, the need for investment disappeared. The elimination of investment expenditure further decreased consumption through the reduction of consumer income.

The general low level of consumption of the 1930's reduced the quantity of goods and services obtained by many individuals to a point that was inadequate to provide even the basic necessities.† At the same time that this situation existed, persons were idle and natural resources that could have provided these necessities were wasted. The reduction of consumption to these low levels reduced the productivity of the people of the United States through inefficiency arising from malnutrition and inadequate housing, education, and medical attention. Also, productivity was reduced because the unemployed lost their skills through disuse and lost the incentive to improve their productivity and economic position because of the hopelessness of their economic position.

The portion of national income spent for consumption is likely to be too great during a period of war or of rapid preparation for increased future production. The consumption expenditure is usually not too great in the sense of providing more than an adequate scale of living; rather, the expenditure is too great to permit the use of the determined quantity of productive resources for war or investment. If the people believe it is for their best interests to allocate a very large portion of the nation's productive resources to war or to the expansion of the quantity of capital

* *National Income Supplement* to *Survey of Current Business,* July, 1947, p. 19.

† The analysis of income distribution on pp. 63–65 considers the problem of a subsistence level of consumption in greater detail.

goods, then it is also to their best interests that provision be made for the reduction of consumption. The reduction of personal consumption will make possible large war expenditure or investment without a great general price rise. Some of the undesirable effects of a large general price rise were pointed out on pp. 48-49. The United States in 1948 is committed to a huge war-preparation and economic-reconstruction program that may require the reduction of consumption expenditures in order to prevent a rapid general price rise.

The description of the goal of desirable prices included a brief statement of the ability of prices to determine the quantities of resources used and types of goods produced. It was pointed out that fiscal activities, through the levy of special taxes or special payments, could decrease or increase prices and thus affect resource use. These fiscal activities affect resource use largely because they decrease or increase the quantity of certain goods consumed. Fiscal activities can decrease or increase the quantities of particular goods consumed and in this way affect resource utilization. The levy by local governments of high property taxes upon houses decreases the quantity of shelter consumed. The Federal government provision of G. I. loans and payment of part of the costs in the provision of public housing increases the consumption of such resources as lumber and steel. They also determine the portion of the total quantity of these resources that will be used in the provision of shelter. Government action of this type can have a great effect on the way in which the consumer dollar is divided.

The achievement of a desirable level of consumption is an important part of the obligation of many sections of the business, political, social, and economic life of the nation. Government fiscal activities alone should not be assigned the duty of bringing about the best level of consumption. However, fiscal activities should and can have an important effect on the quantity of consumption.

Fiscal activity can increase consumption by providing for a reduction of the taxes levied upon persons within the lower income brackets—for example, by reducing general sales taxes and special excises upon necessities. Consumption can also be increased by obtaining a larger portion of government revenues

from borrowing. Consumption of particular goods, especially luxuries, can be decreased by levying a special high tax upon them; and the general level of consumption can be decreased by increasing general sales taxes and excises levied upon necessities.

General sales taxes are collected in twenty-three states (1948). The tax is usually a certain percentage of the price of all goods and sometimes of services purchased for consumption. The cigarette tax (7¢ Federal tax on each package) and the gasoline tax 3½ to 9¢ a gallon) are examples of special excises levied upon necessities.

Government expenditures can affect consumption by subsidizing the production of certain goods—for example, during World War II the production of butter was maintained but the retail price was held down by the payment of a portion of the farmer's production costs by the Federal government. Government expenditures can also directly affect the general level of consumption by the payment of subsidies to low-income recipients.

The fiscal activities mentioned above and many others will always have an important effect upon the general level of consumption and the consumption of particular types of goods. Some of the possibilities are mentioned in this general description and analysis of the goal, but the full description of the manner in which fiscal activities have and can affect consumption is reserved for Chapters III and IV which follow.

The proper general level of consumption and consumption of particular goods and services is to a great extent determined by income distribution. This relationship between the level of income and the portion of income consumed is shown in Tables 1-4 and 3-1 on pages 35 and 98. Therefore an important contribution to the solution of the continuing economic problem of the maintenance of the correct level of consumption is the manner in which the nation's income is divided. The goal of desirable income distribution is discussed on pages 63 through 69.

EMPLOYMENT

Importance of Full Employment

The efficient employment of all productive persons is the most important single factor in the determination of the scale of living in a modern industrial nation. An hour of labor that is lost is lost forever. An hour of labor is the most perishable of all commodities and the most necessary element in production. Full utilization of labor is a *must* in the attainment of the maximum height of economic activity. It is also an important goal in the maintenance of political stability. Great emphasis has been placed upon the problem because of its importance and because of the inability of modern industrial nations to provide for a desirable level of employment during periods of peace.

From the time of the American Revolution to World War I, while population, technology, and resources were expanding rapidly, full employment of labor and sufficient investment opportunities were not a problem. The mere recollection of conditions then existing is sufficient proof that this was an unusual period—for example, new areas were being explored and colonized and the industrial revolution was in progress. The opportunities offered for the use of savings assured that funds not spent for consumption would be quickly spent on investments. In fact, the demand for investment funds was so great that an expansion of savings through loans from commercial banks was likely. Because of this opportunity to use continually expanding quantities of savings, the private economy experienced no difficulty in maintaining aggregate demand—that is, the quantity of purchasing power arising from production was always available as effective demand.

The best-developed plans aimed at the provision of full employment * are the programs presented by Sir William H. Beveridge in *Full Employment in a Free Society* and Professor Alvin H. Hansen in *Economic Policy and Full Employment.*† Neither of the plans has been adopted by any nation of the world,

* Full employment is defined on pp. 23–24

† William H. Beveridge, *Full Employment in a Free Society* (New York, Norton, 1945); and Alvin H. Hansen, *Economic Policy and Full Employment* (New York, McGraw-Hill, 1947).

but the fundamental principles, which are the same in both proposals, are very much a part of the economic thought in both England and the United States.

The plans proposed by both Hansen and Beveridge assign an important role to government revenue sources and government expenditure. The position of the government, however, is not all-inclusive as it is in Russia and the other control states. In Beveridge's opinion, the first and most important function of the public economy in providing full employment is the maintenance of expendable income at a size sufficient to purchase the goods and services provided by a fully employed working population. In Beveridge's words:

> It must be a function of the state in the future to ensure adequate total outlay and by consequence to protect its citizens against mass unemployment, as definitely as it is now the function of the State to defend the citizens against attack from abroad and against robbery and violence at home. Acceptance of this new responsibility of the State, to be carried out by whatever Government may be in power, marks the line which we must cross, in order to pass from the old Britain of mass unemployment and fear to the new Britain of opportunity and service for all.*

A desirable employment level has become synonymous with the popular term "full employment." Full employment is considered a necessity for political stability and maximization of production. More than any other goal, that of a desirable employment level is the aim of the entire economic and social system. The importance of full employment was expressed by Eric Johnston, former president of the United States Chamber of Commerce, in an even more forceful manner when he said:

> Two powerful nations, Russia and the United States, will enter the postwar world representing opposite poles of economic and social thought. The Russian system will be propagandized. Ours will be, too—I hope, by example. . . . The test will be our ability to solve the problem of unemployment. . . . . I believe we can solve it on a democratic basis.†

The analyses of both Hansen and Beveridge largely assume that the expansion of purchasing power (aggregate demand) is

* *Full Employment in a Free Society*, p. 29.

† Quoted by Randolph E. Paul in *Taxation for Prosperity* (Indianapolis, Bobbs Merrill, 1947), p. 235.

the same as an expansion of employment.* Both Hansen and Beveridge are aware that the provision of full employment and a desirable level of economic activity is a very complicated business in a democracy. Hansen has pointed this out:

> Thus in the "mixed economy" of modern political democracies, full employment must be achieved, not by the simple process of setting people directly to work, but by the far more complex process of ensuring an adequate volume of aggregate demand.

But even this is not the end of the problems facing a democratic capitalistic country attempting to provide full employment.

> Though aggregate demand is adequate, a country may yet suffer from monopolistic restrictions, from strikes, from unbalanced wage-and-price structures, and from unemployment in stranded areas. All this is true, but it must nevertheless not be forgotten that aggregate effective demand is the *sine qua non* of full employment in a market economy.†

The Direct and Indirect Methods of Obtaining Full Employment

Direct expansion of aggregate demand and employment arises when the government—through taxation, borrowing, sales, or expenditures—increases the quantity of funds available for the purchase of goods and services. This type of activity can be more effective in a largely socialized economy, where a large portion of the total economic activity is public. The increase in the portion of economic activity conducted by the governments of the United States has increased the possibilities of changing aggregate demand through direct action. In the United States, however, direct action upon aggregate demand cannot be expected to be as efficient as in a nation as largely socialized as Great Britain. In any fiscal activity in a democratic capitalistic nation, not only the direct effects but also the indirect effects upon the private economy must be considered.

* "If we succeed in establishing an aggregate volume of output corresponding to full employment as nearly as is practicable, the classical theory comes into its own again from this point onward." Taken from "Keynes on Economic Policy" by Alvin H. Hansen, in *The New Economics*, edited by Seymour E. Harris (New York, Knopf, 1947), p. 203.

† Alvin H. Hansen, *Economic Policy and Full Employment*, p. 42.

Aggregate demand and employment can be affected by indirect action largely through the stimulation or retardation of private investment. Investment is stimulated first of all by the maintenance of adequate aggregate demand. Private individuals certainly will not invest money to produce goods and services which cannot be sold. However, investment itself stimulates the sale of goods and services. To a great extent, therefore, aggregate demand is necessary for investment and investment is necessary for adequate aggregate demand. Investment is also stimulated by stable or rising prices, adequate net return on investment, and abundance of savings. The fiscal activity of the government can affect all of these factors necessary for large-scale private-investment activity.

The difficulties in the stimulation of private investment as a method of providing adequate employment lie in the disagreement over the manner in which stimulation of investment is to be provided rather than over its desirability (as has been true of direct activity). Much of this disagreement is because of the fact that private investment will be affected by any action of government. Also, the possibility of expansion of investments arising from inventions and discoveries is not enhanced as the result of any particular fiscal policy. Finally, the large degree of monopoly which has developed in the economy of the United States has restricted investments that would provide competitive goods and services. Everyone in the United States favors competition for others but desires a small monopoly for himself.

Fiscal policy can also indirectly influence employment by the assurances that it can provide the typical worker and consumer; for example, the provision of adequate social security and the elimination of violent economic fluctuations would decrease the tendency to save. This reduction of savings would aid in solving the problem of finding adequate investment opportunities for the savings arising at a particular level of national income.

Recent Employment Levels

Unemployment has not been a problem since World War II. However, unemployment was an important unsolved problem from 1931 to 1941. Throughout this entire period, over 20 per cent of the nonagricultural working population of the United States

was unemployed.* The importance of preventing unemployment is emphasized by the large portion of national income arising from employee compensation. In 1947, which was a year of very nearly continuous full employment, about 63 per cent of national income arose as employee compensation. A decrease in employment means a sharp drop in national income, which is indicative of decreased production. Unemployment is closely related to a reduced volume of consumption, the low morale of the workers, the breaking up of family units, the deterioration of trade skills, the loss of political democracy, and the breakdown of a free-enterprise economy. However, the mere provision of full employment, despite its close relationship to these problems, is not the long-searched-for panacea. This fact has been proved during the full employment existing since the end of World War II.

Full employment and inflation are very closely related. The possible evils of inflation must be risked in order to gain the great economic, social, and political benefits of full employment. Full employment is also closely related to reduced output per man-hour. Man-hour output in 1946 and 1947, periods of full employment, did not increase by as much as the prewar trend. Nevertheless, the total productivity of the economy was greatly above the prewar level.† The reduced man-hour output that arises during full employment does not indicate, as some have assumed, that the efficiency of the economy has been reduced. The reason for the apparent decrease is that the man-hour production of the man unemployed is not included in comparative man-hour production data. If the zero or nearly so man-hour production of the unemployed were included in the comparisons of man-hour production data of periods of full employment with periods of unemployment, the inefficiency of unemployment would be evident. In other words, man-hour production data only consider the efficiency of the employed and do not include the inefficiency that exists because of unemployment. Man-hour productivity measured in the traditional fashion increases during periods of full employ-

* C. R. Daugherty, *Labor Problems in American Industry*, 5th ed., p. 65 (New York, Houghton Mifflin, 1941).

† The real income of workers in 1947 was substantially higher than in 1939; and, in addition, large quantities of goods were shipped abroad to rehabilitate Europe. *Survey of Current Business*, February, 1948, p. 25.

ment, maybe at an even more rapid rate than during periods of considerable unemployment, but the increase is from a lower base which exists because of the employment of the relatively inefficient. This relationship was shown in the 4-per-cent rise of man-hour productivity between the two full-employment years of 1946 and 1947.*

INCOME DISTRIBUTION

Importance of Income Distribution

The type of income distribution largely determines the type of economic activity and the amount of savings. These in turn are closely related to prices, consumption, and employment.

Public finance can change income distribution by changing the portion of taxes collected and of expenditures made in the various income levels. The relative portion of income available to the low income brackets can be increased by decreasing their taxes and increasing expenditures that directly improve their income position. Also, the relative income of those in the high income brackets can be increased by decreasing their taxes and increasing the expenditures directly related to their income position. The many ways in which public finance activities can change income distribution are discussed in Chapters III and IV.

Fundamentally, income distribution is related closely to quantity of inherited wealth and equality in the provision of income-making opportunities. Both of these can be affected by public-finance activity in a manner that will increase the equality of income distribution. A very unequal distribution of income means an inefficient use of the nation's resources, both human and natural. An unequal distribution of income results in a waste in some areas, while in others efficient productive activity is prevented because of shortages.

Unequal income distribution directly reduces productivity of human resources in two principal ways: (1) if persons capable of useful employment remain idle because they can enjoy all the material benefits of the society without working; and (2) if the goods and services that can be purchased with wages earned are fewer than those required to maintain good health and

* The productivity in areas readily measureable increased by 4 to 5 per cent from 1946 to 1947; *Survey of Current Business,* February, 1948, p. 26.

develop the productive abilities of the individual. Indirectly, unequal distribution of income reduces productive activity through its tendency to increase the quantity of savings arising from a given-sized national income. The increase of savings reduces productivity of human resources because savings tend to rise to the point where they result in a reduction of purchasing power and the development of unemployment.

How Should Income Be Distributed?

Consumption Considerations

The idle rich, who are a product of unequal income distribution, are not undesirable because it is good in itself to work or because idle hands are likely to get into trouble. Idleness is undesirable because it reduces the quantity of goods and services which could have been made available for human enjoyment.

Table 2–1. Distribution of spending units by size of income, in Metropolitan areas, 1946.

Annual Money Income before Taxes	*Per Cent of Spending Units*
Under $1,000	10
$1,000-$1,999	17
$2,000-$2,999	26
$3,000-$3,999	20
$4,000-$4,999	10
$5,000-$7,499	9
$7,500 and over	7
Not ascertained	1

Source: *Federal Reserve Bulletin*, vol. 33, no. 7, July, 1947, p. 793.

Much the more serious direct influence of unequal income distribution upon the productivity of human resources is the reduction of efficiency through inadequate income. Table 2–1 given above shows the distribution of income by spending unit in metropolitan areas in 1946. Table 2–2 (p. 64) gives the cost of a family budget, in a number of United States cities, that is sufficient to provide the goods and services required to maintain an adequate scale of living.*

* The Technical Advisory Committee of the Bureau of Labor Statistics defines a family budget as the list of goods and services required by an employed adult male, a housewife, and two children under 18 years of age.

TABLE 2–2. Estimated cost in selected cities of a family budget, March, 1946.

City	Estimated Total Cost of Budget
Washington, D. C.	$2,985
Seattle, Washington	2,913
New York, New York	2,820
Boston, Massachusetts	2,811
Detroit, Michigan	2,813
Pittsburgh, Pennsylvania	2,761
Chicago, Illinois	2,793
San Francisco, California	2,853
St. Louis, Missouri	2,824
Los Angeles, California	2,766
Cleveland, Ohio	2,712
Philadelphia, Pennsylvania	2,681
Cincinnati, Ohio	2,678
Houston, Texas	2,532
New Orleans, Louisiana	2,573

Source: *Monthly Labor Review*, vol. 66, no. 2, February, 1948, p. 152.

The data presented in Tables 2–1 and 2–2 show that a large portion of the families of the United States in 1946 received an income that was inadequate to maintain a budget that did not contain deficiencies in one or more aspects of family consumption.* In 1946, over 40 per cent of the families in the

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The budget itself is a list of goods and services that, according to the prevailing standards of the community, are considered essential. The definition of the budget recognizes that in the actual experience of families there is a scale that ranks various consumption patterns in an ascending order from mere subsistence to plenitude in every respect. The budget level described here is at a point on this scale below which deficiencies exist in one or more aspects of family consumption.

Items that might not be considered necessary for production efficiency are considered necessities; for example, "Ice cream cones and soft drinks have become essentials even for the poorest city family with children, who will sacrifice an otherwise adequate diet for a minimum of these items for their children." "The City Worker's Family Budget," Lester S. Kellogg and Dorothy S. Brady (*Monthly Labor Review*, February, 1948, vol. 66, no. 2), p. 142.

* A spending unit is smaller than a family unit as used in the Federal Reserve study, there being 40.6 million families and single individuals and 46.3 million spending units. The spending-unit income is slightly less than

United States received an income that was insufficient to provide the standard American budget.* This is a very large percentage of the population of the United States. If it is assumed (and it is very difficult to assume otherwise) that productive efficiency of all persons with incomes below the standard budget has been reduced because of a shortage of purchasing power, the income distribution in the country, even in this favorable postwar period, was far from the point that would maximize the utilization of human resources. Certainly 1946 was a particularly good year. Salaries were high and the post-O.P.A. price rise had not as yet taken hold. For example, the standard family budget in New York City that cost $2,820 in 1946 cost $3,347 in 1947,† an increase of about 19 per cent. The average weekly earnings of all manufacturing units increased during the same period from $43.74 to $49.33, or an increase of about 15 per cent.‡ Also the number of low-income families in 1946 was greatly reduced because unemployment was practically nonexistent.

The above analysis of the cost of a standard family budget in 1946 and of the distribution of the national income among the families of the United States shows that under the most favorable conditions the incomes of a large portion of the nation's producers are inadequate to maintain conditions correct for peak production. The situation during periods of depression and widespread unemployment are certainly much less conducive to a high utilization of human resources than the situation that existed in 1946 or 1948.§ The first fundamental basis for judging whether a par-

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that of the family and single individuals, but data for metropolitan areas for which budget data are available are given only in family units. The income of the family reported in the *Monthly Labor Review* is perhaps greater than that of the spending unit reported in the *Federal Reserve Bulletin*. For this reason, of course, the data of the two tables are not completely comparable.

* The Maintenance Budget for Families or Children developed "as a standard for good administration by relief agencies" by the Heller Committee for Research in Social Economics, University of California, required approximately a $2,000 annual income in 1946 for a family of four. The costs are for the city of San Francisco.

† *Monthly Labor Review*, February, 1948, p. 152.

‡ *The Handbook of Basic Economic Statistics* (1948 ed.), pp. 34-35.

§ See Table 1–4 for income distribution during the middle 1930's. See *Quantity Budgets of Goods and Services Necessary for a Basic Maintenance Standard of Living and for Operation Under Emergency Conditions*, W.P.A. Division of Social Research, series 1, no. 21, 1936; *Intercity Differences in*

ticular income distribution is desirable is to determine whether it renders idle potentially productive individuals. The second fundamental basis of judgment is whether people in the lower income brackets have enough money to develop fully their productive potentialities. In the United States, the income distribution meets these tests better than in many countries, but great improvement is possible.

The manner in which income is distributed is also closely related to quantity of savings arising from a given national income. This relationship has been indicated by all income and savings studies that have been made in the United States. The most recent analysis of savings in relation to income was made by the Board of Governors of the Federal Reserve System.* Table 2–3, given below, shows the quantity of liquid savings held by members of

TABLE 2–3. Distribution of family units and liquid assets, by income groups, 1946 and 1945 (per cent).

Annual money income before taxes	1946		1945	
	Family units	Liquid assets held	Family units	Liquid assets held
Under $1,000	15	4	18	5
$1,000–$1,999	20	9	22	9
$2,000–$2,999	22	15	22	14
$3,000–$3,999	18	15	17	17
$4,000–$4,999	10	13	9	14
$5,000–$7,499	9	16	8	15
$7,500 and over	6	28	4	26
All income groups	100	100	100	100

Source: *Federal Reserve Bulletin*, vol. 33, no. 7, July, 1947, p. 802.

different income brackets in 1945 and 1946. This table does not show all savings and dissavings taking place during the year but refers only to liquid savings, which are usually considered the most important in analyzing the quantity of hoardings and the

Costs of Living, March, 1935, 59 Cities, W.P.A. Division of Social Research, Research Monograph 12 (Washington, U. S. Government Printing Office, 1937).

* Quantity of savings arising from the different levels of income is also shown in Table 1–4 on p. 35 and Tables 3–1 on p. 98.

quantity of purchasing power that can be expected from disgorged savings. Both of these are, of course, very important in forecasting the quantity of economic activity in the future.

The data in Table 2–3 show that a small number of families in the highest income brackets possess most of the liquid savings. This corresponds with other earlier studies of the relationship between savings and size of income. The comparison between 1945 and 1946 indicates that not only are a large portion of all liquid savings owned by the few families in the upper income brackets, but that between 1945 and 1946 the percentage of the total liquid savings possessed by the persons in the upper income brackets increased while, of course, that of the lower brackets decreased.

Saving Considerations

The importance of the relationship between savings and type of income distribution arises because it was believed during the 1930's that it was excess savings that largely caused idle men and idle machines. This is also very likely to be the cause of any depression of the future. It was not entirely the abundance of savings that caused the inadequacy of productive activity in the 1930's, but rather the quantity of savings combined with the investments that individuals and corporations planned to make. It was believed that the problem of idle men and idle machines could be removed by either decreasing the quantity of savings or increasing the amount of investment. Reducing the inequality of income distribution works at this problem from both ends. Savings are reduced because the portion of national income going to high-bracket income receivers is reduced. Investment is increased because demand for consumer goods and services is expanded through an increase of the portion of national income received by persons in the lower income brackets, where the propensity to consume is greater.*

* The point regarding the possibility of savings being very detrimental to efficient economic activity was very clearly brought out by Prof. Alvin Hansen during the Temporary National Economic Committee hearings in Congress. As an aside, it should be pointed out that the conclusion was supported by considerable statistical proof. "... but it is extremely important to keep firmly in mind the fact that we cannot maintain full employment unless there is

The eighteenth- and nineteenth-century economists correctly urged that every effort should be made to expand savings. Shortage of savings was preventing the introduction of new machines and expansion into new geographical areas. Under these conditions, Benjamin Franklin's adage that "a penny saved is a penny earned" was excellent economic advice. Gradually during the twentieth century, production increased to the point where savings arising from the existing income distribution at full employment appeared to be in excess of desire for investment. The data presented at the Temporary National Economic Committee hearings showed that it was inability to use purchasing power accumulated as savings for investment that made men and machines idle.*

It has been as conclusively proved as any economic cause-and-effect relationship that excess of savings was responsible for the purchasing-power shortage that caused the decrease in productive efficiency evidenced by idle men and machines during the 1930's. The statistical proof was presented at the T.N.E.C. hearings, and the logical basis of the position is presented on pages 23 to 33 of this book.

The accumulation of savings during the eighteenth century can be compared to a man accumulating water in an area of seasonal rainfall and drought. The activity of building dams and cisterns and storing water in the reservoirs created is the most productive type of activity. This accumulation of water will help tremendously to expand the quantity of goods and services produced in the area. Accumulation of savings in the twentieth century can be compared to a person engaged in this type of activity in an area where the rainfall is always sufficient to meet

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continuously going on a sufficient volume of plant and equipment expansion over and above replacement and renewals to absorb the full flow of savings. Savings do us good or harm according as they find or do not find investment outlets in productive expansion of plant and equipment and durable goods, including residential building and public works." *Hearings before the Temporary National Economic Committee, Congress of the United States,* Part 9, "Savings and Investment" (Washington, U. S. Government Printing Office, 1940), p. 3542.

* See the data given in Table 2–4 on page 69 regarding the relationship between national income, investment, and consumption during the late 1920's and the 1930's.

the needs of productive activity. In this case the activity is a waste of resources; it decreases productive activity to the extent that the energies could be better spent in cultivating, fertilizing, and the like. Under the first set of circumstances the saver or dam builder was the most vital person in the community, while under the second set of circumstances he is quite unimportant.

TABLE 2–4. Net capital formation and consumers' outlay, 1929–1937 (in millions of dollars)

Year	Net capital formation	Consumers' outlay
1929	10,082	73,342
1930	3,879	69,061
1931	-- 278	56,288
1932	–4,427	44,055
1933	–2,987	42,270
1934	–1,533	49,704
1935	2,189	52,235
1936	6,301	58,906
1937	9,531	62,497

Source: *Hearings before the Temporary National Economic Committee, Congress of the United States*, Part 9, "Savings and Investment," pp. 4007–4008 (Washington, U. S. Government Printing Office, 1940).

Fiscal activity aimed at a more equal distribution of income reduces individual savings because persons in all income brackets typically cut down their quantity of savings before they reduce their scale of living. Statistics are not available to prove this relationship completely, and it is very doubtful if they could ever be gathered. The best data are perhaps those that show the fluctuations of consumption and saving. Table 2–4, given above, shows net capital formation (savings) and consumer outlay (consumption) for the years 1929 through 1937. The data cover two relatively prosperous periods, 1929–1930 and 1936–1937, and the serious depression period of 1931–1934. The data of this table leave no doubt that when income goes down, savings, as measured by net capital formation, are reduced before, and by much more, than consumption expenditures. This same relationship between savings and consumption is shown by the 1947 study of the Board of Governors of the Federal Reserve System (see

Table 2–3). The study indicates that savings had begun to decrease in the lower income brackets and that amounts of disgorged savings had been used to meet general living expenses.

The quantity of savings arising in an economy producing a certain-sized income is certainly determined by a number of factors. The experience of the United States and other nations during World War II showed that price controls, rationing, and a strong propaganda program can greatly expand the quantity of savings. Also, certainly, political uncertainties, amount of savings already accumulated, and expectation of continued employment can have a great effect on the quantity of savings arising from a given-sized national income. Assuming all of these to be given, the quantity of savings is largely varied by changing the distribution of income.

Interrelationship between Fiscal Goals

The goals of desirable price, consumption, employment, and income-distribution levels are closely related to each other. It is very doubtful that any one of the goals can be reached and enjoyed without the other three also being largely achieved. However, the interdependence between the four goals varies. For example, it appears as though it would be possible to have a desirable level of prices without having full employment, or that full employment could exist with an undesirable price level, an undesirable level of consumption, and an undesirable income distribution. However, if these above conditions existed and a desirable level of employment were to be maintained by free private enterprise operating through the dictates of a market economy, the period of its continuance would be dependent upon large quantities of additional purchasing power being continually created. The latter method of maintenance would surely be brief and would end in the disorganization of inflation.

All four of the fiscal goals used here are related to the provision of a good allocation of resources. The worst allocation of the most important productive resource—labor—is idleness and the resulting poverty and loss of efficiency. However, the best allocation of labor in a market economy can be assured if consumption is maintained at a desirable high level and the distribution of

income is good. For this in turn will result in price levels and relationships that allocate and utilize resources in a manner that will meet most standards of efficiency. (The adjective good is used here to refer to the conclusions of the analysis of consumption and income distribution that were presented earlier.) Therefore, a good allocation of resources would exist only if the existing prices utilize resources in a manner that assures full employment, a desirable level of consumption, and an income distribution that is consistent with their maintenance. All of the four goals of fiscal policy work together to bring about the most desirable distribution of resources.

CONCLUSION

The activities of the government that involve collecting, spending, and handling funds are fiscal activities. However, if such a broad definition were used, the subject would extend far beyond the possibilities of proper analysis at this time. In order to limit the discussion to an area that can be covered with some prospect of completeness, four basic economic relationships have been selected at pivotal points around which the government's activity of a fund-collecting, spending, and handling nature is centered. These four relationships are (1) prices, (2) consumption, (3) employment, and (4) income distribution. Their selection was determined by the vital role played by each in setting the quantity and type of goods and services produced by the economy.

QUESTIONS AND PROBLEMS

1. Select a number of things that government can accomplish through raising and spending funds and relate their accomplishment to prices, consumption, employment, and income distribution.

2. Discuss the ways in which prices affect economic activity. How is relative price related to the problem of monopoly?

3. By the use of data mentioned in the chapter, or other reliable data, develop an income distribution that would provide the most efficient use of resources. Would this type of distribution provide for the most efficient use of resources under all conditions?

4. Do you think the interrelationships between the four goals of fiscal policy (prices, consumption, employment, and income distri-

bution) are so closely related that they should be considered as one goal? Why?

5. Do you think it is just to take income earned by one individual and give it to another who has not earned it? Why? Do you think it is just to take wealth from one individual who has inherited it and give it to another? Why?

6. Briefly point out the importance of the co-ordination of monetary and police activity with fiscal-policy plans.

7. How is the problem of the mature economy linked with the concept of oversaving?

8. What is the concept of aggregate demand? How is it related to full employment? Compare the ways in which Sir William Beveridge and Professor Alvin Hansen would provide for an adequate aggregate demand.

9. It is sometimes said that the quantity of consumption is dependent upon investment; also, it is often pointed out that investment is dependent upon the prior amount of consumption. Which of these two do you consider correct? Why?

10. What are some of the results of a general price level that rises too high or goes too low? What are the results if the prices of particular products increase considerably or decrease considerably? How can fiscal policy affect prices?

CHAPTER

3

Revenues and the Achievement of Fiscal-Policy Goals

INTRODUCTION

How Revenue Measures Affect Achievement

Government revenues are obtained in four important ways; (1) by the levy of taxes, (2) by the sale of bonds, (3) by printing money, and (4) by the sale of goods and services. While the sale of bonds and printing money have certain common aspects, there are significant differences which warrant separate consideration. The expenditures of government, as was pointed out in the previous chapter, may be divided into two groups: (1) expenditures necessary in the ordinary performance of accepted government functions, and (2) expenditures closely related to attainment of a certain economic goal (that is, in addition to the financing of a certain group of activities).

Through its sources of revenue—the collection of taxes, borrowing from individuals and commercial banks, sale of goods, services, and privileges, and the printing of money—the government can greatly affect all aspects of a nation's economic activity. The levy of taxes upon particular goods will increase their prices in relation to other goods. This increase in price will raise the prices of other goods, if the items originally taxed enter into their cost

of production. Then the quantity of the taxed good sold and produced will decrease the number of laborers employed in the taxed industry, and the profits and rents available to ownership will be reduced. The reduction of employment will decrease the demand for all the goods and services formerly demanded by the employees of the taxed industry, and the reduction of profits and rents will decrease the quantity of private investment.

The effects of a particular tax are innumerable. This also is true of the other ways in which a government obtains its revenues. A listing of all possible effects will not be attempted at this time. The point that is being stressed here is that all revenue measures affect the type and quantity of economic activity. This is true whether the measure is undertaken to accomplish a particular fiscal goal or whether it is used merely because it is the way revenues were obtained in the past or because it is politically most acceptable. All revenue measures at the time of their adoption and during the period of their retention should be evaluated in regard to possible impact upon the achievement of desirable fiscal goals. Efficiency of a tax measure in this respect is more important than its ability to make available sufficient quantities of money in a politically acceptable manner.

Built-in Revenue Flexibility

The public-revenue system of the United States can aid in the achievement of the goals of fiscal policy without the initiating of new governmental action. The amount of tax revenues obtained by the Federal and lower levels of government automatically (without a change in tax legislation) decline during periods of depression and increase during periods of prosperity. If the level of expenditure remains constant during prosperity and depression, this necessitates that the government enter into deficit financing during a depression and accumulate a surplus or retire its outstanding debt during prosperity. Such an automatic corrective response of the revenue system is called built-in flexibility. Built-in flexibility also exists in government expenditure (see pages 143-144).

Stable tax rates bring about variation in revenues, which aids in reaching fiscal-policy goals. Although this tendency has always

existed, it is now of increased importance for the following general reasons:

1. Tax collections have become a larger portion of total economic activity.
2. The Federal tax system has become more progressive; therefore, receipts increase more rapidly with rising prosperity and decrease more quickly when depression sets in. An unemployed man will pay no income tax but will continue to pay excise and sales taxes on articles purchased.
3. The introduction of the withholding method of collecting the income tax has made tax receipts vary much more quickly as a result of a change in income than was previously the case.

If allowed to remain unchanged, during the different phases of the business cycle, the existing revenue system of the Federal government and, to a lesser extent, that of local governments can aid greatly in stabilizing prices, consumption, and employment, and in maintaining a desirable distribution of the national income.

Shifting and Incidence of Taxation

The incidence of a tax is briefly defined as the place where the burden of the tax finally comes to rest. The burden is taken from one person and placed upon another by the process called shifting. Shifting takes place only if an exchange transaction is involved. It is obvious that the location of the incidence and the manner of shifting are of vital importance in determining the effects of government revenues on the goals of fiscal policy. It is also true that it is very difficult to determine what the incidence of a particular tax is and the manner in which the tax will be shifted. A large portion of the difficulty arises from shortage of statistical data, but an important additional factor is that the manner of shifting and incidence of a particular type of tax changes, depending upon the rate at which levied and the prevailing market and production conditions.*

* Otto von Mering, *Shifting and Incidence of Taxation* (Philadelphia, Blakiston, 1942); Marion Hamilton Gillim, *The Incidence of Excess Profits Taxation* (New York, Columbia University Press, 1945); Duncan Black, *The Incidence of Income Taxes* (London, Macmillan, 1939); John F. Due, *The Theory of Incidence and of Sales Taxation* (New York, Kings Crown Press, 1942).

A tax is said to be shifted *forward* if it is moved toward the consumer of the product or service taxed and *backward* if it is moved away. A very important factor in determining the direction of shifting is the elasticity of demand. If the demand for the product is very inelastic—for example, the demand for salt or cigarettes—the full amount of the tax levied upon the product can be shifted forward without decreasing appreciably the quantity of the product sold. Under these conditions there is little doubt that the tax will be readily and quickly shifted forward. If the demand for a product is elastic, an increase in the price will decrease the quantity sold. An additional tax under these conditions is very likely to be either absorbed by the firm upon which it was originally levied or shifted backward onto the firm's suppliers.

The elasticity of the demand for products or services produced and traded, upon which an additional tax burden has been placed, is determined by many factors. One important factor is the generality of the tax. If the tax covers a large geographical area and also includes all producers of substitutes as well as producers of a particular product, the demand for the taxed goods and service will be inelastic. Also, if there is an abundance of purchasing power in relation to the quantity of goods, the demand will be inelastic; with either or both of these conditions prevailing, a tax increase will be rather readily shifted forward. If the reserve relationship exists between purchasing power and goods, the tax is likely to be absorbed by the firm upon which the tax is levied or shifted backward upon the resource providers. Also, of course, elasticity of demand is determined by the importance of the need filled by the good and the closeness of substitutes.

The degree of elasticity of supply is often more important in the shifting of taxes than elasticity of demand. A tax that is shifted in higher prices causes a reduction of consumption of the taxed product.* This will decrease the price obtained by the producer,

* An example of an exception to this generalization would be a tax placed on meat, where the proceeds of the tax were made available in food stamps to the very poor, who, as a result, obtain their protein from the eating of meat rather than beans. The effective demand for meat would be increased by the full amount of the tax collected and, in addition, would benefit from

unless the supply is decreased. If the supply of a product is inelastic, all taxes placed upon the product will tend to be shifted onto producers. Supply is apt to be inelastic if there are many producers (competition)—for example, agriculture—and elastic if there are only a few producers (oligopsony)—for example, manufacturers of farm machinery. Also, the supply of goods that can be used for a long period of time is inelastic. In addition to current production, the supply of these latter goods includes many of the units produced during a number of years in the past—for example, homes and pianos.

Additional data and problems of shifting and incidence of taxation are included throughout this chapter and book as a part of the discussion of the effects of government revenues and expenditures upon the goals of fiscal policy. The discussion at this point of this very complicated and difficult problem serves largely as an introduction to the broad influences which must be considered. Actually, it is an area of economics in which a great deal of research is needed. The concepts which have been developed in relation to the determination of tax incidence were in many cases based upon inadequate understanding of the changes arising when taxes include a greatly expanded portion of the national income, when the rates of certain taxes become very high, and when labor unions are strong and aggressive.

THE ACHIEVEMENT OF DESIRABLE PRICES

The General Role of Fiscal Policy in Price Stability

Since the establishment of the Federal Reserve System in the United States, it has been generally assumed that the responsibility for providing stable prices rested upon banking and monetary policy. In turn, banking and monetary policy were to be determined with little consideration for government fiscal activities. However, stable prices have not been provided, and also banking and monetary policy have been affected by government fiscal activities.

Because of this rather widely accepted priority of banking in the field of price-stability policy, public-finance courses have con-

the transfer of the purchasing power which the poor formerly used to obtain their beans.

ventionally neglected to analyze government revenues and expenditures in relation to their effect on the price level. However, the actual relationship makes the maintenance of an acceptable price stability an important goal of fiscal policy. Professor Abbott, who is rather pessimistic concerning the ability of fiscal policy to accomplish many of the goals set for it, believes that fiscal policy should be definitely concerned with the provision of an acceptable price stability and also that this goal can be largely accomplished at the present stage of the development of Federal government techniques.* The surprising fact is not that price policy is now included within the scope of fiscal policy, but rather that until very recently it could have been assumed that government revenues and expenditures did not affect price levels.

Professor Abbott states that fiscal policy should set as its objective: "the provision of a monetary unit the value of which is not subject to wide variation, nor to political manipulation, nor to the threat of political manipulation." † This goal for price stability has been advocated for some time by monetary economists. *The new development is that the goal is now understood to be largely attainable through fiscal policy.*

The maintenance of a stable monetary unit in terms of purchasing power is usually considered to be the first requirement for the development of a rational economic program. Fiscal policy must have as a principal goal the prevention of the depreciation or the appreciation of the value of the monetary unit. Price-stability activity must be related to a base which is accepted by the community as being desirable and accepted by fiscal authorities as being attainable and not contradictory in its effect upon other important aims of fiscal policy. Certainly, political pressures such as those experienced in the summer of 1946, which brought about the removal of price controls, will make impossible the maintenance of stable prices through fiscal policy.

The goal of stable price levels does not necessarily require that the purchasing power of money remain constant. It is also true, however, that any monetary unit to be acceptable must possess a great deal of stability, particularly when large portions of

* Charles Cortez Abbott, *Management of the Federal Debt* (New York, McGraw-Hill, 1946).

† Charles C. Abbott, *Management of the Federal Debt*, p. 173.

savings are in investments stated in a certain number of monetary units. Also, the savings held in this manner are savings accounts, insurance, and government bonds, all popular with persons in the low and middle income brackets. If the desirability of maintaining a stable price level is outweighed by other desirable goals of fiscal policy, the goal of maintaining an acceptable price level requires that the purchasing power of the unit be changed. Such a conflict could arise, for example, in regard to the desirability of levying high income taxes, which would take away purchasing power that was being used to bid up prices and would decrease the value of the monetary unit. At the same time, these high tax rates would reduce the attractiveness of new investments and thus retard the development of new production needed to stabilize the value of the monetary unit. Investment is stimulated by rising prices, but rising prices mean inflation—the reduction of the value of the monetary unit. An additional factor to be considered is that investments made during a rapid price rise are selected less carefully and are likely to be less productive and therefore relatively inefficient in reducing inflationary pressure.

Problems in Eliminating Inflation and Deflation (the Two-Headed Dragon)

Today, a government revenue program can affect general economic conditions much more than it could in 1929. This change has arisen because of the great relative increase of the public economy and also because of the development of the science of economics and the increased quantity of economic statistical data.* The way in which the government collects or does not collect $56.4 billion from a gross national product of $229.6 (1947) will obviously have a much greater effect than the manner in which it collected $11.3 billion from a gross national product of $103.8 (1929).

Desirable fiscal policy to prevent a fall in prices will be quite different from the type of fiscal policy recommended to prevent an increase in prices. Fiscal-policy recommendations must be

* Depressions are costly affairs. It has been estimated that the depression of 1929 to 1941 cost the businessmen of the United States over $300,000,000 in lost sales. Taken from Randolph E. Paul, *Taxation for Prosperity.*

constantly re-examined to steer the nation's economy in the "middle course betwen inflation and unemployment." *

The year 1948 in the United States has been a period during which it was desirable that fiscal policy be aimed primarily at the prevention of the development of boom conditions. During the period of World War II, inflation was an ever-present menace; the citizens were well aware of the danger and supported government programs aimed at reducing it. After the conclusion of the war, the realization of harm from inflation was less evident and, in addition, the danger of deflation began to appear. Thus, intelligent fiscal policy during the postwar period has had to be two-headed, one head facing inflation and the other facing deflation. Because of the very different problems, the two programs must also be very different. This fact has led to the postwar charges of inconsistency and confusion. These charges of inconsistency and confusion arise from either a lack of understanding of the problem of maintaining economic stability or a desire to gain a political advantage from creating a misinterpretation.

The problem of pursuing the narrow winding path between inflation and deflation is to a great extent political and psychological. The main political problem lies in placing sufficient power in an agency that it can act quickly when conditions appear to be approaching either inflation or deflation. Another political problem stems from the psychological influence of a boom period when public opinion is very much opposed to government action that will disrupt what seems to be a new era. However, after a deflation period has set in, public opinion aids government activities to raise prices and increase the amount of economic activity. The business community, which to a large extent determines the ability of government to act, enjoys a boom period but does not enjoy a deflation period. Yet if the boom period which businessmen enjoy is allowed to continue upward, it will create the conditions for the deflation period which they dislike.†

* Alvin H. Hansen, *Economic Policy and Full Employment,* p. 248.

† See Alvin H. Hansen, "Cost Functions and Full Employment," *American Economic Review,* vol. 37, Sept., 1947. If boom periods are expected to continue, the profits arising during the period would not be great because capital would soon cease to be the scarce factor. The high profits of the

In a democracy, it is very doubtful whether any agency of the government will ever be given sufficient power to act decisively to prevent a boom or a depression whenever one or the other *appears* to be developing.

Another problem of maintaining correct general price levels arises from the lack of adequate statistical data to determine accurately what is developing in the economy. The data are particularly meager in regard to the expenditure and saving plans of individuals and business firms.* Certainly any intelligent action that might be decided upon to keep the economy in the middle ground between deflation and inflation can be determined only on the basis of adequate information.

Revenue Sources Correlated with Desirable Price Level

A type of fiscal policy aimed at stable prices has been stated by Professor Boulding as the "adjustable tax plan." Professor Boulding describes the plan as being usually preferable to expenditure in that it can be more readily adjusted. Briefly, the plan is that "the rate of tax should depend on the movement of money income during the past month." † Thus, if money income has risen during the past month beyond an amount designated, the rate of tax in the next month should be increased in order to prevent inflation. The plan of Professor Lerner called "Functional Finance" also includes the idea of fluctuating tax rates. "The Government . . . will tax individuals, or a certain class of individuals, when it believes it to be socially desirable that they should not be so rich or should not spend so much. It will tax particular forms of spending (on whiskey for example) as a means of decreasing them. It will tax more generally as a means of cutting down total spending, when this is necessary to prevent excessive total demand and inflation. Taxation is important not as

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boom period have been the main cause of the assumed instability. These high profits during the period that the boom was becoming stabilized could be eliminated by excess-profits taxes or price controls.

* See *Federal Reserve Bulletin*, vol. 33, no. 9, Sept., 1947, pp. 1103–1104; no. 10, Oct., 1947, pp. 1212–1215; and pp. 66, 128 of this book.

† Kenneth E. Boulding, *The Economics of Peace* (New York, Prentice-Hall, 1945), pp. 161, 162.

a means of raising money but as a means of cutting down private spending." *

In order to rid the mind of the concept that governments must assess taxes to obtain funds required for expenditure and therefore must abandon a tax policy consistent with the requirements for stable price levels, Professor Boulding suggests that we assume the government has no expenses. "Then the tax rate would fluctuate between positive and negative levels, accordingly as inflation or deflation threatened." † When the analysis is made upon this basis, it is seen that even though there were no government revenue requirements the tax system would still be continued as a very useful tool of economic and social control.

Both Professors Lerner and Boulding point out with considerable vigor that their plans for adjusting tax rates do not necessitate a huge government debt. For example, changes in the tax system to increase the taxes upon the rich and decrease them upon the poor will increase the income stream available for the purchase of consumer goods but may not decrease government tax revenues; in fact, tax receipts may increase. If the system is suffering from an over-all shortage of money, taxes would be lowered, and the government would obtain funds by the direct printing of money; this, also, would not increase the debt. Furthermore, if the government obtained funds from borrowing during periods of an abundance of liquid funds, it could repay these loans during a period when there was a shortage of funds in the hands of individuals; thus the debt would not continue to climb year after year. Borrowing under the adjustable-tax plan is accomplished to decrease the quantity of money in the hands of individuals. Government borrowing from the commercial banks to increase the quantity of money in the hands of individuals would be discontinued. Governments would increase the quantity of money by printing directly.‡

* Abba P. Lerner, *The Economics of Control* (New York, Macmillan, 1944), p. 308.

† K. E. Boulding, *The Economics of Peace*, p. 165.

‡ Some of the problems involved in financing government expenditures from sources other than tax receipts are discussed in *Deficits and Depression* by Dan Throop Smith (New York, Wiley, 1936).

Government Revenues and Prices During War

How Government Taxes Controlled War and Postwar Inflation

Inflation danger is always greatest during a period of war. It is then that large additional quantities of money reach consumers but that the quantity of goods for consumer purchase tends to decrease. A period of war is also the time when the revenue and expenditure of government become an increased portion of total economic activity.

The control of inflation during the period of actual hostilities has proven easier than during the postwar period. It is possible for governments to impose strict direct controls during the actual shooting war, but it is very difficult to maintain these restrictions during the period of reconstruction. For example, in the United States on the day following Japan's surrender, the controls over man power were dropped; within a few weeks many price, priority, and production controls were lifted; by the end of 1945 rationing of all commodities other than sugar had been removed; and by the beginning of 1947 nearly all wartime direct controls were gone.

Tax activities of the Federal government played a secondary but co-operative role in the effort to prevent price rises during the war period. Also, much government borrowing was attempted in a manner that would decrease the inflationary pressure. Credit and monetary controls of the war period played a relatively minor part in inflation control. In general, credit was extended so as to raise rather than lower prices.

The excess-profits tax was raised three times during World War II, and the final rate was 85.5 per cent.* This tax on profits made it politically and therefore practically possible to use severe direct economic controls effectively. Also, this tax combined with the regular Federal corporate-profits tax reduced substantially the dividends paid to individuals by corporations and the accumulations of corporate reserves.† Both of these effects reduced the inflationary pressures. Federal corporate taxes at their peak

* The tax was 95 per cent, but a postwar credit of 10 per cent was included. This was a type of compulsory saving.

† In 1943 the 52,098 excess-profits tax returns showed an adjusted excess-profits net income of $8,368,072,530.

(1945) brought in 12½ times as much revenue as in 1939, but corporate profits after taxes continued to climb.*

The Federal individual income-tax rates were increased greatly during the war and the exemptions were decreased. The effect of this twofold action was to increase the rate on the first $2,000 of taxable income from 4 per cent to 23 per cent. A maximum effective-rate limitation was set at 90 per cent, which meant that an individual's total taxable income could not bear an individual income-tax burden greater than 90 per cent. Receipts from the Federal individual income tax were 18½ times greater in 1945 than they had been in 1939. Individual income-tax rates were perhaps raised as high as practical, in view of administrative and incentive considerations.

The Federal government introduced many new excise taxes during the war and raised the rates of many others. Special excises were imposed on consumer durables to help conserve materials and also to bolster direct controls. Federal excise-tax receipts increased 3½ times from 1939 to 1945.

In 1945, along with the cry "bring the boys home," there arose the demand for tax cuts. The regular Federal corporate-profits tax was reduced from 40 per cent to 38 per cent in 1946, and the excess-profits tax was removed. This type of tax legislation obtained Treasury support in 1945 because it seemed desirable to strengthen the reserves of business to speed up reconversion. However, reconversion was accomplished much more readily than expected, and the postwar consumer boom has been heightened by these reduced taxes on inflated profits. Also, the investment boom has been increased, and the bunching arising from the acceleration principle has been permitted to have its undesirable effect on price stability.

The high individual income-tax rates were maintained until the Federal Revenue Act of April, 1948, which provided for individual income tax cuts that totaled approximately $4.5 billion.† This

* Contract renegotiation was also used during the war to capture excess profits. The device proved to be quite efficient.

† The law provides a tax cut of 12.6 per cent on the first $2,000 of taxable income; a cut of 7.4 per cent on taxable income in the bracket from $2,000 to $136,719; a cut of 5 per cent on taxable income above the $136,719 bracket. In addition, income of married couples may be split for income tax purposes.

increase of individual spending power, and therefore of additional inflationary pressure, was divided approximately as follows: 42.6 per cent of the saving or $1,953 million to those having taxable income below $3,000; and 27.9 per cent or $1,272 million to those having a taxable income from $3,000 to $5,000. These two income brackets include about 96 per cent of the income-tax payers, and they received about 70.5 per cent of the additional private income made available by the tax cut. It was very undesirable to make this substantial cut in income taxes when the economy was operating in full employment and prices were continuing upward.* It really made little difference in 1948 whether the tax cut went to individuals who would use the funds for investment or consumption. In both areas the nation was experiencing shortages of factors and an expansion was not dependent upon more money but rather upon additional labor and raw materials. The tax cut would be desirable in relation to prices only if persons benefiting from the cut hoarded the money; there is no reason to believe that this will ever be the case when the business community is experiencing an expanding boom.

The war excise-tax rates have been largely maintained. The receipts in some cases have advanced—for example, automobiles and tires—because of greater availability of the taxed goods.

Relationship Between Taxes and Borrowing

The portion of the war expenditures financed with taxes appears to have been less than would be desirable if postwar inflation were to be avoided. Only about 40 per cent of the cost of World War II was obtained from tax receipts. The remaining 60 per cent, or about $190 billion, was obtained by borrowing. Much of this borrowing was done in a way that added to the pressure for higher prices during the war and the postwar period. The savings-bond program, which was the portion of borrowing that had a deflationary effect during the war, resulted in the sale of about $55 billion of bonds between May, 1941, and January, 1946; however, during the same period $10 billion were redeemed. Moreover, the spending of these savings during the postwar period

* The United States Department of Labor's combined consumers' price index rose from 153.2 in February, 1947, to 167.5 in February, 1948.

has provided a portion of the support of the postwar boom. Over $73 billion of the wartime borrowing was accomplished through the commercial banks and the Federal reserve banks. This latter type of borrowing directly increased the size of the monetary stream and was certainly inflationary.

The effects of the great increase in purchasing power through government war finance and the additional increase through the extension of credit to business firms by commercial banks have shown up in the postwar period.* The result has been a tremendous inflationary drive, which has been allowed to work its will during the postwar period, with the exception of some deflationary pressure provided by continued high government tax rates and the accumulation of a total government surplus of $3.5 billion (measured on national-income basis) in 1946 and $12.9 billion in 1947. However, the deflationary effect of the surplus is largely determined by the manner of its use.

In retrospect, it appears that the Federal government could have made greater use of the compulsory loan device. The compulsory loan as proposed by Keynes and a number of other economists would have been effective in wiping up purchasing power, but it would not have been as destructive of worker initiative as the assessment of very high taxes on additional earnings from overtime, or the like. Briefly, the plan provides that a portion of all income would be loaned to the government, to be repaid when the economy can absorb the released purchasing power without great price rises. In a sense, workers as well as soldiers would get a postwar bonus. The United States Treasury proposed a spendings tax in 1942; however, Congress did not find it acceptable. The collections from the tax were to have been two-thirds a compulsory loan to the Federal government and one-third a tax.

This Treasury plan of a spending tax to be assessed as indicated above would have been a very desirable revenue measure to prevent war and postwar inflation. The spendings tax is to be preferred to a general sales tax for two reasons: (1) The amount of tax paid by each individual can be ascertained, and, therefore,

* Nonbank liquid assets rose from $86 billion in 1940 to $313 billion in 1947, an increase of $227 billion.

the compulsory loan feature can be included. The compulsory loan makes it possible to assess higher rates than would be otherwise possible. (2) The assessment of a spendings tax makes possible the assessment of higher rates upon individuals and families that make large annual expenditures.* A spendings tax of this type, or some variation, would have been a desirable war-revenue measure. Certainly this sort of a levy would have been superior to the general sales tax that was not enacted, or to the conglomeration of special luxury and excise taxes that were placed on the statute books during the war and were still being collected in 1948. One basis for this preference for the spendings tax is that a collection of an equal amount of revenue from the spendings tax would consume a much smaller amount of resources.

Co-ordination of Fiscal and Direct Controls

Some attempts were made during World War II to restrict the use of scarce materials by the assessment of taxes. The special taxes on tires and leather goods are examples. Generally, this method of obtaining additional revenue and also restricting the use of materials in short supply was permitted to remain fallow during the war years. If this theory of obtaining revenue were combined with the ration system it could become a very effective price-control tool.

The portion of the supply of goods obtained by the exchange of ration coupons would be tax free. This exemption would allow individuals living on a minimum budget to obtain their necessaries without paying the tax and would therefore prevent a rise in minimum cost-of-living indices. The same good (specially marked as taxable and ration-free) could be purchased without a ration coupon by the payment of a much higher price that would include a high tax. This procedure would have increased

* The plan proposed by the Treasury in 1942 consisted of two parts, a flat-rate tax plus a graduated surtax. The flat-rate tax of 10 per cent was applicable to spendings in excess of $500, for a single person, $1,000 for a married couple, and $250 for each dependent. The surtax was to be levied at graduated rates ranging from 10 to 75 per cent on spendings in excess of exemptions, which were twice as high as those under the flat-rate tax. The flat-rate tax was in the nature of a compulsory loan. *Annual Report of the Secretary of the Treasury for the Fiscal Year Ended June 30, 1943*, pp. 410-420.

government revenues, kept trade in legitimate channels, and in this manner maintained a larger portion of the market economy and at the same time developed deflationary pressures. The administrative problems of a scheme of this sort would be great but not insurmountable.

State and Local Fiscal Activities

The state and local governments during World War II generally maintained without change the taxes and tax rates existing during the immediate prewar period. Some reductions were made in state income-tax rates and a few reductions were made in effective rates of excise taxes, but the changes were not great; those that were made tended to increase the inflationary pressure rather than to decrease it. Local governments did not lower their property-tax mill rates, but the value of property for taxation purposes was not increased along with expansion of market values. However, state and local government fiscal activities were, on the whole, deflationary; this effect arose from the reduction of expenditures and the retirement of debt.

The brief examination that has been made here of the fiscal activities of the governments of the United States aimed at preventing price increases during the war and the postwar period emphasizes that much more could have been done. The greatest weaknesses of the Federal revenue policy during the war were the unwillingness to inaugurate a comprehensive compulsory-saving program and the failure to correlate sufficiently the rationing and tax programs. The greatest weakness in the postwar period was the speed with which taxes upon profits and also individual incomes were reduced. In fairness it must be mentioned that revenue controls were maintained much better than the direct (police) controls and that monetary controls were not effective during the war nor during the postwar period.

Effect of Taxes on the Prices of Particular Commodities

General Considerations

The United States tax system has for many years included special levies upon particular products. In most cases the special high tax has been levied because the consumption of the article

was not considered necessary for good health and because a tax placed upon the item would bring in substantial revenues. The outstanding examples of this type of tax levy are the Federal, state, and even local taxes on alcoholic beverages and tobacco products. During World War II, very high special Federal retail excise taxes were placed upon jewelry, furs, toilet preparations, and luggage. These taxes were still in effect in 1948.

Gasoline is another commonly consumed commodity that has had its price greatly raised by the levy of special taxes. In this case, the state taxes are the most important and they have been levied largely because gasoline consumption has been considered a good measure of the benefits received from highway construction. The funds collected from the application of this tax do not go into general revenue, as do most of the revenues of the other special commodity taxes; instead they are largely set aside for expenditure upon highways. The Federal gasoline tax of 1½ cents per gallon is not levied as a use tax, and the revenues collected are not segregated.

An unusual example of special commodity taxation is the taxation of margarine by the Federal government and the continued taxation by state and some local governments. The tax has been particularly heavy upon margarine colored yellow. In fact, the tax restrictions upon yellow margarine have been so great that it has been practically removed from the market. The tax has not produced large revenues and margarine has not been considered a luxury; the principal purpose of the tax has been to prevent the substitution of margarine for butter and, therefore, to maintain higher butter prices.*

The communication, electric-utility, automobile, and amusement industries have also been selected for additional tax burdens. The levy of special taxes upon industries that provide necessary production services has a particularly undesirable effect upon prices. Prices to the consumer are likely to be increased by considerably more than the tax because of the common trade practice of percentage markups based on cost, which in these cases

* Wisconsin levies the following taxes upon margarine: $25 retailer's license fee, $500 wholesaler's license fee, $25 restaurant license fee, $1,000 manufacturer's license fee, $5 boarding-house license fee, plus an excise tax of $0.15 per pound.

would include the tax.* In the case of a retail sales tax, the base is greater as a result of markups and therefore a tax of a lower rate will bring in the same revenues as a higher-rate manufacturing tax.

Probable Effects on Prices of Special Commodity Taxes

The revenues from the taxes on alcoholic beverages have become tremendous during the prosperous 1940's. It is estimated that Federal and state tax collections will be about $3 billion in 1948. The cynical advice "Put the taxes on the vices for they have the broadest shoulders" continues to be good revenue policy. The quantity of consumption of alcoholic beverages is very sensitive to changes in prosperity and an abundance of purchasing power; for example, the consumption in 1948 was considerably below the 1947 level. Beer consumption is a possible exception to this generalization. High taxes on alcoholic beverages increase prices of legal sales until the difference between manufacture cost alone and cost plus tax is great enough to overcome the risks of illegal manufacture. Money collected in liquor taxes is generally purchasing power that would have been saved or used to bid up prices of other luxury goods. Only the tax upon beer is likely to reduce the money available for the purchase of necessities and thus to tend to reduce their price and to have an important deflationary effect.

The tax on tobacco products is largely a cigarette tax. Since 1919, cigarette consumption has continued to increase (with the exception of a slight drop from 1931-1933), despite several Federal tax increases and the introduction of state taxes. The

* An example of the result would be:

Before tax:		
Cost to manufacturer	$10	—markup 10%
Cost to wholesaler	$11	—markup 5%
Cost to retailer	$11.55	—markup 20%
Cost to consumer	$13.86	
After tax of $1 on manufacturer:		
Cost to manufacturer	$11	—markup 10%
Cost to wholesaler	$12.10	—markup 5%
Cost to retailer	$12.71	—markup 20%
Cost to consumer	$15.25	

A tax of $1 per unit has raised the price to the consumer by $1.39.

direct Federal and state excise taxes are typically 50 per cent of the price of a package of cigarettes.* Cigarette prices have not increased as much as the tax. This relationship exists because the great increase in volume has made possible a considerable reduction in manufacturer, wholesaler, and retailer margins. Cigarette-consumption data indicate that cigarettes have become a necessity. This is borne out by grocery store managers, who say that a frequent practice is to buy cigarettes first and food afterwards. Low prices on cigarettes have replaced low prices on sugar and flour as leaders to bring shoppers into stores.†

High taxes on cigarettes undoubtedly reduce the quantity of money available to be spent on other goods. In a period of inflation, these taxes tend to reduce prices of food, shelter, and clothing by draining off purchasing power that would otherwise be brought to bear on these prices. During a period of deflation, these taxes result in a reduction of expenditure for goods and services badly needed to maintain their prices.‡

The best information available shows that the special Federal luxury taxes on jewelry, furs, toilet preparations, and luggage were not actually luxury taxes. At least they were not luxury taxes in the sense that the persons in the upper income brackets spent a larger portion of their income for these products than people in the lower brackets. Information obtained in the family-expenditures study of 1941 showed that all income brackets between $500 and $5,000 spent about the same portion of their income on jewelry and toilet preparations; however, the higher income classes spent a larger portion of their income on furs and luggage. Undoubtedly, a certain quantity of toilet preparations and jewelry is considered a necessity.§

* The Federal tax is 7 cents a package of twenty, and the typical state assesses an additional 2 or 3 cents.

† The per-capita consumption of cigarettes in 1929 was 977; by 1939 it had risen to 1,318, and in 1946 it was 2,324.

‡ The Division of Tax Research, Treasury Department, made available in February, 1948, an excellent study titled *Federal Excise Taxes on Tobacco.*

§ The Heller Committee for Research in Social Economics of the University of California included expenditures for toilet preparations in their "Restricted Quantity and Cost Budget for Maintenance of Families or Children." The budget also included expenditure for tobacco products (pipe tobacco, however, rather than cigarettes). These budgets were developed to determine relief-expenditure requirements. Therefore, it would seem that some products called luxuries are actually necessities.

These luxury taxes, which are generally 20 per cent, increased the prices of the items taxed by the amount of the tax during the period of short supply of World War II. In 1948, it appears that the prices of the more expensive varieties of items subject to the luxury tax had absorbed a portion of the tax. The tax on cheap toilet preparations is a tax on necessities and tends to have a general deflationary effect.*

Although gasoline taxes have been levied since 1919 at continually higher rates, the price of gasoline including the tax declined until the postwar period. The price of gasoline in 1919 was 25.47 cents, when its direct tax burden was but 0.06 of a cent; in 1945, when the tax burden was on an average 6 cents, the price was about 21 cents including tax. Between 1945 and 1948, the price of gasoline rose more rapidly than the tax burden, making the tax a smaller percentage of the price.

The gasoline-tax collections are largely made directly available for road construction and repair. The gasoline tax, by financing an improved road program, has undoubtedly reduced general prices through decreased costs of transportation. However, the natural question to ask is: Couldn't the road-construction program have been financed in another manner that would not have placed quite such a heavy burden upon the quantity of purchasing power available for other goods and services? Actually, during the depression of the 1930's much road construction was financed with revenues from other sources. The Federal government continues to spend much more on roads than it collects from the assessment of the 1½ cent tax on the gasoline used to propel vehicles over the public roads of the nation. The portion of gasoline taxes collected on gasoline used for commercial purposes is undoubtedly passed through the economy and results in price rises considerably greater than the revenues obtained by government.

The existing market and production conditions must be very unusual if a sales or manufacturer's tax on a particular product does not raise the product's price. A special commodity tax on one of two close substitutes—for example, margarine and butter—will not only increase the price of the taxed product but also the price of the close substitute. A commodity tax upon a product that is

* The Division of Tax Research, Treasury Department, made available in October, 1947, an excellent study titled *Federal Retail Excise Taxes.*

produced largely from the utilization of the nation's natural resources—for example, gasoline—is less likely to be passed on in higher prices than a commodity whose cost arises nearly entirely from the payment of ordinary market-rate wages. However, even in the case of the price of gasoline, the amount paid to the natural-resource owner is a very small portion of the total cost of the product.

A commodity tax levied upon a product that is customarily sold under luxury conditions—that is, with wide margins of profit and handled by many middlemen—is less apt to bring about a price rise than a tax levied upon a product sold under very competitive conditions. Also, a sales tax or a special excise levy collected when a prevailing buyer's market exists is less likely to result in higher prices.*

Revenues May Be Inflationary

Inflationary Possibilities of Taxes

It is usually assumed that an increase in the collection of taxes by the government would bring about a general decline of prices. The basis of this statement is twofold. (1) It is taken for granted that government expenditure does not change as a result of the levy of the tax; therefore the levy reduces the total quantity of purchasing power bidding for goods. (2) The levy of a general tax—for example, a sales or income tax—makes it possible for the consumer to shift the tax backward onto the merchant in reduced prices.

The danger of increasing taxes to eliminate purchasing power is that the taxes may become a basis for increasing the inflation rather than a basis for its decrease. This possibility is particularly strong under conditions approximating full utilization of available resources and strong aggressive union activity. The levy of an additional tax of a type that would increase payroll withholdings may be considered a reduction in wages, and the demand may be made that take-home wages remain constant; if the tax is an excise tax, which would increase the cost of living, the demand may be made that wages be increased to keep pace with this

* John F. Due, *The Theory of Incidence of Sales Taxation*, pp. 194–197.

rising cost of living.* Any tax measure aimed at reducing purchasing power by reducing the quantity of goods purchased with money received for a day's labor is based upon the assumption that wage earners will accept this cut of their scale of living, and will not use it as a basis for increased wage demands. This assumption is reasonable under conditions of underemployment of labor and weak economic and political action by labor. It is doubtful, however, if it can be assumed as a generalization always accurately describing conditions during an inflation period, which is the very period when the action is recommended.

It was pointed out on page 52 that a lump-sum tax assessed upon a producer making greater than normal profits will not affect price as long as the tax does not bring profits below the normal level. There are undoubtedly many firms and industries making greater than normal profits, but the important Federal revenues are not lump-sum taxes. The Federal income and excise taxes vary with output. The property and some special franchise taxes, largely local sources of revenue, are the only ordinary government revenues that could be considered lump-sum taxes. The renegotiation of contracts used during World War II could also be considered a type of lump-sum tax.

Taxes that vary with output, which are levied upon either monopolies or competitive firms, tend to be shifted in higher prices. Most of the taxes levied in the United States are certainly of this type.

The higher prices arise under monopoly because the new point where profits are greatest will be where price is greater and quantity less. Also, a new tax levied upon a monopoly may be used to justify a price rise that was previously not made because of fear of public opinion. A tax levied upon a firm operating under competitive conditions forces costs above price and some firms will be eliminated; this reduction of quantity will enable the remaining firms to sell their output at a higher price. This

* "To mop up excess purchasing power by increasing purchase tax, or Customs and Excise duties, the Government must obviously touch the goods which figure in working-class budgets. Then the cost-of-living index will rise accordingly. Though few wage scales are now linked officially to the index, it is quite certain any upward movement will encourage workers to claim higher pay. And it will be a powerful bargaining weapon in negotiations." *The Financial Times*, London, March 27, 1948, p. 4.

tendency of taxes levied upon firms and also resource owners to increase price and reduce production must be considered inflationary. However, the total effect of the levy cannot be determined without considering income groups paying the tax and income groups receiving the funds when spent by government. In other words, the effect of the tax upon the quantity of money bidding for goods and services must be determined before the effects of tax changes on general price levels can be fully determined.

Effect of Borrowing on Prices

Borrowing must be recognized as an important method available to government for acquiring a quantity of funds. The decision whether it is a desirable way to obtain funds needed must be based to a great extent upon price considerations. The desirability of government borrowing from the banking system is partly determined by the expectations regarding private borrowing. Often large government borrowings of this type produce conditions conducive to expanded private borrowing. The expansion of both public and private borrowings is very likely to bring about a price rise greater than is desirable or is anticipated. It is at this point, or where private borrowing begins to develop, that monetary and banking policy can be most helpful through co-operative action. The action must be aimed at preventing the expansion of money from becoming too great.

Borrowing in itself is deflationary (money is merely exchanged for bonds), but because an increase of total expenditure usually accompanies borrowing it is associated with price increases. The increase in prices is considered desirable if it results in the employment of a significantly larger quantity of the factors of production and undesirable if it merely results in the transfer of, or higher prices for, factors already employed. Borrowing can be considered as a type of tax. The burden or incidence of the tax in the case of borrowing rests upon the persons who have their relative economic position worsened by the levy. The use of borrowed funds is desirable if the worsening of the economic position of certain groups is accompanied by an increase of productive activity. The latter situation exists if prices at the time of government borrowing are generally considered to be so low

that the burden of debt upon important production groups has become excessive. Also, the increase of prices decreases the purchasing power of the inactive groups and the unorganized groups. This has a desirable effect on productive activity if the increase can be stopped before it reaches the jaws of inflation. The experience in the middle 1940's in the United States has shown that the tremendous possible purchasing-power expansion caused by war is not easily controlled. In contrast, the experience of the 1930's showed that a peacetime price rise through borrowing can be readily controlled—for example, between 1937 and 1938.

A large government debt and an active private demand for loan funds would tend to drive up the rate of interest. An increase in the market rate of interest would reduce the value of long-term government bonds and would also increase the interest burden of government debt and intensify the transfer problem. The expenditure of the Federal government for interest in 1948 is about $5 billion annually, and the average rate of interest is less than 2 per cent. A doubling of this average rate would increase the interest burden to $10 billion, equal to total Federal expenditures in 1940; it would also reduce the confidence of investors in government securities, for the higher interest rates would markedly reduce the market values of long term government bonds. Under these circumstances, there would be great pressure for the alternative inflation. The rise of interest rates could be prevented by an increase in the quantity of money through reduced restrictions on private credit creation or through direct government action aimed at increasing the quantity of money. Either of these programs under conditions of full employment would raise prices as well as reduce interest rates. The burden of the debt is then transferred to those whose relative purchasing power declines during an inflation—for example, fixed-salary workers, retired pension and annuity recipients, institutions financed by a foundation, and the like. A large government debt tends to increase the desirability of an easy money policy that is likely to mean a degree of inflation or certainly the prevention of deflation.

THE ACHIEVEMENT OF A DESIRABLE CONSUMPTION LEVEL

General Effects on Consumption of Revenue-Raising Activity

If resources are to be most efficiently used, the consumption level must be high enough to give laborers the goods and services needed to bring forth the greatest possible labor effectiveness. This would necessitate (1) a minimum consumption level—that is, adequate housing, food, clothing, education, medical care, and recreation—and (2) savings sufficient to assure the introduction and wide use of the most efficient machines and techniques. In a capitalistic society, these achievement goals require that the holder of savings must be induced to risk them in a new venture, and savings must not be so great that consumption loses its ability to encourage new investment. However, it is possible for consumption to be high enough to avoid oversaving and yet not great enough to support maximum labor effectiveness. This would be true if the additional goods and services that could be obtained with increased labor activity were insufficient to stimulate the increase. This was perhaps the actual situation in England in 1948; it arose from the rationing of many consumption goods and the resulting reduction in the ability of money to command goods and services. The difficulty can be alleviated by payment of both money and ration coupons to certain groups of workers.

The whole problem of getting the correct level of consumption is closely related to income distribution, which is discussed in relation to government revenues on pp. 98-100 and in relation to expenditures on pp. 156-162. Government revenues affect consumption directly by reducing purchasing power in the hands of individuals and indirectly through effecting the distribution of income. Consumption from a given national income is also affected by interest rates, distribution of savings, availability of consumption goods during a previous period, population composition, and provision for social security; a number of other relationships perhaps also have an important effect. The quantity of personal savings in the United States between 1946 and 1947 shows the importance of these miscellaneous factors in affecting consumption. The tax system between 1946 and 1947 did not

change a great deal, the distribution of income was approximately the same, and the total personal income of the period rose from $177.2 billion to $196.8 billion; but the personal savings in 1947 were $4 billion less than in 1946. Thus the percentage of personal income consumed in 1947 was much greater than in 1946.

Saving and Consumption Relationships

The variations arising from different methods of obtaining revenue are closely related to the portion of income saved in the different income brackets and the portion of revenue raised that is obtained from the different income brackets. If the government obtains its revenues without reducing the revenue available to individuals—for example, borrowing from commercial banks or printing money—the raising of revenue by the government does not in itself decrease consumption or saving activity of individuals.

Table 3–1, given below, contains the most accurate current data of savings made within the different income brackets. The table shows that in 1944, when the United States was benefiting from price controls, high wages, and full employment, 30.9 per cent of the families were within income brackets with no net

TABLE 3-1. Average money income, expenditures, and savings of families and single persons in cities, by income class, 1944 *

Annual income after personal taxes	Expenditures for current consumption	Net savings or deficit	Per cent of families in each class
Under $500	$ 594	−$320	4.2
$500 to $1,000	939	− 206	7.7
$1,000 to $1,500	1,317	− 126	7.1
$1,500 to $2,000	1,690	− 3	11.9
$2,000 to $2,500	1,946	213	13.9
$2,500 to $3,000	2,375	236	13.2
$3,000 to $4,000	2,816	538	19.9
$4,000 to $5,000	3,428	767	9.6
$5,000 and over	4,324	2,856	12.5

Source: *Monthly Labor Review*, January, 1946.

* The savings arising in the middle income brackets are overstated in this study. The overstatement arose from considering all mortgage-principle payments as savings and not reducing them by depreciation taking place during the year.

savings. Additional taxes collected from these brackets would reduce private consumption by very nearly the full amount of the taxes collected. The portion of individual income saved and consumed is closely related to the size of income. However, there are individuals within each income bracket who save a portion of their income. Rural dwellers and white-collar workers are more likely to do some saving despite a low annual income than are urban laborers.

By obtaining its funds in different ways, the government can have a varying effect upon the private consumption level.* If revenues are obtained by the levy of taxes that are paid largely by persons in the low income brackets who are city dwellers and nonwhite-collar workers, private consumption expenditures will be decreased by nearly the full amount (if unemployment develops, consumption will be decreased by more) of the revenues obtained. If revenues are obtained by taxes collected largely from the members of the upper income brackets, consumption will be decreased by considerably less than the amount of the revenues obtained. This difference arises because most savings are made by individuals in the upper income brackets and because saving levels rather than consumption levels will be changed when the tax burden is increased. If the government obtained its funds from taxes upon businesses or by borrowing from individuals or business firms, the resulting reduction in private consumption would be even less. If the government borrowed from commercial banks or printed money, and full employment did not exist, the amount of private consumption would be likely to expand. Government receipt of revenues from the sale of basic commodities would also, under most conditions, expand the quantity of private consumption.

How Taxes Directly Affect Consumption

An increase of the tax burden in itself reduces the quantity of funds available for consumption and saving. The desire to maintain consumption levels is greater than the desire to maintain

* In this analysis it is usually assumed that funds obtained by a government are not spent. See Chapter IV for the general impact of government expenditures upon the consumption level.

saving levels, thus savings will be decreased in all income brackets but the decrease will be most important where net savings arise; in the lower income brackets there will be an immediate reduction of consumption by very nearly the full amount of the tax. If the tax is general and brings about a reduction of total quantity of money bidding for goods and services of all kinds, the general price level will tend to decline so that the regular quantity of consumption can take place with the reduced quantity of money; this tendency would be particularly strong in the case of a sales tax with the revenues utilized to repay public debt. Recent studies have shown there is considerable variation of savings within income brackets. Therefore, the effect on consumption and savings will vary, depending on which groups within an income bracket are affected.*

How Commodity Sales Directly Affect Consumption

The sale of commodities by the government increases the quantity of goods and decreases the purchasing power in the hands of individuals. The direct effect is deflationary, and consumption of the commodities sold will increase. Government action of this type is limited, of course, by the quantities of commodities possessed. The Ever-Normal Granary Plan adopted by the United States in 1938, after the bumper crop of 1937, is aimed at the equalization of the supply of farm products between good and bad years. The plan, which is financed by the Commodity Credit Corporation, attempts to accomplish this aim through storage and sale from storage. A sale of large supplies of farm commodities held by the Federal government at the outbreak of World War II made it unnecesary to ration bread in the United States and increased the consumption level of our allies.

How Borrowing Directly Affects Consumption

The existence of a large government debt increases the portion of tax receipts that (because of large interest payments) will be

* The studies of Consumer Finances by the Board of Governors of the Federal Reserve System in 1946 and 1947 referred to on p. 66.

made available to individuals with a low propensity to consume. Unless this fact has also brought about a more progressive tax system than would have otherwise existed, it will decrease the portion of the national income spent for consumer goods and increase the portion saved.

If there are factors of production formerly unemployed that become employed because of the expenditure by government of funds borrowed, the quantity of consumption of the nation has expanded as a direct result of this borrowing activity. Under these circumstances, the consumption expenditure of no individual has been directly decreased, while the consumption of the unemployed who are now employed has expanded considerably. Government expenditures financed by borrowing are very likely to bring forth a decline of consumption if completed during periods of full employment. The result under these latter conditions would be inflation and a reduction of the factors of production allocated to the production of consumption goods, and an increase in speculative hoarding of goods.

Inflation that develops from government borrowing during full employment decreases consumption because (1) wages tend to rise less rapidly than prices during a period of this type, (2) rising prices stimulate investment and the use of an increased portion of the factors of production for capital construction, and (3) rapidly rising prices stimulate hoarding of goods and therefore a reduction of the goods which can be consumed. The tendency for investment to rise rapidly during money-wage increases is pointed out below.*

Indirect Effects of Government Revenue Activities

The indirect effects of government revenue activities refer largely to the resulting changes in interest rates and the impact of interest rates upon economic activity. When the Federal Reserve System was established in 1914, most experts believed that the quantity of economic activity could be determined by interest-rate changes. Today, the effect of interest rates is considered to be much more uncertain, but one point is certain—

* The sale of gold by the government during this period would reduce the quantities of consumption goods held off the market. See p. 104.

mere power to change interest rates is not sufficient to control economic activity.

It has been assumed by most economists that a high rate of interest stimulates savings and decreases investment; this, of course, makes the interest rate important in determining the amount of consumption and economic activity. However, the quantity of savings arising appears to be at least as closely related to height of profits, money-wage increases, and the level of economic activity.

A British study concludes that "the effect of variations in the rate of interest on business savings seems to have been so small as to be negligible." * Data gathered in the United States show a very close relationship between changes in money wages and the quantity of business investment and savings. The increase in money wages in the spring of 1946 touched off a great expansion of orders for new capital goods in the United States, while in the fall of 1945, when it was believed wages would not increase, the orders for capital goods were declining.† This also heralded the first important upward turn in the United States inflationary spiral.

Apparently savings and investment are closely related to profits and money wages, as well as to the capitalized value of earnings, which is determined by the interest rate. If interest rates increase, the capitalized value of earnings decreases sharply; if interest rates decrease, the capitalized value of earnings increases sharply.‡ Money-wage levels are important because when they go up costs of capital goods in the future will be higher; in addition, high wages will mean an active demand for goods produced. Emphasis upon the importance of the long-term rate arises because it is to a great extent an independent variable and because it does affect investment; perhaps it is largely in its effect upon investment that the rate of interest affects savings.

If the government obtained its funds from persons in the upper income brackets through either taxation or borrowing, the rate

* E. A. Radice, *Savings in Great Britain, 1922-1935* (London, Oxford University Press, 1939), p. 78.

† Charles F. Roos, "The Demand For Investment Goods," *American Economic Review*, vol. 38, no. 2, May, 1948, p. 315.

‡ The capitalized value of earnings is calculated by dividing earnings by the prevailing rate of interest.

of interest would tend to increase. The same tendency would exist if funds were obtained by borrowing from the commercial banks. This tendency for interest rates to increase with the latter type of government revenue-raising would be much greater if excess commercial-bank reserves did not exist. The tendency of interest rates to rise as a result of obtaining revenues from savings or through borrowing from commercial banks counteracts slightly the direct expansionary effect on consumption of obtaining revenues from these sources.

The government, through the levy of taxes upon persons in the high income brackets, also reduces the net return on investments. This relationship arises because a large portion of the income of the wealthy is obtained from the ownership of property. A high tax upon corporate profits would have the same effect upon the return on investment.* This would mean that investments that had seemed to offer a sufficient financial inducement prior to the levy of the tax were no longer considered desirable. (It is doubtful whether, under even the most favorable conditons, it would be possible to shift the full amount of a corporate income tax.) We have here, therefore, two indirect effects of obtaining revenues from persons in the higher income brackets. The first effect is to increase interest rates and the quantity of savings, and the second effect is to require a higher return on investment.

The higher rates of interest would tend to stimulate the amount of saving but would tend to reduce the amount of investment. This undesirable impact on the balance between saving and investment plans could have a very detrimental effect on the total activity of the economy and, therefore, on the amount of total consumption.†

The sale of commodities by the Federal government increases the revenue of the government. If the commodities have been originally purchased with borrowed funds, their sale will merely reduce the quantity of money existing in the community and increase the quantity of commodities. If the products have been purchased with funds obtained from taxes, their sale makes possible a reduction of taxes and increased consumption at constant

* During World War II, corporate tax rates increased greatly but net profits after taxes did not decrease; rather, they increased by 125 to 150 per cent.

† See pp. 27–29 for an analysis of oversavings.

prices. Also, if the commodities are sold for a price higher than their purchase price, the sale would be very likely to become a basis for decreased taxes, whether the original funds had been obtained by borrowing or tax receipts. If it is considered undesirable to reduce government debt, the money obtained from the sale of commodities would always be available for additional expenditure or a tax reduction. Any of the alternative actions would stimulate consumption.

The Effects of Government Sale of Gold

The purchase and sale of gold has usually been a monetary operation and not a fiscal activity of government. The purchase and the sale of gold usually do not directly increase or decrease government revenues or expenditures. An exception to this was the sterilization of gold by the Federal Treasury late in 1937. The Treasury at this time spent about $1,400 million of government revenues for the acquisition of gold. However, in 1938 the quantity of business activity decreased and it was considered desirable fiscal and monetary policy to desterilize the gold. Thus, late in 1937 expenditures were made for the purchase of gold, and early in 1938 revenues were obtained from the sale of gold.

The reserves of the Federal Reserve System and the entire private banking system are based upon the quantity of gold held by the United States Treasury. If the government began the sale of gold, the amount of credit which commercial banks could extend would be reduced. This reduction would be particularly sharp if the reserves required by law for the Federal Reserve Banks were completely utilized. Such a restriction in credit would reduce business activity and, as a consequence, would lay the basis for a serious depression and a reduction in consumption. This unusual effect of the sale of this commodity by the government arises from the unique position that the commodity gold holds in our banking and monetary system.*

The difference between the sale of gold and the sale of com-

* An interesting discussion of the effects of gold is given by Raymond Mikesell in an article titled "Gold Sales as an Anti-Inflationary Device," *Review of Economic Statistics,* vol. 28, no. 2, May, 1946, pp. 105–108.

modities such as wheat and cotton is that the sale of wheat and cotton would also lay the basis for the reduction of debt or the reduction of taxes. The reduction of taxes would be stimulating to the private economy, particularly if the taxes were being collected largely from the low income brackets. This stimulation does not arise from the sale of gold, nor does it arise when the Federal Reserve System sells securities on the open market.

The sale of gold by the government would also tend to raise interest rates through its reduction of the reserves of commercial banks. This reduction in the reserves of commercial banks arising from the sale of gold has an effect on consumption similar to the decrease in the quantity of money in the hands of individuals arising from the government sale of wheat and cotton.

The Use of Taxes to Control a Consumer Boom

The booms developed during a period of war are closely related to consumption expenditures and could be called consumer booms. The booms developed during periods of peace are likely to be closely related to investment expenditures and could be called investment booms.

The control of a consumer boom requires that taxes be aimed at reducing the quantity of purchasing power being used to bid up prices, while increasing the portion of the total resources of the nation that is allocated to the provision of additional production facilities. High excise or spendings taxes closely correlated with an efficient rationing program are best suited to achieve this goal.

An effect similar to a spendings tax can be obtained by placing a higher tax upon corporate distributed profits than upon profits not distributed. This is done by placing extra taxes on corporate profits distributed and lower taxes on corporate profits used to expand production. Such a relationship partially exists in 1948, with corporate income subject to additional taxation if distributed.* Under the Federal income-tax laws of 1948, if corporate profits are used to expand the business the tax rate is 38 per cent, while if they are distributed as dividends the tax rate is 38 per cent plus

* The British tax rate on distributed corporate profits is 25 per cent and on undistributed profits 10 per cent.

the individual income-tax rate applicable to the bracket in which the receiver of corporate dividends falls.*

THE ACHIEVEMENT OF A DESIRABLE EMPLOYMENT LEVEL

Attaining Full Employment with a Balanced Budget

The old rule of public finance was: "The budget must be balanced annually." The new rule, which the leaders of most of the progressive countries of the world have adopted, is: "The budget must balance the economy." The advantages of performing this new type of balancing operation by the use of a budget balanced in the old sense are quite persuasive and worthy of attention.

The first and most important reason for reliance upon taxes is political. The group in power will usually desire to obtain full employment through borrowing, for this procedure is nearly certain to be more politically acceptable. A government that accomplishes through borrowing what could be accomplished just as successfully by the use of tax revenues is engaging in a type of political bribery; this is more likely to be the case in fighting a war than in fighting unemployment. It is attempting to win a war or perhaps gain power by pursuing a policy based upon political expediency. This sort of a course is not sound fiscal policy aimed at the utilization of the resources of the nation and could transfer it into a program of bread and circuses. The income- and estate-tax reduction in 1948 must be considered this type of fiscal action.

On occasion, the full-employment goal could be accomplished and maintained as efficiently with a major emphasis on taxes as it could with a major emphasis on borrowings. Usually, however, the floating of loans is very nearly a necessary requirement or is the only logical course of action—for example, capital investments should usually be financed with borrowed funds, for the utilities

* One of the better recent tax studies is *Taxes and the Budget* by the Research and Policy Committee of the Committee for Economic Development (November, 1947). This study recommends a stabilizing budget policy. Briefly, the program is as follows: Set tax rates to balance the budget and provide a surplus for debt retirement at an agreed high level of employment and national income. Having set these rates, leave them alone unless there is some major change in national policy or condition of national life.

arising from the expenditure are going to be enjoyed over a period of years.

An economic disadvantage of continued large borrowings is that they increase the number and the wealth of the persons obtaining the requisites of life from income obtained as interest payments. This is undesirable for, if other stimulations of production remain the same, the greater the number of persons who may live although they do not toil the less productive activity will be accomplished. Also, the hardship involved in transferring funds from the pockets of those engaged in productive activity will be restrictive. These disadvantages are sound arguments for a minimum-sized public debt and low interest rates. However, if private borrowing were merely replaced with public borrowing the development would be desirable, for it would produce an actual decrease in the portion of national income accruing to property owners.

Attaining Full Employment with an Unbalanced Budget

The general basis for favoring deficit government financing is also convincing, and under certain conditions overwhelmingly so. For example, there is little doubt that the use of deficit financing was the desirable government method of providing funds for the full-employment efforts in the United States during the depression of the 1930's. The general conditions that made the use of borrowed funds desirable were: (1) In relation to the income and wealth of the nation, the government debt was small. (2) Investment in the economy was predominantly dependent upon possibilities of private profit; therefore, an increase in the progressive rates of taxes might decrease greatly the incentives for investment. (The policy-determiners of a socialist nation would not have to bother with these effects of progressive taxes.) (3) The portion of the national income collected in taxes was not great enough to make a percentage reduction in tax rates significant. (4) Banks and other investment institutions were anxious to find a place to invest their idle funds. (5) The credit of government was very good; this was especially true of the Federal level.

A government policy aimed at full employment financed with borrowings can usually be accomplished with a smaller change

in the institutional arrangement and relative power positions of groups within the society. Also, a smaller total outlay is required if the funds are obtained by government borrowing. A dollar raised by taxation will reduce consumption expenditures, investment expenditures, and hoardings. The portion that each will be decreased is determined by the type of tax used to collect the dollar and the prevailing economic atmosphere. It is very nearly certain, however, that the whole dollar will not be obtained by a reduction in hoardings. On the other hand, a dollar spent by the government that was obtained by the sale of bonds to commercial banks possessing excess reserves will increase the expenditures of the community by the full amount of the government expenditure.*

Taxation and borrowing, as has been previously mentioned, can also be considered in relation to their effect upon the income stream arising within the private section of the economy. For example, a fiscal policy composed of combining tax reductions with a maintenance of government expenditure would be this type of a program. Under these circumstances, the increased expenditure is expected in the private economy. However, if the government had formerly obtained its revenue from taxes upon current expenditure, the increase in the income stream would arise because funds for government expenditure came from borrowing which did not decrease private expenditure by the amount of their collection. If the tax reductions were made largely upon income received as profits, then the increase in the size of the income stream would be more closely related to a stimulated increase arising from the private section of the economy. If profit possibilities were bright, a considerable increase in private investment would follow. The expectation of this sort of a reaction is dependent upon excess commercial-bank reserves, the possibility of idle savings, and the fact that individuals and firms benefiting will find the inducement sufficiently increased to warrant the risking of their capital.

The idea that government borrowing could increase the

* An exception would be where the levy of the tax brought forth an increase in consumer expenditures or investment. Consumer expenditures might be increased by a tax if it were expected that a series of tax increases was to be assessed. A tax could increase investments if it were levied only upon large monopolies or upon imports.

quantity of employment is a recent development. It is, however, difficult to understand why this should have been the case with the many examples of full employment arising from government borrowing during periods of war. Nevertheless, this was the situation when the national leaders began to develop fiscal policy to combat the rising tide of unemployment during the early portion of the 1930's.

In the spring of 1933, with more than 20,000,000 men involuntarily out of employment and with the relief needs of most of the local government units going unfilled, the defeated President Hoover and his Secretary of the Treasury, Ogden Mills, pleaded for a balanced budget. The balanced budget was to be obtained by cutting expenses to the bone and raising additional revenues by the levy of a Federal sales tax. In the light of developments in fiscal policy that have occurred since 1933, it is difficult to imagine that a government could consciously follow this policy of additional deflation during a period when the country was writhing from pain caused by the existing deflation. The strength of the folklore at this period that required this policy is realized when it is recalled that the new president was elected on a platform providing for greater economies than those practiced by President Hoover. The events proved too strong; after a start at government economies, the new administration soon abandoned attempts at budget balancing, and the Federal budget of 1934 provided for expenditures of nearly $10 billion, with about 70 per cent to be raised by borrowing operations. It had been decided, finally, that a patient suffering from loss of blood should not be treated by the withdrawal of more blood but rather should be given a transfusion.

In this unplanned manner, government borrowing was introduced as a fiscal-policy tool to be used in combating unemployment. It took an additional four years after the 1934 budget before deficit spending was definitely related to the bloodletting of oversaving.* A person dies from loss of blood and does not lose blood because he is dying. The same cause-and-effect relationship exists between purchasing power (the blood) and economic activity (the person).

* The establishment of this relationship gave birth to the concept of compensatory government expenditures discussed on pp. 30 and 170.

Sources of Government-Borrowed Funds

The Federal Government can go into debt in a number of different ways; to a great extent it is possible for it to choose the manner in which debt will be incurred. The choice of type of debt largely involves selecting the lender or the purchaser of government debt. For purposes of the discussion at this time it is convenient to divide the purchasers of government debt into three broad groups: * (1) commercial banks, (2) wealthy individuals and business concerns unable to find a more lucrative place for the investment of their savings, and (3) individuals or business concerns with funds that would have been spent, if the bonds had not been available, for capital goods or consumer goods. These three divisions of government bondholders overlap, and there are many borderline cases that cannot be placed definitely within either group. However, separation is sufficiently accurate to provide considerable aid in analyzing the effects of government loans on employment levels.

Bonds purchased by the first group, commercial banks, bring about expansion of purchasing power by the full amount of the loan. Bonds purchased by businesses or individuals possessing savings that would not have been used to purchase additional capital goods or consumer goods have practically the same effect as bonds sold to commercial banks. The difference in the effect would be that interest rates—that is, the cost of investment funds—would increase if the excess of savings seeking private investment were reduced; and as a result of this the amount of private investment would tend to decrease. The price of money, like the price of bananas, goes up when the quantity is reduced. The stimulation would also be decreased if the provision of a safe haven for savings in government bonds were to cause a withdrawal of funds invested in private undertakings. The importance of these countereffects of borrowing from savers would vary, but it is doubtful that they would be important under normal conditions.

During periods of government propaganda to reduce capital

* These three groups do not include the purchase of debt by government itself. For a more comprehensive study of the different types of Federal government debt, see pp. 124–128.

construction and consumption, or because of high costs or scarcities, the third type of holder of government bonds, those who delayed desired expenditure, becomes important. This group becomes a large holder of debt during periods of war or when unusual conditions similar to those arising from war exist. Debt purchased by this group amounts to a transfer of purchasing power similar to that which takes place upon the payment of taxes. The stimulus to additional employment and the increase in the expenditure stream that arise from the increase in government borrowing from the first two groups does not arise from government borrowing from the third group. However, it is possible that borrowing of the third type would result in employment increase if the shift in demand arising from the transfer of purchasing power were to stimulate new investment.*

Government borrowing generates full employment by increasing aggregate effective demand either through public investment, which does not compete with private investment and in fact provides opportunities for additional private investment (for example, builds highways or schools, or cleans out slum areas), or through the subsidizing of consumption by the man in the street by the payment of subsidies or the lowering of direct taxes. The advantage of finance through borrowing is that it does not involve curtailed private investment (unless the rate of interest is forced up) and does not reduce (in most cases) the quantity of private consumption.

Influence of Taxation on Full Employment

As was the case with government borrowing, the analysis of the effects of taxation upon full employment will be limited to the effects of Federal taxes. The emphasis on Federal revenue sources is justified by two characteristics: (1) the Federal government possesses a much greater freedom of revenue source, and (2) the important fact that the Federal government raises the great preponderance of revenues.

Taxes at this time are considered nearly entirely in relation to their influence upon full employment through their effect on the

* This is called the accelerator effect.

aggregate demand of the private economy. The influence of taxation upon the portion of the total aggregate demand arising from the public economy, either directly through government purchases or indirectly through payment of subsidies, is not included in the analysis.

The aggregate demand of the private economy consists of total private consumption expenditures plus total private investment expenditures.

General Effects of Taxes on Investment Expenditure

The consideration of taxes in relation to their effect upon private investment expenditure requires attention to the following points: (1) The effect upon savings available for investment. This relates largely to the accumulations of the rich and the use that corporations make of their profits and reserves. (2) The effect upon return obtained from an investment. This relates to the way in which taxes of various types decrease interest, dividend, and profit payments, as well as capital gains. (3) The relationship between tax burdens borne by private and public enterprise. The opportunities of private investment in those industries in which there is public competition will be reduced if the public enterprises receive tax favors.

The encouragement of private investment is important, but it must also be remembered that every boom period that arose, other than those occurring during a period of hostilities, came to an end largely as a result of a relative over-expansion of all types of private investment. There were not too many homes or too many hospitals or too many resort hotels to meet the requirements of the advertised American standard of living, but there were too many of them in relation to the purchasing power available in the hands of the people who were supposed to utilize these facilities. It is largely true, also, that the reason private investors require an opportunity to make large returns is the uncertainty whether purchasing power in the hands of the consumers will be great enough to buy at a sufficient price the goods or utilities produced from the investment. In a private economy, higher prices and capacity production produce the higher returns which become the incentive for increased investment; a business is not expanded when profits and prices are falling. However, the

dividend and interest payments would not have to be as great if investors were certain of getting them.

Savings could be so great that all the vaults in the country were overflowing; also, all taxes could be removed from interest and dividend income and capital gains; yet, if purchasing power were insufficient, new private investment would be very small.

The best guarantees of a continuous return from an investment are (1) a high purchasing power and (2) regular technological development. The second of these conditions is seemingly impossible to attain, but the first is certainly within the capabilities of an integrated public and private program.

General Effects of Taxes on Consumption Expenditure

The analysis of the effect of taxes on purchasing power requires consideration of the effects of the revenue measure on (1) individuals with varying propensities to consume and (2) prices of consumption goods.

A tax policy aimed at the maintenance of purchasing power is the first requisite for the stimulation of private investment. This type of a tax program, as previously indicated, requires that excise taxes and other taxes that reduce the impact of purchasing power be reduced to a very minimum and during periods of depression be removed entirely; and that highly progressive taxes upon personal income, estates, gifts, and trusts (with all loopholes filled) be the principal source of all government tax revenues. The rates of the income taxes should vary, depending on whether the income is obtained from active productive effort or from property ownership, with higher rates being applied to income from property. (This latter provision was formerly a part of the Federal personal income-tax and many of the state income-tax plans.) However, taxes on investment income must not be so great that the plant is not expanded despite the stimulation of adequate purchasing power. For purchasing power will be largely dissipated in higher prices unless new investment takes place to provide the additional quantities of goods.

The corporation income tax meets these requirements particularly well. The tax is collected only from profits and is therefore entirely a tax upon investment income. The Federal individual income tax does not differentiate between earned in-

come (wages and salaries) and unearned income (interest, rent, and dividends); this weakness is partially rectified by the prevailing tax upon corporate profits. The 1948 taxes of Great Britain differentiated very sharply between investment and earned income.

The reason for high taxation of investment income is that this income is mostly obtained by high-income receivers. The propensity of these persons to consume is considerably below that of the low- or middle-bracket income receivers.* Also, high taxation of profits is necessary if direct controls over wages and prices are to be successful.

Taxation aimed at maintaining a high level of consumption must, under the existing distribution of income (see Table 3–1, p. 98), be progressive. The data available indicate the tax burden borne by the low income levels in the United States to be entirely too high in 1948. Consumption can be increased most readily by tax measures if the tax burden of those possessing a high propensity to consume is reduced. This requires a lowering of the taxes paid by the recipients of small incomes. The Temporary National Economic Committee study of tax burdens in the United States and the study completed by Tibor Barna of tax burdens in England show the burden of the different excise taxes to be particularly heavy on the low-income receivers.† These same studies show the burden of the income taxes and the estate taxes to be relatively heavy upon the recipients of large annual incomes. If private consumption expenditures are likely to lag, the inexorable conclusion is that the relative importance of excise taxes should be decreased and that of estate, property, and income taxes increased. (See Table 3–2, p. 119.)

Corporation income taxes are levied by the Federal government and the state governments. The Federal levy is much the more important because it includes corporations in all states and because the rates of the Federal tax are much higher than the state taxes. The Federal tax is 38 per cent of the profits of corporations making profits annually above $50,000, with lower

* See pp. 35 and 98 for savings and income distribution.

† Temporary National Economic Committee, Investigation of Concentration of Economic Power, Monograph No. 3; Helen Tarasov, *Who Pays the Taxes?*, Monograph No. 3 (Washington, U. S. Government Printing Office, 1940), p. 6; and *Redistribution of Incomes* by Tibor Barna (Oxford, Clarendon Press, 1945), p. 188.

rates applying to corporations making a smaller profit. This tax is levied on the corporation and not on the individuals owning stock. It is only the returns of property owners possessing common stock that are directly reduced by the levy of the tax; however, there is some doubt that the tax is passed only onto profit claimants. Some postwar studies of the burden of the corporate income tax tend to leave the impression that taxes on corporate profits merely mean higher prices, so that the rate of earnings per dollar of investment in common stock is returned to what it was prior to the levy of the tax.* During World War II, profits of corporations expanded despite high corporate income taxes. It is doubtful that experience during this unusual period should be considered typical.

Corporation income taxes certainly do not place an additional burden upon income from all types of property ownership. Income obtained as interest, preferred-stock dividends, or earnings from investment in a partnership, proprietorship, or cooperative are not directly reduced by the levy of the corporate income tax. If an additional corporate-income-tax-rate is placed upon a corporate-tax rate that is already quite high, the persons who control corporate policy, the owners of common stock, will find the tax more difficult to pass on than if the total tax rate were low. This increase in the likelihood that the tax will be borne by the owners of common stock arises because the additional profits required to pass on the tax would also be highly taxed and therefore a very great profit increase would be required to shift the burden of the tax.

Taxing Idle Money to Provide Full Employment

Always in a depression there appears to be a shortage of money. The obvious action is either to increase the amount of money or to force the holders of money to spend. Those persons opposed to an unbalanced Federal budget have recommended programs aimed at directly increasing the velocity at which money circulates.

During the period of the middle 1930's, considerable popular support was obtained for tax plans aimed at increasing the circulation of money. The advocates of plans to tax hoarding thought

* Carl Shoup, "Incidence of the Corporation Income Tax," *National Tax Journal*, vol. I, no. 1, March, 1948, pp. 12-17.

that, by levying the special tax, pressure would be placed upon persons to transfer funds into investments or to use the money to purchase consumer goods.

Idle money is always held by relatively wealthy individuals and business firms. If these holders of idle money could be induced to spend their funds by the levy of a tax, economic activity would be expanded. It was believed that the levy of such a tax would stimulate additional investment or induce "consumer spending by the rich above the customary levels." However, it is doubtful that these expected results would have been realized if the program had been actually adopted.

At least a portion of the idle funds might have been used to purchase private and public investments held at that time by commercial banks. This would have resulted in a decrease in the quantity of money and certainly only a very slight increase in the velocity. To the extent that this latter result would arise, the levy of a tax upon cash hoards would not have accomplished its purpose. The desire to place funds in investments rather than in cash will reduce the rate of interest. The old theory was that this would increase investment by reducing the cost of money; just as important a result is that, when interest rates are low, individuals are less likely to assume the risk of investment. This reduced inducement to invest arises because the loss of income from holding funds as cash or idle deposits has decreased. The additional income arising from investment of funds is not enough to compensate for the additional risk. However, despite the danger of the falling interest rate making liquidity more desirable, the general stimulating effect of a tax on savings is important and actually provides a part of the desirability of income and estate taxes. The tax upon idle funds also provides a stimulation of investment similar to a rise in interest rates without the disadvantage of increased costs to borrowers.

THE ACHIEVEMENT OF A DESIRABLE INCOME DISTRIBUTION

The incentives of a capitalistic economy are largely determined by the manner in which income is distributed. Income distribution also has a great effect on the portion of national income spent for

consumption and the portion saved or invested. Income distribution is determined by the prices paid for various types of resources—for example, labor or cotton—and by the quantity of the resource controlled by particular individuals. The actual income distribution determined by the interplay of market forces is, to a great extent, determined by the ability of individuals and groups to produce cheap and sell high. However, this efficiency or ingenuity, which is rightly so highly valued in the United States, is not the only determiner of income distribution. Inheritance and fortuitous circumstances are also important in determining the existing inequality of income distribution.

The Relationship of Goal to Government Revenues

The assumption underlying fiscal policy is that the income distribution achieved through prevailing patterns of prices and existing ownership of resources does *not* provide the most desirable distribution of income. Also, a necessary part of the achievement of the goal is the existence of some standards other than relative price that may be applied to determine efficiency of resource use. (The discussion of minimum personal budgets and quantity of savings on pages 63-66 provided a basis for a different income distribution.) The present income distribution must be considered most desirable if the relative prices paid resource owners, which is reflected in income distribution, is considered correct.* Finally, to have the goal related to government revenues, it is necessary that its achievement be closely associated with the manner in which governments obtain their funds.

The collection of government revenues affects income distribution among (1) individuals (for example, the rich and the poor), (2) producer groups (for example, farmers and manufacturers), and (3) income types (for example, profits and wages). The change is largely made in two distinct general ways: (1) The collection of revenues through taxes or loans or sale of commodities can directly reduce the net assets and/or liquid assets of individuals and firms. (2) The collection of revenues on particular types of income or particular commodities can discourage certain

* With the exception that unequal income distribution due to existing unequal resource ownership need not be justified on this basis.

economic activities and encourage others. The second reaction to revenue collection is partially an effect of the original impact of a reduction in net assets and/or liquid assets.

The levy of high taxes on the poor and low taxes on the rich would reduce the relative quantity of net assets available to the poor and increase the quantity of net assets available to the rich. At least this would be the case if the tax levy did not bring forth an even greater relative change in government expenditures in the opposite direction. High taxes on the rich and low taxes on the poor would have the reverse effect. This is the most important type of income redistribution and is called *vertical redistribution.*

The Effect of Tax Levies on Income Distribution

Vertical Redistribution of Income

Much economic theorizing has been concerned with the problem of changing the existing level of individual incomes. The Malthusian theory of population combined with the Ricardian theory of tax incidence left little doubt that it would be impossible to improve the position of the low-income groups by lightening their load of taxation. The incomes received by laborers would always be at subsistence level, whether the taxes were light or heavy. A decrease in the cost of subsistence would cause an increase in the number of laborers until their incomes were again down to the subsistence level. This would be the case because population (laborers) according to Malthus and Ricardo, would increase more rapidly than the food supply (subsistence).

Vilfredo Pareto (1848–1923) developed * what has become known as the "Pareto law of income distribution," which concluded that relative inequality of income distribution could not be changed because it represented the unequal distribution of human abilities. The data relationships gathered by Pareto to provide a statistical basis for his law have nearly completely disappeared. The logical foundation that incomes are distributed on the basis of ability was always weak.

It is doubtful that any useful purpose has been served by past theorizing regarding the possibility of changing income distribu-

* In the *Cours d'economie politique* (1896–1897), by Vilfredo Pareto.

tion through taxation. Fortunately it is possible today to do more. The results of studies aimed at answering the question, Can taxation change income distribution? offer reliable data on this subject.

An excellent study examining the effect of British taxes upon the distribution of British income in 1937 is available.* The general conclusion of the study is that the British taxes in 1937 did reduce the inequality of the income distribution.† The data included in Table 3-2, given below, shows the proportion of the income of different individual income brackets that was taken in

TABLE 3-2. Taxes as proportion of income in Great Britain (1937) and in the United States (1938–1939).

United States income classes	Proportion of income taken in taxes, %	British income classes	Proportion of income taken in taxes, %
Under $500	21.9	Under $500	16.8
$500–$1,000	18.0	$500–$1,000	18.1
$1,000–$1,500	17.3	$1,000–$2,000	20.0
$1,500–$2,000	17.8	$2,000–$4,000	27.4
$2,000–$3,000	17.5	$4,000–$8,000	33.8
$3,000–5,000	17.6	$8,000–$40,000	44.5
$5,000–$10,000	17.9	$40,000 and over	71.8
$10,000–$15,000	25.5		
$15,000–$20,000	31.7		
$20,000 and over	37.8		

Source: United States data taken from Temporary National Economic Committee Monograph No. 3, *Who Pays the Taxes?*, p. 6. This was written by Helen Tarasov under the general supervision of Gerhard Colm. The British data are taken from Table 49, p. 187, of Tibor Barna's study *Redistribution of Incomes.*

taxation in the United States in the year 1938–1939 and in Great Britain in 1937.‡ All British taxes took about 17 per cent of the income of persons having an annual income below $500 and approximately 72 per cent of incomes above $40,000. This varies considerably from the tax burden in the United States, where 22 per cent of the income below $500 was collected in taxes and

* Tibor Barna, *Redistribution of Incomes.*

† Tibor Barna, *Redistribution of Incomes*, p. 188.

‡ The British data are for the calendar year 1937, and the United States data are for the year 1938–39. The differences in the incidence assumptions are not sufficiently great to destroy the comparability of the data.

38 per cent of the annual incomes above $20,000 was taken in taxes. The British tax system before World War II provided for a considerably greater income redistribution than the tax system of the United States.

The comparison of the entire schedule of proportions of income of the different income brackets taken in taxes shows a considerable variation between Great Britain and the United States. In Great Britain, the percentage of income paid as taxes shows a continued increase from the lowest brackets to the highest, while in the United States the percentage of income paid in taxes is less for the middle income brackets than for the very lowest. The British tax system is progressive throughout all income brackets, while the United States tax system is regressive in the lowest income brackets, approximately proportional in the middle income brackets and progressive in the highest income brackets. However, the tax systems of both nations reduce the portion of the total national income available to the members of the high income brackets and increase the portion available to members of the lower income brackets.

Redistribution of Income by Type

The kind of income redistribution that has been largely the subject of our analysis here has been between the different income brackets or vertical redistribution. There is also redistribution of income between different types or categories of income. Government revenues obtained in different ways have a varying effect upon income obtained as wages, pensions, interest, rent, dividends, and profits.

Because most of the income obtained in the lower income brackets comes from wages and a large portion of the income obtained in the upper income brackets comes from property, a progressive tax system would place a lighter burden on wages than upon interest, rent, and profits. Different types of income also bear varying tax burdens in addition to differences in tax burden due to size of income.

The study previously referred to of the effect of British taxes in 1937 contains an estimate of the quantity of redistribution of income of different types or categories provided by the British tax system. The summary of the findings is given in Table 3–3,

below. The amount of redistribution by income types is not so great as that between income brackets. The situation in the United States would be similar to that existing in Great Britain, with proper consideration taken of the greater progressivity of the British system. A possible exception would be the taxation of social income, which is largely exempt from the income (direct) tax burden in the United States but is subject to these taxes in Great Britain.

TABLE 3–3. Taxes as proportion of different income types in Great Britain (1937).

Type of Income	*Per Cent Taken as Taxes*
Rent, profits, and interest:	
Actual	34
Imputed	40
Salaries	22
Wages	18
Social income	16

Source: Tibor Barna, *Redistribution of Incomes*, p. 193.

The recent increase in the tax burden on income obtained from property ownership, particularly profit income, has been the subject of considerable speculation and analysis. The higher burdens have been considered desirable because they reduced savings that were thought to be too great for investment opportunities, and to be undesirable because they reduced the return from risky investments and therefore decreased the quantity of venture capital. Finally, the increased tax burden on property income has been considered as a mere incidental arising from the necessity for an income distribution sufficiently equal to preserve the economic basis required for democracy.

Comparatively low taxes upon income obtained from productive activity under conditions approaching competition and relatively high taxes upon income obtained without productive activity or as a result of monopoly would foster increased efficiency of resource use. Efficient resource use requires that taxes upon wages and return upon competitive investments be decreased. It means, also, that taxes upon inheritances, windfalls, and return upon monopoly investments should be increased.

REDISTRIBUTION OF INCOME BY SOURCE

The total national income of a nation arises from the nation's different industries. A tax burden varying from industry to industry can affect the national income and the income arising from a particular industry. If the taxes are high upon agriculture, for example, the returns paid on capital and labor used in the industry would decrease, and thus there would be a decrease in the income arising from the industry. Gradually, the amount of capital and labor in agriculture would decrease, which would force up the return per unit of producing factors. However, resources do not flow readily from one industry to another; therefore, a change in the tax burden changes the return that the factors receive in a particular industry.

The redistribution of income by source does not necessarily mean a change in the vertical distribution of income or a change in the relative portions of different types of income, but it does influence the quantity of resources used in different industries and the return per unit of producing factors. Only very meager data are available for comparing the tax burden of various industries. Also, the determination of incidence and effects of taxes on business is particularly difficult.*

In 1938, Dun & Bradstreet completed a study of relative tax burdens of manufacturing, wholesaling, and retailing and also the tax burdens of the different industry groups within these three broad classifications.† The most useful basis of comparing the tax burden borne by different industries is that of total tax paid as a percentage of value of services rendered. Table 3–4, given on p. 123, shows that in 1938 there was considerable variation between industries. The very high taxes paid by the distilleries, breweries, petroleum refiners, and tobacco-product manufacturers reflect the very high excise and manufacturing taxes assessed on the products of these industries. The taxes paid by other industries

* One recent study of this type is *The Public Finance of Domestic Air Transportation*, by Richard W. Lindholm, Bureau of Business Research, Ohio State University, 1948.

† The study is based on questionnaires completed by 27,000 business firms. The study is for the calendar year 1938, when only $5 billion were paid in taxes by or through all commercial enterprises. In the year ended June 30, 1948, the Federal corporation taxes alone totaled $10.2 billion.

vary within the range set by the low of 2.18 per cent of value of services rendered by wholesalers of dairy and poultry products to the high of 18.56 per cent of canning and other food manufacturing. (This high rate arises largely from special taxes on margarine.) The manufacturers of automobiles and transportation and agricultural machinery were also high taxpayers, paying 15.66 per cent and 15.56 per cent respectively of the value of services rendered.

TABLE 3–4. Taxes paid by business (1938) as percentages of value of services rendered.

Business	Tax	Business	Tax
Manufacturing–total	12.43	Nonferrous metal products	6.95
Meat packing	4.55	Distilleries and wineries	70.07
Flour and feed milling	6.87	Breweries	53.41
Canning and other food manufacturing	18.56	Petroleum refining	40.49
Clothing	4.56	Tobacco products	72.66
Lumber and planing mill products	6.88	Wholesaling–total	17.11
Furniture	6.66	Dairy and poultry products	2.18
Industrial chemicals	6.67	Alcoholic beverages	47.72
Iron and steel	11.35	Petroleum and petroleum products	32.47
Automobiles	15.66	Lumber and fuel	12.18
Other transportation	15.56	Retailing–total	7.73

Source: *A Survey of Taxes Paid by Business in 1938*, Dun & Bradstreet, Inc. (New York, 1939), table 10, p. 29.

The relative tax burden upon different commodities partly indicate the tax burden of industries making, selling, or using these products.* As an example, the special taxes upon truck bodies, truck parts, truck tires, and gasoline certainly place additional tax burdens upon the trucking industry. Also, the taxation of these products places an additional tax burden upon the producers of automobile parts, tires, and gasoline. Other examples of commodities that have been selected for special taxation are the so-called luxury items † such as tobacco, alcoholic beverages,

* The T.N.E.C. study, *Who Pays the Taxes?*, gives the relative tax burden by industry as a per cent of income produced in 1938–39. The burden varies from 25.7 per cent in the case of utilities to 3.8 per cent in the case of construction. See p. 22, table 5, of the study.

† See pages 91–93 for an analysis of luxury taxes.

jewelry, toilet articles, and leather goods. The general sales tax in many states places an additional tax burden upon those industries producing goods in relation to those producing services, owing to the common practice of exempting services from the state general sales taxes.

The Effect of Federal Government Borrowing on Income Distribution

General Factors

The borrowing of funds by the Federal government brings about a change in the type of asset held by individuals and legal entities and/or an increase in the total quantity of assets. Because only the relatively rich have assets that can be exchanged for bonds and only the commercial and federal reserve banks can purchase bonds with money manufactured for the purpose, much of the Federal debt is held by these groups. The manner in which the Federal debt is distributed among different owners affects income distribution. Income distribution is affected because the government collects funds for interest payment by the application of the general tax system and makes the expenditure on the basis of the ownership of government debt. Also, debt repayment affects income distribution because the funds for the repayment of debt are largely obtained by collections from current income, and the repayment is merely a change in type of asset and not income. The repayment of debt may also result in the destruction of the money paid in taxes out of current income. This latter result would arise if tax receipts in excess of government purchases of goods and services were used to retire the debt held by the Federal Reserve Banks or commercial banks (if reserves were abundant).

Holdings of Federal Government Debt and Economic Relationships

Table 3–5, given on p. 125, shows the manner in which the Federal debt was owned at the end of January, 1948, and at the end of December, 1945. The data do not indicate the ownership of debt in the detail which might be desired, but they do provide a basis for considerable analysis.

TABLE 3–5. Ownership of United States Government Securities, December, 1945, and January, 1948 (par value in millions of dollars).

	Jan. 31, 1948	Dec. 30, 1945
Total amount outstanding	256.7	278.7
Held by banks:		
Total	90.8	115.0
Commercial banks	68.9	90.8
Federal Reserve Banks	21.9	24.3
Held by nonbank investors:		
Total	165.9	163.6
Individuals	66.5	64.8
Insurance companies	24.1	24.4
Mutual savings banks	12.0	10.7
Other corporations and associations	21.4	30.2
State and local governments	7.2	6.5
U. S. Government agencies	34.6	27.0

Source: *Treasury Bulletin*, U. S. Treasury Department, April, 1948, p. 29.

The distribution of the debt given in Table 3–5 also shows a considerable difference in the manner in which the debt was held at the end of the war, or December 30, 1945, and on January 31, 1948. Although the Federal debt at the end of the war was over $20 billion greater than in 1948, the amount held by individuals at this time was over $2 billion less. Also, since the war there has been an absolute increase in the amount of debt owned by mutual savings banks and United States government agencies. A very important development since the war has been the reduction of the amount of debt held by commercial banks and Federal Reserve Banks and an increase in the amount of debt held by United States government agencies.*

Debt Ownership by Income Brackets. The Federal debt held by United States government agencies (1948) has been largely purchased by the Old-Age and Survivors Insurance Trust Fund ($9.6 billion), the Unemployment Insurance Trust Fund ($8.2 billion), and the National Service Life Insurance Fund ($6.7 billion). Other large holders of Federal debt are the Federal

* Hedwig Reinhardt, in his article "On the Incidence of Public Debt" in *Social Research*, May, 1945, points out that debt held by banks has a considerably smaller incidence than debt held by individuals and that the burden of the debt is minimized if it remains unfunded (short-term and held by banks). He is thinking largely of the regressive effect of interest payments.

Deposit Insurance Corporation, government employees' retirement funds, the postal-savings system, and the railroad-retirement account. This $34.6 billion of government debt is therefore owned largely by all employed persons, excluding agricultural and state and local government workers. This portion of the Federal debt is very widely distributed among all income groups. However, the salaries of workers covered by social security are slightly higher than those of uncovered workers. The $6.5 billion of Federal debt owned by local government represents reserves set aside for capital construction or debt repayment. This portion of the debt is owned by state and local governments with citizens having incomes above average.

Federal debt held by mutual savings banks is largely owned by small savers. In June, 1946, the deposits of mutual savings banks totaled $17 billion, and they had more than 15 million depositors. Also, the postal savings banks operated by the Post Office Department receive deposits from only small savers, and the deposits are invested nearly entirely in Federal government bonds. Postal savings banks have over $3 billion of deposits and over 4 million depositors.

The Federal debt held by insurance companies ($24.1 billion) and other corporations and associations ($21.4 billion) is largely a part of the assets of persons in the upper income brackets. New savings arising from life-insurance companies have averaged $3½ billion a year. Life-insurance companies find it advantageous to invest a large portion of these funds in Federal government bonds. Exact data are not available regarding the number of persons and the amount of their holdings in these institutions; however, it can be assumed with considerable certainty that this portion of the Federal debt is largely held by higher-income individuals.* The same generalized statement can be made of the large holdings of Federal bonds by the commercial banks. The bonds held by the Federal Reserve Banks can be considered to be held by all people of the nation.

* The survey of the Board of Governors of the Federal Reserve System showed that 78% of all families held some life insurance. The life insurance carried by low-income receivers was small; much of this insurance was national service life insurance and therefore does not represent ownership in private insurance-company assets.

Revenues and Achievement of Fiscal-Policy Goals

As a result of a survey conducted by the Board of Governors of the Federal Reserve System, considerable information has been made available regarding the manner in which the Federal debt owned by nonbank individuals is distributed. Table 3–6 presents a summary of these findings.

The data presented in Table 3–6 merely indicate the government debt held directly by individuals and do not include other types of holdings discussed above.

The campaigns to obtain a wide distribution of ownership of government debt were quite successful. In early 1946, 63 per cent of all spending units possessed some Federal government savings bonds; however, by 1947 the percentage had decreased to 56 per cent. A further examination of Table 3–6 reveals that spending units below $3,000 found it very difficult to hold their savings bonds during the immediate postwar period. (About 65 per cent of all spending units received an annual income below $3,000 in 1946.) The percentage of Federal debt held by the lower income brackets decreased between 1946 and 1947, and there is little reason to believe that this trend had been halted in 1948.

Relationship between Debt Ownership and Tax Distribution. The data obtained in this same study of total liquid savings, which is given in Table 2–3 on page 66, show that even when all types of savings accounts are taken into consideration the portion of the Federal debt held by the low-income receivers is quite low. In early 1947, 51 per cent of the spending units receiving an income under $1,000 possessed no liquid assets; this was also true of 27 per cent of the spending units receiving an income between $1,000 and $2,999.*

The Federal debt, despite high personal incomes and Treasury policy, is still held in such a manner that unless the repayments and carrying charges are made from highly progressive taxes an undesirable redistribution of income will result. The substantial increase in the holdings of debt by United States government agencies since 1945 has been the most important factor in widening the base of ownership of Federal debt. The high prices of 1947 and 1948, plus the greater availability of goods, have been the most important factors tending to narrow the portion of Federal debt held by persons in the low income brackets.

* *Federal Reserve Bulletin,* July, 1947, p. 797.

TABLE 3–6. United States savings-bonds holdings of spending units in early 1947 and 1946, by income groups.*

Amounts of savings bonds †	Percentage distribution of spending units within income groups									
	All spending units		Under $1,000		$1,000–$2,999		$3,000–$4,999		$5,000 and over	
	1947	1946	1947	1946	1947	1946	1947	1946	1947	1946
None	44	37	75	69	47	37	28	18	13	9
$1–$499	32	37	19	24	37	45	36	39	21	21
$500–$1,999	18	20	4	6	13	15	30	35	34	40
$2,000 and over	6	6	2	1	3	3	6	8	32	30

Source: *Federal Reserve Bulletin*, July, 1947, p. 797.

* Data for early 1947 based on interviews in January–March 1947 (second survey); data for 1946 on interviews in January–March 1946.

† Amounts refer to purchase price of savings bonds.

Current data of the distribution of Federal taxes between the different income brackets is not available. However, it is certain that all spending units directly pay some taxes to the Federal government; if not the income tax, then the tobacco or some other Federal excise tax. Also, all persons pay Federal taxes indirectly through Federal taxes becoming a part of the cost of production of all articles—for example, Federal taxes on gasoline, transportation, etc. However all spending units do not own portions of the Federal debt either directly or indirectly.*

The study of the Board of Governors of the Federal Reserve System previously mentioned shows that in 1947, 24 per cent of the spending units possessed no liquid assets—that is, they did not own bonds or stocks nor did they have any savings, checking accounts, or insurance. The same study showed that 44 per cent of all spending units possessed no Federal government bonds. The vast majority of these spending units that did not possess liquid savings or Federal government bonds were in the low income brackets.

Everyone pays Federal taxes, but everyone does not possess a portion of the Federal debt. Also, the persons who do not possess a portion of the Federal debt are in the lower income brackets. Thus the carrying charges of the Federal debt and its repayment are certain to bring about a greater concentration of income in the upper brackets. In 1937, about 40 per cent of all taxes collected in the United States were obtained from persons within income brackets that, in 1947, apparently possessed no government bonds or had only a very small claim to bonds held by the government (see Table 3-2, p. 119).

State and Local Government Debt Considerations

The ownership of state and local debt is concentrated in the upper income brackets to an even greater extent than Federal debt or all liquid assets. This greater concentration of ownership arises from the exemption from the Federal income tax of interest income paid on state and local bonds. Because of this tax exemption, state and local governments find it possible to float

* An exception would be that all persons could be assumed to possess a portion of the debt owned by the Federal government that is not set aside for a particular purpose.

bond issues at a very low interest cost. These low interest rates are compensated for by the great gain of tax exemption to the persons in the high income brackets; this tax exemption is not of as great value to persons in the lower income bracket, and therefore ownership of state and local bonds tends to be concentrated in the upper income brackets.

The net amount of state and local debt in 1947 was about $14 billion; the debt of these levels of government is expanding quite rapidly. The payment of state soldier bonuses has been an important cause of increased state debt.

State and local debt is today much less important than Federal debt, but it is increasing while Federal debt is declining. The expansion of state and local debt is undesirable, for it possesses the possibility of having a greater effect upon increasing the concentration of wealth and income than Federal debt. This results because the ownership is concentrated to a greater extent in the hands of the large-income receivers and because the tax systems of the states are much less progressive than that of the Federal government.

The tax exemption given interest paid on state and local bonds encourages the purchase of these securities by the rich, which, with the prevailing state and local revenue system, increases the concentration of income. An effect working in the opposite direction, but growing out of this same tax exemption, is that the ability of local governments to obtain funds cheaply encourages the purchase and construction of utilities and other enterprises. Price policy of government-owned and operated enterprises usually favors low-income receivers and reduces the maldistribution of income.

The effect of government debt on income distribution is closely related to the influence of government debt on prices, consumption, and employment; and most of all with the relationship between government bondholders and government taxpayers. Most of the saving of the nation accomplished by individuals is done by members of the higher income brackets. Therefore, these are the individuals who own Federal bonds either directly, or indirectly through insurance companies and savings banks. However, individuals in the very highest income brackets are more

likely to be large owners of common stock and state and municipal bonds.

The Federal government debt is so large and the concentration of ownership is so great that, if large-scale debt reduction were to be attempted by the levy of tax revenues, it would be desirable to use a special surtax on individual incomes and an excess-profits tax on corporate income. This action is recommended solely on the basis that it would prevent the creation of greater inequality in income distribution, and it does not include consideration of a possible inflationary effect of excessive consumer-good prices at the time of debt reduction.

Another effect of government borrowing related to income distribution is that it will decrease the portion of the economy controlled by private ownership. The reduction of private ownership of basic resources, particularly, reduces the ability of small groups to obtain huge returns through the attainment of varying degrees of monopoly. Also, the rate of return obtained on investment in government bonds is typically less than that received on investments in the private area of the economy. Both of these latter tendencies would reduce the inequality of income distribution.

The government can reduce the income received by capital owners if it decreases the quantity of funds obtained through borrowing and increases the portion obtained through the direct increase of the quantity of money. If the economic conditions are proper for borrowing from the commercial banks, they are also largely correct for the direct increase of the quantity of money.* If deficit financing is carried out through the direct issue of money, the government interest payments are not increased as they would be if the government debt were increased. Therefore, this method of obtaining revenues would further reduce the portion of national income paid to capital owners.

* See the analysis of government debt on pp. 193–204. The book titled *Financing Full Employment* by John Philip Wernette (Cambridge, Mass., Harvard University Press, 1945) provides an excellent analysis of this problem.

The Effect of Government Revenues on the Fundamental Causes of Income Distribution

Government fiscal activities will always change the distribution of income. The previous changes in income distribution arising from fiscal activity were largely accidental. Taxes and expenditures were made because of their desirability—that is, the existing revenue system plus the politically and socially acceptable changes decided the manner in which funds were raised. The effects of these two sets of conditions determined the income redistribution arising from government fiscal activity. For example, these determiners decided that fiscal activities would have a considerably greater effect upon income distribution in Great Britain than in the United States.*

The redistribution of income attempted in both the United States and Great Britain has been in the nature of a palliative rather than a cure. Redistribution of income activities has not attempted to get at the fundamental reasons for maldistribution of income. Briefly, the most important reasons are (1) the unequal distribution of capital ownership, (2) too large a portion of national income paid to capital owners, and (3) unequal opportunity for acquiring skills and adequate nutrition and medical care. These basic causes of unequal income distribution can be affected by government revenue-raising and expenditure activities.

Estimates of the Distribution of Capital Ownership

The importance of capital in creating the unequal distribution of income is clearly shown in the table given below. Table 3–7 contains data of wage income and dividend and interest income of selected income brackets. The data were obtained from the Federal individual income-tax returns for 1945.

The data provided in Table 3–7 do not give a complete picture of the relative importance of income obtained as a result of ability and productive activity and of income due to possession of property. However, it does offer a sufficiently accurate idea of the relationship between the two types of income to show the

* See the study made by Charles Stauffacher of redistribution through fiscal activities in the United States and the study by Tibor Barna of the redistributive effects of fiscal activities in Great Britain.

TABLE 3–7. Relationship in the United States of Interest and Dividends to Wage Payments for Calendar Year 1945

Selected adjusted gross income classes	Salaries and wages	Ratio of salaries and wages to total adjusted gross income, %	Dividends and interest (in thousands)	Ratio of dividends and interest to total adjusted gross income, %
$1,000 to $1,250	$3,356,289,000	83.1676	$ 57,041	1.4135
$2,000 to $2,250	6,246,287,000	88.9485	73,960	1.0532
$4.000 to $4,500	1,629,488,000	23.6399	90,289	1.3099
$10,000 to $11,000	431,315,000	39.4210	85,186	7.7858
$20,000 to $25,000	564,235,000	30.4381	200,835	10.8342
$50,000 to $60,000	176,973,000	24.1925	111,128	15.1914
$100,000 to $150,000	108,853,000	16.4564	141,410	21.3783
$500,000 to $750,000	6,519,000	5.6883	36,969	32.2583
$2,000,000 to $3,000,000	153,000	0.9104	5,734	34.1188

Source: *Statistics of Income for 1945,* Part 1.

great relative importance of capital income in the high-bracket incomes and the relative unimportance of income from this source in the lower brackets.*

The Temporary National Economic Committee's study of *Concentration and Composition of Individual Incomes, 1918–1937,* also shows that a large portion of the income received by individuals in the high income brackets arose from property ownership.† It is of interest in relation to the oversavings theory of economic depression that the study's findings indicate that there is a greater concentration of income during periods of prosperity than during periods of depression.

The concentration of property ownership is considerably greater than that of income receipts. Large portions of the population of all countries of the world are practically propertyless, but all individuals must receive an income sufficient to provide the necessities for life. This concentration of the control of the economic system through concentration of property ownership and control has been frequently condemned, but little information is available regarding the actual distribution of property ownership. The data on page 133, which showed that a large portion of the income obtained by individuals in the highest income brackets came from property ownership, are also proof of the unequal distribution of property ownership.

The concentration of wealth in the United States is shown in a general but striking fashion by the list given below of American corporations controlled by the five interest groups: Morgan-First National, Mellon, Rockefeller, du Pont, and the Cleveland financial group.‡

* Other types of property income not included are rents and royalties, sales and exchange of capital assets, income from estates and trusts, and business income from professions and partnerships. Also, a portion of dividend and interest income arises because of either present or previous productive activity of the recipient.

† T.N.E.C. Monograph No. 4, by Adolph J. Goldenthal, pp. 18, 39.

‡ Morgan-First National: American Radiator & Standard Sanitary Corp., General Electric Co., Baldwin Locomotive Works, Continental Oil Co., Kennecott Copper Corp., National Biscuit Co., Phelps Dodge Corp., Pullman, Inc., United States Steel Corp.,

du Pont: General Motors Corp., du Pont (E. I.) de Nemours Co., Inc., United States Rubber Co.

Cleveland financial group: Goodyear Tire & Rubber Co., Inland Steel Co.,

The five groups control 31 of the 250 largest American corporations. "The facilities of these 31 corporations total 18.2 billion dollars, or 30 per cent of the Nation's usable manufacturing facilities." *

Actually, the determination of the total wealth of a nation is a very difficult matter and any estimate of it is subject to a wide margin of error. None of the estimates of wealth in the United States has been sufficiently detailed to permit its accurate distribution by brackets in the same manner as income. Table 3–8, given below, summarizes the findings of different wealth studies.

TABLE 3–8. Principal findings of major wealth studies of the United States.

Studies	Percentage distribution	Period
Massachusetts Labor Bureau	2% of pop. own 48% of total	1873
Thomas G. Shearman	1% of pop. own 70% of total	1889
George K. Holmes	10% of pop. own 75% of total	1890
Charles B. Spahr	1% of pop. own 55% of total	1896
Willford I. King	2% of pop. own 59% of total	1900
Willford I. King	2% of pop. own 40% of total	1921
Federal Trade Commission	1% of pop. own 59% of total	1922
Robert R. Doane	1% of pop. own 20% of total	1932

Source: *The Anatomy of American Wealth*, by Robert R. Doane (New York, Harper, 1940), p. 32.

The data, of course, do not provide a complete distribution of wealth but appear to give an indication of great concentration of wealth holdings for at least the past seventy-five years.

The study of wealth completed by the Federal Trade Commission is the most complete attempted in the United States.

Interlake Iron Corp., Republic Steel Corp., Wheeling Steel Corp., Youngstown Sheet & Tube Co.

Mellon: Aluminum Co. of America, American Rolling Mill Co., Crucible Steel Co. of America, Gulf Oil Corp., Jones & Laughlin Steel Corp., Koppers Co., Pittsburgh Plate Glass Co., Westinghouse Electric & Manufacturing Co.

Rockefeller: Atlantic Refining Co., Socony Vacuum Oil Co., Inc., Standard Oil Co. of California, Standard Oil Co. of Indiana, Standard Oil Co. of New Jersey.

Source: *Economic Concentration and World War II*, Senate Document 206, 79th Congress, 2d Session (Washington, U. S. Government Printing Office, 1946), p. 347.

* *Economic Concentration and World War II*, p. 42.

The study is now over twenty years old. It was based on probate records and therefore gives wealth distribution only at time of death. The study showed that, in 1923, 11.1 per cent of the population possessed only 0.2 per cent of the private wealth of the nation and that only 0.3 per cent of the population possessed 17.9 per cent of the total private wealth.*

TABLE 3–9. The distribution of personal incomes and estates in 1937.

Income distribution		Estates distribution	
Cumulative per cent of persons	Cumulative per cent of income	Cumulative per cent of persons	Cumulative per cent of estates
0.01	2.3	0.01	9.8
0.05	4.3	0.06	18.3
0.6	13.4	0.5	39.0
1.6	19.2	1.3	54.7
4.2	26.9	2.5	65.8
14.4	41.9	8.4	83.9
30.6	56.9	16.1	90.7
54.0	72.2	31.0	95.8
100.0	100.0	100.0	100.0

Source: Tibor Barna, *Redistribution of Incomes*, p. 68.

A study recently completed provides a comparison of income and property or estate concentration in England. These data are given in Table 3–9. Examination of the table shows that the 1937 conditions in England and those appearing to prevail in the United States (see Tables 3–7 and 3–8) are not greatly dissimilar; 46 per cent of the population received only 28 per cent of the income, which is bad enough; but the situation in property distribution is much worse, with 69 per cent of the population possessing only 4.2 per cent of the total quantity of property.

THE REDUCTION OF THE CONCENTRATION OF CAPITAL OWNERSHIP

The maldistribution of income created by the concentration of capital ownership can be most efficiently corrected by getting at the cause, namely, the reduction of the concentration of property

* *National Wealth and Income*, 69th Congress, 1st Session, Senate Document No. 126 (Washington, U. S. Government Printing Office, 1926), p. 59.

ownership. The collection of government revenues can have an effect upon the concentration of wealth ownership.

The most efficient revenue devices for the reduction of property-ownership concentration are the estate, inheritance, gift, and property taxes. For greatest efficiency, these taxes must be properly correlated with each other and also with the income tax. The efficiency of these taxes is based upon their ability to reduce property ownership concentration without destroying the incentive to produce. However, if only the reduction of concentration of property ownership is considered, the revenue measures to use would be the income tax and the capital levy. They would be favored because of their greater speed in accomplishing the purpose.

Congress, however, believes death taxes are undesirable. The Revenue Act of 1948 decreased estate taxes in the United States. Prior to 1948, a net estate (after deduction of funeral expenses, debts, taxes, etc.) of $500,000 left to a wife would have borne a tax of $116,500. After 1948 the tax will be only about $45,300.

The right to pass property accumulated during life to particular individuals is a basic cause of maldistribution of property ownership and income. This right is guaranteed by legislation and is made possible largely through government action. The government can and does levy a tax on this kind of property transfer. The taxes levied when these transfers made after death are called the estate and inheritance taxes, and, if made while alive, gift taxes. Theoretically these taxes could be levied at such high rates that all possession of wealth through inheritance would disappear. Actually, modest-sized estates are exempt, and the assessed rates upon larger estates are much lower than they appear to be. The lower applicable rate than statute rate exists because of the many ways in which the tax base (size of taxable estate) can be reduced. If estate-, inheritance-, and gift-tax rates are increased and the typical loopholes for avoidance removed, the concentration of property ownership would be reduced; and as a result the slope of vertical distribution of income would be reduced.* It is generally agreed that the collection of death

* The Federal government collections from the estate tax have increased from $6 million in 1917 to $709 million in 1947. The tax brings in about 1.5

taxes has a less undesirable effect on productive activity than any other tax.*

Reduction of the concentration of property ownership is also accomplished by high individual and corporate income taxes. If an individual's income is reduced, the probabilities are very great that accumulations will also be reduced. The principal disadvantages of this method over the use of death taxes are that the incentive to produce and earn a larger income is reduced, and the reduction of profits decreases the quantity of new investments. Thus reduced property accumulation will be partly attained through the reduction of the national income. This is undesirable and unnecessary. The same aim can be achieved and the harmful effects largely avoided through the levy of effective high-rate death taxes. The productive activity of the decedent is completed, and the productive activity of heirs is likely to be reduced as a result of receipt of an inheritance.

Concentration of property ownership is increased by the levy of regressive taxes. During the eighteenth century, when the Western European nations were suffering from a shortage of savings, this might have been a desirable policy; but such is certainly not the case in the twentieth century in the United States.

An effective way of preventing concentration of property ownership is the elimination of large incomes arising from market domination caused by control of essential raw materials, patents, and trade marks. This control by private individuals can be replaced by government control. However, the political problems arising from a great extension of public control are tremendous and in many cases may be greater than the economic problems arising from private control. Taxation can decrease income arising from monopoly control by encouraging new and additional firms in the area. Inducement of this type on the revenue-gathering side would be in the form of tax reductions for new and small firms, taxation of excess profits, and special taxation of unused capacity. On the expenditure side, inducements would be in the form of subsidies paid to producers of new products, government-

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per cent of total Federal revenues, and the different state death taxes bring in about the same percentage of total state revenues.

* See *Economics of Public Finance* by Edward D. Allen and O. H. Brownlee (New York, Prentice-Hall, 1947), chapter XVII.

financed research, and government investments in certain strategic areas.

INCOME OF CAPITAL OWNERS AND EQUALITY OF OPPORTUNITY

The effect of government revenue-raising activity on the portion of national income paid to capital owners is discussed on pp. 118-120 and pp. 132-138 of this chapter. Also, this second fundamental basis for unequal vertical income distribution is closely related to expenditures and is discussed in Chapter IV on pp. 173-182. Briefly, the government through the provision of funds for capital construction can reduce the portion of national income going to capital owners. The Federal government through its lending operations has had considerable success in lowering the cost of obtaining loan funds.

The third basic cause of unequal vertical income distribution, the provision of equal opportunities, can be destroyed by government expenditure providing this equality. Expenditures of this type are briefly described in a general manner in the following chapter, pp. 176-179.

CONCLUSION

A sovereign government obtains revenue from four principal sources: (1) taxation; (2) borrowing; (3) sale of goods, services, and privileges; and (4) printing money. Each of these methods of obtaining revenue affects differently the four economic relationships selected as centers for analysis. Also, various types of taxes, borrowing, sales, and money printing have a dissimilar effect. In addition, the same revenue-raising act utilized under different prevailing economic conditions will have a varied effect. The problem of correct use of government revenue-raising tools is largely concerned with an accurate understanding of the existing economic conditions and the effects of raising revenues in a particular way.

The revenue-raising tools are effective in changing relative prices, consumption, employment, and income distribution. The total effect of the use of a particular revenue-raising procedure is determined by the manner of expenditure and administration, which is discussed in the two following chapters. Revenue-raising

activity has, however, been discussed most frequently in regard to its effects on vertical income distribution. This emphasis is justified by the effectiveness of government revenue collection in changing the vertical distribution of income and by the vital importance of income-distribution changes. Revenue collections can do the most adequate job of changing income distribution if they change the distribution of wealth holdings, and this change can be effected most advantageously at the time wealth is transferred from one living person to another as a gift (*inter vivos,* that is, between living persons) or at death.

QUESTIONS AND PROBLEMS

1. What is meant by built-in revenue flexibility? What are the principal advantages of this type of revenue flexibility?
2. What is the problem of the "two-headed dragon"? Why is the problem important?
3. Higher taxes are usually considered deflationary; they may, however, have an inflationary effect. Explain.
4. Give, and briefly analyze, the two principal ways that taxes affect aggregate demand.
5. Compare the effects on full employment of debt purchased by commercial banks and debt purchased by individuals.
6. What is the relationship between investment activity and consumption activity in obtaining full employment? How can a tax program best stimulate both of these types of expenditure?
7. How effective have tax programs been in changing vertical income distribution? How can sale of commodities and borrowing affect the vertical income distribution?
8. How can the government revenue-raising program change prices? What would be some of the probable results of these price changes?
9. Briefly outline the ideas of Professors Boulding and Lerner regarding the correlation of revenue sources with the needs of the private economy.
10. What is meant by the taxation of idle money? Why might plans of this sort fail to accomplish their purpose?
11. Why is it important to analyze the types of debt issues and debt ownership in attempting to determine the economic effects of public debt?
12. Defend or attack the following statement: The Federal debt is not a burden because it is largely owned by Americans and the payment of interest is like transferring money from one pocket of your trousers to another.

13. If the nation were threatened with inflation and the public debt were very large, how would you manage the debt to reduce the inflationary threat?

14. Select two possible goals of fiscal policy other than desirable levels of prices, consumption, employment, and income distribution. Analyze government revenue collection in the attainment of these goals.

15. If you were placed in complete charge of the revenue system of a nation during a major war, what would you do to prevent price rises during the war and during the postwar period?

CHAPTER

4

Expenditures and the Achievement of Fiscal-Policy Goals

INTRODUCTION

How Expenditures Affect Achievement

This chapter is concerned with the general effects of government expenditures upon (1) prices, (2) consumption, (3) full employment, and (4) income distribution. The separation indicated by the analysis of the effects of revenues and expenditures in two separate chapters overemphasizes the difference between the two. The manner of raising revenues is always closely related to the final effect of expenditures. It is also true that expenditures of different types would affect changes arising from revenue-raising programs. At all times revenues and expenditures are interrelated.

The use of government expenditures to affect economic conditions is better established than the conscious use of revenues. In all cases, however, it is necessarily true that what is spent must previously be raised. The greater emphasis upon expenditures during the 1930's and World War II perhaps arose from their greater political popularity. Public interest in a prospective ex-

penditure can be aroused much more easily than public interest in most revenue programs. This is the case because the beneficial results arising from an expenditure are likely to be much more concrete than those arising from a change of revenue source. Also, it has been typical for legislatures to decide upon expenditures first and then to determine the means of obtaining the required revenues.

Built-in Expenditure Flexibility

Built-in expenditure flexibility refers to the provision for automatic variation in government expenditure that is correlated with the ups and downs of activity in the private economy. This type of correlation would exist if legislation were passed that provided for starting work on certain public-works projects when the number of unemployed reached a certain predetermined figure in any section of the nation. As yet, this particular desirable type of built-in expenditure flexibility has not been enacted into law in the United States. However, a number of Federal expenditure acts do possess a desirable built-in flexibility.

The Federal and state unemployment-compensation legislation results in an increase of government expenditure during depression and unemployment. The legislation is written in such a manner that unemployment-benefit payments increase when the number of unemployed rises. Another example of this type of legislation is the Federal farm-price-parity program. When agricultural prices begin to fall, it is also true that the economy is generally in need of additional government expenditure. It is precisely at this time that the Federal farm-price-parity program provides for an automatic increase of government expenditure.

The built-in flexibility of the unemployment-benefit payments has been reduced by the introduction in forty-four states (1946) of what is called the experience-rating method of determining the unemployment-compensation tax rate. Briefly, this scheme provides that individual employer-contribution rates are varied from the standard rate because of the employer's experience with the risk of unemployment and the condition of his account with the state unemployment fund. This has the effect of increasing unemployment-tax rates during a period of depression and unem-

ployment and decreasing them during a period of prosperity and full employment. The experience-rating schemes have reduced the net impact of the desirable flexibility of unemployment benefit payments.

THE ACHIEVEMENT OF DESIRABLE PRICES

The General Effects of Expenditure on Prices

Government expenditure to increase the general price level is more effective if the funds are obtained by government borrowing from a commercial bank or by the printing of additional quantities of money. If government funds are obtained from the levy of taxes or borrowing from individuals, the money in the hands of individuals will be decreased to the extent that the government expenditure is increased. If taxes are collected from persons that would have spent all of the money now taken in taxes, the effect of increased government expenditure on the general price level would be very little. Also, government expenditure will have a greater effect on prices if the net worth of the beneficiary is increased rather than merely the type of asset possessed. This latter statement means that government expenditure to pay off debt or to purchase commodities is less likely to stimulate prices than a government expenditure that provides additional income to individuals—for example, bonus payments or relief payments.

A government expenditure increasing investment will change existing price patterns in a different manner from a government expenditure increasing consumption. An expenditure by the government providing additional productive facilities—for example, additional investment in electric-power development—will decrease the relative price of electricity. The relative price decrease will arise because the supply of electric power has been increased beyond that required to meet the effective demands at the old higher prices. Government expenditure that expands consumption will tend to increase prices of certain products for which the demand is expanded. This increase in the relative prices of particular products would tend to decrease as additional private investment, stimulated by these prices, increases the production facilities. Prices can be made permanently higher if additional

government expenditures are made to prevent the increase of production.

During the 1930's, government expenditure was made to decrease the quantity of production of certain agricultural products and also to increase the quantity of consumption. Both of these expenditure programs had the effect of increasing the relative prices of agricultural products.

Payments were made to farmers if they would reduce the area planted in certain crops and would increase their soil conservation activity. These expenditures would tend to raise prices in the short run and decrease them over the long run. Farm prices would be increased in the short run because the supply of agricultural commodities would be decreased through restriction of plantings. (The demand for most agricultural products is quite inelastic.) Farm prices, however, would be reduced in the long run because the quantity of soil suitable for raising crops tomorrow would be increased by soil conservation activity today.

An amendment to the Agricultural Adjustment Act in 1935 provided that 30 per cent of the gross customs collections should be spent to increase the consumption of agricultural products. The first program to stimulate demand was that which provided for direct purchase of food for relief. The largest amount was spent for this program during 1934–1935 ($149,339,000). Since July, 1939, the School Lunch Program has been in effect as a method of providing a market for farm products. This program is also very important in assuring an adequate diet to develop strong healthy citizens capable of maximum productive effort. In May, 1939, a Food Stamp Program was developed for families on relief; the program was abandoned on March 31, 1943, when the demands arising from the war had eliminated all surplus agricultural products.

Actually, the Food Stamp Program was not more than a large-scale experiment ($10,000,000 a month); however, the experiment showed that this type of program possessed great possibilities in the maintenance of suitable agricultural prices without waste. Under the scheme developed, relief families would purchase from their local retailer the quantity of orange stamps equal to their normal food purchases. The purchase of these orange stamps entitled the individual to blue stamps equal to one-half the value of

the orange stamps. The orange stamps could be used to purchase any type of food desired. The blue stamps could only be used to purchase those commodities which had been designated by the Secretary of Agriculture as surplus. The nub of the plan was to assure that additional purchases of surplus foods would not decrease the sales of other types of foods.

The low electricity-rate schedules announced by the Tennessee Valley Authority in September, 1933, had an important relationship to the general reduction of electric-power rates which followed. The rates announced by T.V.A. were based on the old American idea that it is financially sounder to sell a large number of units at a low price than a few units at a high price. This idea has proven to be largely sound in the production and sale of electricity as it had previously proven to be largely correct in the other great American mass-production industries. The reduction in costs that has arisen to a great extent from government activity has made it possible for private companies to reduce prices and expand profits. In addition, the private electric-appliance companies in the Southeast, where the influence of T.V.A. is the greatest, became the largest sellers of electrical appliances in the nation.

The Effects of Expenditures on Prices during Different Phases of the Business Cycle

An increase of government expenditure during a period of great unemployment may have little effect on prices but have a great influence on quantity of production. The result would be reversed if government expenditures were expanded during a period of overemployment. This difference in the effect forms a large part of the basis for the recommendation that government expenditures should be increased during depression and reduced during prosperity.

Violent fluctuations of prices of certain basic raw materials—for example, wheat and cotton—have added to the difficulties of maintaining a high level of productivity. Government expenditure through purchasing these products during periods of superabundance and making them available during periods of greater relative need can increase the stability of basic commodity prices.

The government parity-price program in agriculture provides for this type of government expenditure activity.

Basic farm prices can be kept at generally agreed desirable levels by a wholehearted realistic government program. This type of program would necessarily include at least the following concepts: (1) Provision must be made for storage from good years to lean years. This storage must be only to level out production fluctuations and storage of products must not rise because of a weakened demand for the product or because of an increase in average annual production. (2) Funds of the government must be available to equalize demand. During periods of depression, consumption of food must be stimulated by the establishment of aggressive minimum-diet programs. Also, funds must be available to aid in the rapid transfer of agriculture production factors from agriculture to other industries and from one type of agricultural product to another in order to meet the shifting demand for farm products.

The stabilizing of the price paid labor would go far to prevent violent fluctuations of economic activity. The government has partially provided a minimum base through its social-security program. For example, payments under the Unemployment Insurance plan, the Old-Age and Survivors Insurance (O.A.S.I.) program, and the Old Age Assistance (O.A.A.) programs tend to prevent the decline of wages to extremely low levels.

The average family benefit paid by the Federal government under the Old-Age and Survivors Insurance legislation was about $30 (1947). Although this amount is still inadequate, with subsistence-living costing $100 a month, it is a considerable expansion from the 1945 average of $24.24. The benefits received under the O.A.S.I. arise largely because of contributions made by employees and employers equal to 2 per cent of the first $3,000 of annual salary. The Old-Age Assistance program makes payments from general revenues of the Federal government with state matching Federal funds. In most states O.A.A. benefits are paid only to those aged who can show a need; a poverty oath is required in many states. The monthly benefits under this program averaged $40 in 1947. In 1946, $800 million was paid out under the O.A.A. program and only $360 million under O.A.S.I. If the worker is not aged and employed in an industry covered by

unemployment insurance, he will receive unemployment benefits for 14 to 26 weeks, depending upon the state in which he resides, with 20 weeks being the most popular maximum length. The maximum weekly benefit averages $20 a week. This average payment of about $400 will help to maintain purchasing power during a brief period of unemployment and will prevent wages from going below this level. The payments for unemployment benefits are limited, this is also partly true of O.A.S.I. benefits, by the size of the trust fund set aside for their payment. In 1948, the Unemployment Insurance Trust Fund totaled $8.2 billion and the O.A.S.I. fund totaled $6.7 billion.

The minimum-wage program is an example of the government's use of police power to prevent wage fluctuations. The offering of wages at particular levels under the Works Progress Administration program during the depression of the 1930's also prevented the further fall of wages. The "52-20 program" of payment of unemployment aid to veterans of World War II is another example of government expenditure aimed at preventing wage fluctuations, in this instance, in an immediate postwar period. The provision of education by the government and the opportunity to join the Armed Forces are other types of government expenditure that have an important effect in stabilizing wage levels. All of these government expenditures are useful in preventing very low wage rates and therefore helpful in laying the basis for more intelligent private production planning. All of them taken together, however, are still insufficient to prevent great fluctuations in the price paid labor.

The government could prevent wages falling below a certain level by offering to hire all persons at a set minimum wage. This commitment would not only prevent wages from fluctuating widely but would also provide economic and social security and maintain purchasing power. The discussion of different types of expenditure on pages 167-172 and 215-222 indicates ways the government could efficiently employ varying numbers of laborers.

Effects of Expenditures on Prices during War

World War II government activity provides excellent examples in the use of government expenditure to prevent high prices.

Payments to the agriculture industry to induce the production of certain scarce products was one example. Providing expanded plant facilities for synthethic rubber and aluminum are other examples. In these instances, production was expanded more quickly and beyond that level determined by market prices. Also, high prices to the consumer were avoided by the payment of subsidies—for example, the prices of milk and some meat products were lower to the consumer than the actual cost of production. This type of activity, which was largely developed during World War II, can also be used during times of peace.

During World War I, the prices of agricultural commodities were prevented from increasing only through stimulation of production (supply) by the use of guaranteed prices. During World War II, subsidy payments (combined with rationing) were used to decrease the price of agricultural products to the consumer and were also used to stimulate producer activity.

The payment of subsidies to enable the farmers to obtain high prices for their products—and thus to stimulate production and, at the same time, to make the products produced available to consumers at low prices and thus to encourage high consumption and reduce the likelihood of inflation—was quite successful. The program was similar to the food-stamp plan but adjusted to the very different economic conditions. Both programs have the effect of improving the diet and therefore the health of the lower income groups; the subsidy during World War II was combined with a rationing arrangement to prevent short supplies of subsidized foods. The war program, by keeping the price of food down, prevented a rise in the cost-of-living indices which made possible effective wage controls that provided the foundation for the entire war price-control program.

The details of these various programs cannot be included here, but a few thumb-nail sketches are informative. The production of peanuts was stimulated by two types of subsidies; one providing a subsidy to peanuts used for the production of oil, and the other to peanuts for edible purposes. The beef-cattle-feeding subsidy program provided for the payment of 50 cents per 100 pounds, live weight, to cattle feeders when eligible cattle were sold for slaughter. The flaxseed program included the novel provision of a payment of $5 for each acre seeded in flaxseed.

The war program for subsidy payments to roll back prices was largely limited to hogs, beef, and dairy products. The payments were quite substantial, especially on dairy products. Agricultural subsidy payments were the greatest in 1946, totaling $845 million; $544 million of this total were payments to milk producers.

The payment of subsidies mentioned above helped forestall general increases in wages. Much higher wages would have been demanded and obtained if costs of living had not been held down. Also, government expenditures were necessary to provide the rather effective price-control and scarce-raw-material-allocation programs of World War II which further helped to prevent the rise of particular prices and the general rise of wages.

Government expenditure can effectively prevent high wages in particular areas. This possibility was demonstrated during World War II. To do this, the government spends money to (1) train laborers to perform specialized activities, (2) move them where they are needed, and (3) provide housing for them at their new jobs.

Government expenditure can be used effectively to eliminate high prices for necessary imported consumption and raw material goods. The war-developed program of stock-piling demonstrated the efficiency of this type of project. Also, in order to prevent foreign cartels or monopolies from obtaining high prices in the United States market, government expenditure can be used for constructing stand-by industries and for research in developing domestic substitutes.

It was feared that farm prices would drop immediately after World War II; realization has been postponed by tremendous European relief programs which might also be considered as farm price support activity. The very high parity-price payments (of 90 to 95 per cent), provided during the war on most agricultural products, were continued for three years after the declaration of the end of hostilities, with every possibility that a similar program will be continued beyond the end of this period (December 31, 1949). The Commodity Credit Corporation was given an additional $500 million at the close of the war to finance the purchase of farm products that drop below their parity price. These are rather elaborate preparations to prevent the reoccurrence of the sharp drop in agricultural prices that took

place at the end of World War I and the agricultural depression that continued throughout the prosperity of the 1920's. The weakness of the plan is that little provision has been made for production control or for subsidizing consumption, and therefore the problem of surplus is very likely to arise.

The use of fiscal tools by the Federal government in maintaining prices of agricultural products possesses the possibility of expansion into other areas. For example, the government could offer to purchase the excess production of the steel and textile mills. A portion of this production could be stored for periods of increased demand such as during a war or an investment boom. The price offered by the government for surplus production should be gradually decreased. This would cause a gradual reduction in the production of the product. In this manner, the price system could still be used to control the type and quantity of production, but the inefficient use of resources arising from unemployment could be largely avoided.

Government Expenditure for Yardstick Plants

Government expenditure to construct yardstick plants or to provide additional capacity in an area of monopoly is a particularly desirable method of reducing prices through prevention of monopoly exploitation. It might also be a method of stimulating production through an increase of prices in other areas. Actually this was very nearly the existing situation when the Federal government became active in the power industry in the 1930's.* The success of government construction in the power industry during the 1930's, and in the aluminum and other industries during World War II, points to this as being another type of government expenditure that can be very effective in increasing the efficiency of the price system in the allocation of resources.

All of these programs intelligently developed and adequately financed can largely prevent price maladjustments. These activities do not mean an expansion of the public economy at the

* The Federal Trade Commission presented data indicating that by 1932 eight utility holding companies controlled over 70 per cent of the electric-power industry. Also, the construction industry was severely depressed, and it was believed that the erection of great dams would have a very stimulating effect on this industry and the rest of the economy.

expense of the private but, rather, efficient government collaboration with the private economy. Many of the difficulties encountered by the private economy in efficiently utilizing resources have arisen from bottlenecks and monopoly that government expenditures of the type described above would help eliminate.

Government Purchase of Gold

The purchase of gold by the Federal government is neither a budgetary expenditure nor a revenue-raising activity. However, the purchase of gold has a definite effect upon the general price level. This repercussion would be particularly great when bank reserves were being fully utilized.

The purchase of the commodity gold, because of its position in the monetary system, has a much greater effect on the general price level than the purchase of most other commodities. Under present legislation, the government can purchase unlimited quantities of gold without the necessity of raising additional funds either through borrowing or taxation. Gold not only provides the money necessary for its purchase but also, by becoming a part of the reserves of the banking system, makes possible an additional secondary expansion of the money supply of the nation.

The large-scale purchase of gold by the Federal government has enabled foreign countries to buy additional quantities of our goods. By payment for United States exports through the sale of gold rather than the sale of goods, foreign trade has laid the basis for higher prices. The increase in gold holdings expands the quantity of money in the United States and decreases the quantity of goods available for domestic sale. Because this has been true, the purchase of gold has worked toward a rising price level through both an expansion of demand for goods and a decrease in their supply.

The purchase of commodities such as wheat or cotton with funds borrowed from the commercial banks also reduces quantity of goods and increases quantity of money. If the excess reserves created by the purchase of the gold are desired for expansion of bank loans, the effect of gold purchases on prices would always be greater than the purchase of these other commodities. Of course, gold always has the advantage that it is purchased without

expanding the government debt, while the expansion of commercial bank loans to the government for the purchase of other commodities may decrease the amount of lending to private borrowers.

Interest Expenditure

The interest expenditure of the government has an important effect on the price paid for money. The Federal government debt is so great ($253 billion in 1948) that the interest rates paid on this debt influence the general market interest rates. Although the Federal government by its interest policy can affect the general interest rates, it can actually determine interest rates only by directly affecting the relationship between the supplies of loanable funds and the demand for these funds. This relationship can be changed most readily through government revenue and expenditure policy. For example government revenues can lower interest rates by decreasing the demand for loans through increased taxes on profits or by increasing the quantity of loanable funds through sales to commercial banks of securities that can be used to meet reserve needs.

The government through change of maturity, marketability, and interest rate can affect the manner in which the debt will be held. If the interest rates of government securities were increased, it is believed that a larger portion of the government debt would be held by individuals and saving institutions and a smaller portion by Federal Reserve and commercial banks. This change is considered desirable because it would reduce bank deposits and cash and result in the placement of securities in the hands of institutions and individuals who would be disposed to hold them until maturity. The decrease of deposits and cash would arise through their expenditure to purchase government debt. The use of these funds for investment in government bonds is considered a reduction of the inflationary pressure and therefore the possibility of a rapid price rise at some future date.

It is doubtful that any significant results would be obtained in attempts to redistribute the debt unless very substantial interest-rate increases were offered. It appears that the funds flowing into the Federal government security market do not rise and fall as the

result of small interest-rate changes. Much of the investment arises because there is no other suitable place for the investment of the funds—for example, insurance company and government agency purchase.*

A substantial increase in interest rates would increase the transfer burden of the debt. The amount of funds paid into the government would expand to meet the additional expenditure requirement. The collection and expenditure is very likely to increase existing unequal distribution of income, which would tend to make preservation of price stability more difficult. And finally, Federal government securities can be placed in the market as active purchasing power very nearly as readily as deposits or cash.

Debt-Repayment Expenditure

The deflationary effect of expenditure reducing the Federal debt would vary depending upon the type of debt reduced and the period during which the debt reduction is made. If the debt held by the Federal Reserve Banks ($20.6 billion, March 24, 1948) were reduced, the expenditure would not create an expansion of demand for goods and services. The only result of the expenditure by the Treasury would be the release of Federal Reserve System reserves, and conditions would have to change greatly before this could be of any possible importance. On March 24, 1948, the gold-certificate reserves of the Federal Reserve Banks were 50.6 per cent of deposit and Federal Reserve note liability; and gold-certificate reserves were expanding each week. The law requires the Federal Reserve System to have a reserve of 25 per cent behind all deposits held and Federal Reserve notes issued. The gold stocks of the Federal Reserve Banks are two times greater than the law requires.

An expenditure to reduce debt held by the commercial banks would have very nearly the same zero effect on the demand for goods and services. The commercial banks during 1948 have had an average of $1 billion of excess reserves and in addition possessed about $66 billion of government bonds which could be

* See footnote on page 203 for further analysis of this same point.

used for reserve purposes whenever the need arose.* The reduction of Federal government debt held by commercial banks would not seriously deplete reserves, nor would the reduction of the holdings of government bonds create any very strong incentives to expand the extension of private credit. The stimulation to expand private loans which might exist, would arise from a desire to maintain earnings. The deflationary character of the government collection and expenditure, added to the reduction of possible reserves, would tend to retard loans.

The total deflationary effect of expenditure to retire debt held by the Federal Reserve System and the commercial banks would be greater if the funds were collected from persons very likely to have used the money to purchase goods and services if the tax had not been levied. Generally speaking, then, prices would be decreased most if the taxes were collected from the lower income brackets. However, during conditions of a boom such as existed in 1948, income of all groups is likely to be used very quickly, to purchase either investment or consumer goods; therefore, the effects of taxes levied during a boom are not so greatly dependent upon the income bracket from which they are collected. It would appear that any method used by the government to collect taxes would decrease the demand for goods and services by individuals, and the expenditure to retire debt held by Federal Reserve and commercial banks would create no increase to counterbalance this decrease. The net effect of the expenditure under all conditions is to decrease prices.

If the Federal government used excess receipts to purchase government debt held by the different government trust funds ($34 billion in 1948) and forced these trust funds to hold cash, the expenditure would be slightly more deflationary than expenditure to retire debt owned by Federal Reserve and commercial banks.

The expenditure of funds to repay debt held by individuals and savings institutions of different types ($131.3 billion in 1948)

* It is estimated that banks can increase loans by six times the amount of Federal government bonds held. Statement made by Marriner S. Eccles before the Joint Committee on the Economic Report on April 13, 1948. In August, 1948 legislation was enacted increasing commercial bank reserve requirements by 4 per cent.

results in a change in type of asset. The change will slightly increase liquidity and reduce earnings on funds available for investment. Most of these funds will be used for investment again, a small portion will be permitted to lie idle for a time, and some of the funds will be used for consumption purposes. The expenditure will certainly increase the demand for investment goods. Whether the demand for investment goods will be greater than before the expenditure and collection will depend upon the progressivity of the tax system providing the revenues for the debt-retirement expenditure. If the revenue system were only slightly progressive, proportional, or regressive, there would certainly be a net expansion of investment expenditures or an increase of hoardings. The deflationary effects of this last type of debt retirement expenditure would be considerably less than the expenditure of funds to retire debt held by the Federal Reserve System, commercial banks, or government trust funds.

THE ACHIEVEMENT OF A DESIRABLE CONSUMPTION LEVEL

The General Effects of Expenditures on Consumption

Government expenditures are frequently categorized as follows: (1) investment, (2) consumption, (3) increase in individual net worth, and (4) debt repayment.

The first type, investment expenditure, relates to the use of government funds to finance construction such as highways, dams, and public building. Expenditure by the government to subsidize private investment would also be classified as government investment expenditure. Examples of these would be Federal Housing Administration loans, Reconstruction Finance Corporation loans, and Export-Import Bank loans. These investment expenditures increase consumption indirectly, through the provision of additional employment and the reduction of costs of production. Also, government investments—for example, highways—provide stimulation to private investment which will also stimulate employment and increase consumption.

Government investment expenditure can have a very stimulating effect on both investment and consumption expenditure of the private economy. The example provided by government in-

vestment in highways is outstanding in its tremendous stimulation of consumption expenditure. A major portion of the budget of a typical American family consists of expenditures required to purchase, maintain, and operate the family automobile. The enjoyment of this consumption expenditure results largely from the great government expenditure upon highways. The Federal government alone spent $1 billion on highways during 1947 and 1948, and the expectation is that half again as much will be provided during 1949 and 1950.

When the Federal government during the 1930's began to contemplate investment in the electric-power industry, the private power producers presented the argument that their $15 billion industry was providing all the electric power that the nation could effectively use. Government activity, plus the growth of general economic activity, expanded consumption of electric power so that at present the private investment is completely utilized, as is the additional investment of $8 billion of government funds. Government investment is particularly efficient in the expansion of consumption if it results in the reduction of the cost of a good or service the consumption of which can be greatly increased—for example, travel, and power and light.

It is estimated that in 1945 all levels of government spent $3,000 million for the provision of education, $1,000 million for public health, and $544 million for public housing and community facilities. Since 1945, the expenditures in all three of these areas have expanded.

The second type of expenditure, government consumption expenditure, includes government expenditure for the provision of education, health, social security, housing, and the like. In making these expenditures, the government determines types of consumption through the provision of funds for their financing. From 1928 to 1938, government expenditure of this type has increased rapidly in the United States and the nations of Western Europe. The consumption of a population can be increased more efficiently in this manner than is possible through investment or the direct provision of funds to individuals.*

In the case of government consumption, the government provides the actual service or good enjoyed; the individual becomes

* Sir William Beveridge, *Full Employment in a Free Society*, p. 185.

eligible for enjoyment only if he meets certain requirements aimed at increasing the efficiency with which the good or service is distributed. For example, to benefit from most education services offered by the government, it is necessary to meet certain entrance requirements—that is, age, last grade completed, and perhaps a certain scholastic average. Old-age benefits, dependent-children and unemployment benefits are government welfare expenditures but not examples of direct government consumption.

The third type of expenditure is the direct increase of individual income or net worth. Examples of this type of expenditure are the payment of pensions, veteran benefits, poor relief, and the like. The funds spent in this manner are in most cases made available to persons in the lower income brackets. As has been previously pointed out, the people in these income brackets possess a high propensity to consume. Therefore, a large portion of this additional income will be spent immediately for consumption goods. This method of increasing consumption through government expenditure has been criticized as being less efficient than that of direct government consumption. The main reason for this criticism is that individuals in the lower income brackets, often because of lack of opportunity to purchase more desirable goods and services, spend the receipts in a manner which does not materially increase their well being. Sir William Beveridge, the famous British economist, has stated that Great Britain is not sufficiently wealthy to provide for a large amount of consumption increase in this manner.* In the United States, however, this method of increasing consumption expenditure has been considered the more desirable. The reason for this difference of attitude is that increased consumption can take place in this manner with a smaller amount of government control and that, because the United States is rich, the resulting waste of resources can be more easily absorbed.

The final type of government expenditure is that which changes the type of asset held by individuals. The most common expenditure of this type is the repayment of government debt. Another example is the purchase of commodities from individuals. Debt-reduction payments would be made largely to persons in the upper income brackets, where the propensity to consume is small and therefore where a given quantity of government ex-

* Sir William Beveridge, *Full Employment in a Free Society*, p. 185.

penditure would have a reduced effect on consumption. The relative stimulation of consumption arising from the purchase of commodities would be determined by the income level of the holders of commodities. If the commodities purchased by the government were farm products produced on a typical American farm, the income of farmers would be increased and the price to consumers would tend to rise unless a consumer subsidy were involved. An expenditure of this type would have an indefinite direct effect on total consumption and in addition would possess uncertain possibilities of expanding consumption indirectly by maintaining the solvency of important industries—for example, agriculture.

It is clear that all government expenditure is related to consumption. A government expenditure alone very seldom has a repressive effect on consumption. However, a government expenditure could reduce consumption if the manner of obtaining money spent reduces private expenditure more than public is increased. An example of this sort of relationship would be government expenditure of funds to repay the government debt from receipts obtained by the levy of a tax on goods consumed by persons in the lower income brackets.

The Desirability of Government Consumption

The previous discussion pointed out that a method of increasing consumption is for the government to provide and finance certain types of consumption services. Also, this method of increasing consumption is very likely to increase the efficiency with which the resources of the nation are utilized. The price system undervalues certain types of services and goods. This undervaluation arises because part of the utilities or benefits arising from the good or service is not directly available to the individual. The best example of this is in the field of education. A portion of the benefit that is derived from education accrues directly to the individual in an increase in enjoyment of life and an increase in earning power. However, a large portion of the benefit of education accrues to society in a more intelligent and productive citizenry. Because of this lack of individual benefit, this second type of benefit flowing from education will not be given its proper value

by the price system. It is quite proper that the government should make funds available so the price paid for education will be commensurate with the total benefit arising from the activity. Through the provision of consumption goods and services, the government can make it possible for persons with low incomes to obtain benefits through co-operative activity which they would not have been able to obtain if each received a small amount of additional funds from the government. As an example, the provision of a playground in an area makes it possible for a child to play off the streets, while a small increase in the income of each family would not make it possible to provide small individual backyards.* Another advantage of government-provided consumption is that it can be expanded in a more orderly fashion than private consumption.

A disadvantage of the provision of goods and services by the government arises from a tendency of the activity to reduce the incentive to individual effort. If all the requirements of life are furnished on the basis of being able to fill out a form showing need, the lack of goods as an inducement to effort has been largely removed. This type of an argument is based to a great extent upon the position that the quantity and type of goods and services considered to be necessary for the good life remain constant. The provision of a certain group of goods and services by the government may have been considered all that a person could possibly expect fifty years ago, but today the same group would surely fall far short of what nearly every person desires and is willing to work and scheme to obtain.

The Relationship between Consumption Stimulation and Prosperity

During the period prior to World War II, the economies of Western Europe and the United States found it difficult to maintain a sufficiently high level of consumption. The level of consumption is not sufficiently high if at a particular level of income

* This additional benefit arising to individuals from having the government rather than themselves spend the money would be called the "announcement effect of expenditure" if the terminology of Professor Pigou (in *A Study in Public Finance,* London, Macmillan, 1928, p. 73) is used.

the savings arising are greater than the investment opportunities. The way to decrease savings or expand investment, and by so doing bring about a balance between savings and investment, is to expand consumption.

The technological developments of the years 1928-1948 have, on the average, been capital-reducing rather than capital-consuming; also, population growth has diminished. Thus, at a time when savings have been large and increasing, the demand for investments has become relatively smaller. One available method of re-establishing the correct balance between investments and savings and removing a very important cause of economic fluctuations is to increase government expenditure for consumption. The government could expand consumption by expenditure for the direct provision of consumption, provision of more funds for persons in the low income brackets, and guaranteeing complete social security to every citizen. This latter type of action would increase consumption, largely as a result of the reduction of rainy-day and old-age savings. A considerable portion of the drive of individuals to accumulate a nest egg would disappear if the emergencies of life were provided through government expenditure.*

The acceleration principle points out that small changes in consumption greatly affect total economic activity. Government-provided consumption possesses to a great degree the advantage of stability.

Total consumption of the economy is greatly dependent upon consumer income expectations. Government consumption expenditures can be maintained during periods of recession through the borrowing of funds from commercial banks or through the actual printing of additional quantities of money. As a result, government consumption expenditure is likely to be more stable than private consumption expenditure. This fact would tend to bring about an increased stability in the economy, as the relative importance of government expenditure increases.

* Alvin H. Hansen, *Economic Policy and Full Employment*, p. 201.

The Relative Desirability of Investment and Consumption Expenditure

Government investment and consumption expenditures cannot be completely segregated. What has been called government consumption also necessarily requires government investment—for example, government provisions for public health or education also require considerable government investment in buildings. The problem of correct terminology also arises from the tendency to consider investment only if a material object is created as a result of the expenditure. Undoubtedly, expenditure on educational instruction and the attention of a nurse or a doctor are investment expenditures also. The investment in these cases is the creation of a more healthy and intelligent population. However, the typical government expenditure that is considered an investment results in the construction of a material object that will provide services over a period of time. Money spent in this fashion is believed to assure a higher standard of living in the future than an expenditure that does not result in a fairly permanent material object. It is very doubtful if there is any general meaning to this type of differentiation, but there is a meaning in specific instances. For example, a government expenditure providing a bonus that is spent for liquor and nightclub entertainment would be less likely to increase the scale of living in the future than a similar quantity of funds spent to construct an electric power dam or to provide soil conservation.

The meaningful differentiation between consumption and investment is based on the relative stimulating effect on the future scale of living of the community. In most instances, the construction of a building, dam, or road also provides the basis for a relatively great expansion of the scale of living. In addition, the expenditure of funds to improve the health and educational levels always provides the basis for a relatively great expansion and would, on this basis of judgment, be investment expenditure despite the fact that the construction of permanent material objects was relatively unimportant. The efficiency of an expenditure is not determined by whether it bears the label "consumption" or "investment," but by its effect on the total quantity of goods and services produced.

THE ACHIEVEMENT OF A DESIRABLE EMPLOYMENT LEVEL

How Expenditures Can Affect Employment

The expenditures of government that are within the three categories, (1) investment, (2) consumption, and (3) increase in individual net worth, are most important in providing a desirable level of employment. Their approximate relative importance is shown by the order of listing. The fourth type of government expenditure, the change in the type of net worth, is less closely related to the provision of employment. This latter type of expenditure can, however, have an important deflationary influence and might be very useful in preventing the continuation of over-employment conditions.

Government expenditure influences employment by providing or not providing an effective demand for goods and services. The increase of government expenditure, with private expenditure remaining constant, will bring forth an expansion of the effective demand for goods and services. This expansion of the effective demand will cause employment to increase. Of course, an expansion of government expenditure that would cause an equal reduction in private expenditure would have very little effect on the total quantity of employment.

The Use of Government Investments

The term "government investments" is used here only to refer to the construction by the public economy of permanent physical structures—for example, public buildings, dams, or highways.* The timing of investment expenditure by the government can have a considerable influence on the importance of investment in achieving a desirable level of employment. It is, however, impossible always to make public investments at the time that would be dictated by employment conditions. An example of this condition is the typical postwar situation. In 1948, the need for

* Any government expenditure aimed at increasing the health and skills of the population is an investment of a type. Also the government by providing cheap loan funds and guaranteeing loans to private individuals or groups is providing additional investment. Both of these types of expenditure recently have expanded rapidly.

additional public investment was very great, but full employment of labor was already being provided by the private economy.

The construction industry is closely related to unemployment. Government investment can be utilized to prevent declines in its activity. When private demands are utilizing the full facilities of the industry, public investment should be at a minimum; but when private demands are no longer willing to employ construction facilities, government investments can be expanded. The desirable economic effects arising from the stabilizing of the construction industry by government investments would be that (1) the whole economy would not be pulled into a depression as a result of unemployment in this area, and (2) the stabilization of the industry would eliminate the need for high wages and profits during the boom period to tide the industry over depressed periods. This result would reduce building costs and increase the amount of private construction.

Government investment can be economically made in areas in which private investment cannot be made. By this statement is meant that an evaluation of the desirable utilities that would become available as a result of the investment is sufficiently great to justify the use of the nation's resources, yet the monetary return is not of the correct nature to enable private individuals to make the investment. Examples of this type of investment are valley developments such as that of T.V.A., investments to provide health and recreation facilities, and the like. Government investment in fields of this type mean that the resources of the nation will be used more efficiently than if reliance were placed only upon investment induced by prospective monetary return.*

The Use of Government Consumption

Government consumption expenditure, as the term is used here, has often been called social consumption. Actually it arises from

* The undervaluation of certain goods and services by the price system arises partly from the social value which the good provides in addition to its value to the individual. Under these conditions, the individual is able to pay only for the value to him; but this is less than the value of the good to society. Also, undervaluation arises from the maldistribution of income which makes it impossible for large groups of the population to make their desires adequately felt through the price system.

the people determining through their government that certain types of consumption should be expanded beyond the point possible through individual expenditure. The reasons for government consumption are largely the same as those which justified government investment: namely, (1) that the price system, because social values are over and above individual values, fails to correctly equate price and value, and (2) that the maldistribution of income makes the price offered for certain very necessary goods and services so low that the market system allocates too small a portion of the nation's resources to their production.*

Government consumption expenditures cannot be readily varied to meet the requirements of a desirable level of employment. However, a degree of expansion and contraction related to the swings of the activity of the private economy is possible. For example, the government during a period of unemployment and depression could offer positions to doctors and nurses at attractive salaries and offer an increased quantity of preventive medical attention for the entire population. Another example would be the provision of funds to enable good students to acquire advanced training. This would remove these persons from the labor market and provide employment in the training institutions.

The experiment with food stamps during the depression of the 1930's shows that government expenditures could be effectively used to raise the nutrition level of the nation.† This type of a program stimulates employment throughout the nation by increasing the prosperity of a vital industry—agriculture; it also increases the efficiency of laborers.

The Increase of the Individual Net Worth

An individual's net worth is increased by the government (1) if it becomes possible to sell products or services to the government at a higher price than could be obtained from the private economy, or (2) if the individual receives a grant or

* One basis for judging "too small" would be that it is inadequate to maintain labor at peak efficiency.

† This plan is discussed in some detail on p. 145. Briefly, the plan provided to low income groups stamps that could be spent at the neighborhood grocery for food.

pension of value from the government. The most effective types of increase of net worth in providing additional employment are those made available to the low-income receivers.

Government expenditure of this type does not determine the manner in which funds will be spent, but rather determines the groups which will receive funds. However, to an extent, the determination of groups to receive funds also determines the manner of expenditure. In the past, war veterans and farmers have been most successful in obtaining government grants increasing net worth.

If the government makes funds available to persons within the lower income brackets, there is considerable assurance that the funds will be spent for consumption goods within a very short period of time. This additional expenditure becomes a part of the income stream, increases the gross economic activity of the private economy, and swells the tax receipts of the public economy. The first effect will be to reduce the need for the expansion of the public economy to maintain a favorable level of employment, and the second effect will be to reduce the need for public borrowing.

The Change in the Type of the Individual Net Worth

The change of the type of net worth is largely associated with the repayment of the government debt. However, it would also include government purchase of commodities.

The repayment of borrowings obtained from private individuals and groups other than commercial banks gives additional funds to groups possessing a high propensity to save. The increase in aggregate demand, and thus employment, would be less than if a similar sum were made available to a group representing a cross section of the population such as a war veteran group.*

The expenditure for retirement of privately-held government debt is likely to be deflationary, and it certainly would be the last type of government expenditure considered in an attempt to

* The additional funds may induce increased private investment through lower interest rates. The multiplier effect under these conditions could be of such an order that aggregate demand would increase considerably.

expand employment. The extent of the deflationary effect of this type of expenditure would be largely determined by the type of tax system used to obtain the revenues. (The same, of course, would also be true of every other type of government expenditure.) If the tax system were very progressive, the aggregate demand might be greater with debt repayment than it would be if the taxes had not been sufficiently high to bring about a debt reduction. If the tax sources are less progressive than debt holdings, the reduction of government debt tends to reduce aggregate demand and employment.

General Types of Expenditure Theories Aimed at Full Employment

The theories that rely to a major extent upon expenditure to maintain economic equilibrium have advocated that the government use its fiscal powers largely in a compensatory manner. This has meant that when the private economy is prosperous and able to maintain relatively full employment the public economy would be relatively inactive, and when the private economy is not able to employ a large portion of the factors of production these factors would be employed by the public section of the economy.*

Public Works

The concept that a depression is a temporary maladjustment and that the level of public investment should be determined by private investment is basic to the idea of a cyclically planned public-works program. Advocates of public works recommend that the various levels of government contract for needed public-works projects during the periods of full employment, that they might have them available to employ laborers upon during periods of depression and unemployment. It is assumed that public works can be delayed and that this type of expenditure provides a

* "The Federal government has become increasingly committed to a policy, which future administrations will find difficult to reverse, of initiating active and direct measures to maintain the national income at a high level and to encourage, if not to assure, employment to those able and willing to work." Paul T. Homan and Fritz Machlup, editors, *Financing American Prosperity* (New York, Twentieth Century Fund, 1945), p. 3.

good anticyclical use of government funds. It is obvious that public-expenditure and particularly public-investment-expenditure timing are good common sense. Actually they have been advocated and practiced for centuries.*

Assumptions Briefly Considered. The need for an immediate increase in public facilities is often very great and to delay it very difficult. The need for additional public-institution buildings may be very great, and new and improved highways may be needed immediately, but the nation may also be enjoying full employment. Actually, historically, most public-works expenditures have been made during periods of prosperity. It is during prosperity that the need for additional public works appears the greatest and that financing, at least by state and local governments, is the most readily accomplished.

The basic assumption of public-works expenditure to provide full employment and economic stability is that private investment instability cannot be avoided. This natural instability of private investment is to be compensated by inducing an unnatural instability in public investment. It would appear more desirable to maintain private investment at a constant level and to have public investment also at a constant level. It is doubtful, to say the least, whether it is desirable to subordinate public-investment needs to those of private investment.

Many public-investment requirements expand naturally with private investment—for example, streets, sewers, and transportation. The undertaking of these investments far in advance of private investment requires a higher degree of foresight than can be assumed to be always available.

Public works, as a single means of maintaining desirable employment conditions, have the important shortcoming of requiring considerable time to get under way, and they cannot be conveniently stopped until the project is completed. If the depression should be short, the major portion of the actual expenditures for the public-works program may be made during the period of prosperity following the depression. The concept of pump-priming has accepted the tenets of the planned public-

* The pyramids of Egypt were perhaps constructed as an unemployment-relief scheme. C. J. Bullock, *Politics Finance and Consequences* (Cambridge, Mass., Harvard University Press, 1939), pp. 9–10.

works program but includes additions aimed to eliminate some of its operational defects.

Pump Priming

The weaknesses of a public-works program, the urgent need for increased economic activity, and the development of the science of economics brought about the development of government expenditure activities which have become associated with the expression "pump priming." The believers in pump priming continued to hold that public works were very important, but because of the slowness with which a public-works program provided purchasing power they recommended that the government make money available immediately to those groups of the population that would spend the sums received with the least hesitance. As the public-works program got under way, the funds made available directly to consumers could be decreased.

The pump-priming theory is postulated upon the belief that a relatively small amount of government expenditure administered at the correct time and in the correct manner will bring about a considerably greater increase in the income flow arising from the private economy.* Government pump priming activity would consist of both socialized consumption and investment (public works) expenditures.†

Assumptions Briefly Considered. The pump-priming program is predicated upon the beliefs that depressions are periods of temporary readjustment which can be shortened and the hardship decreased by government expenditures, and also that the private economy is stimulated by government expenditure. In fact, the theory assumes that the difficulty which made it impossible for the private economy to maintain an acceptable level of employ-

* "Extremists . . . say that we do not need to worry, because we can always create full employment by pumping enough purchasing power into the system. If there is too much demand for labor and materials—that is, inflation—we turn the faucet off and cause a contraction. Thus by manipulation of Government expenditures and taxation, continuing full employment is assured, and we do not need to worry about anything else in the economy." From *Report of the Council of Economic Advisers,* December 18, 1946, given in the *Federal Reserve Bulletin,* January, 1947, p. 20.

† The impetus of pump-priming is expected to arise from the operation of the accelerator principle.

ment of the factors of production can be rectified by government expenditure.

The assumption of the program which has been criticized most severely is: The expenditure of government funds for a short period will make it possible for the private economy to employ during a relatively long period all the factors of production without the assistance of the income stream made available by the government pump-priming operations. This is also the basic concept of a pump-priming government expenditure program.

The belief that the private economy can provide desirable economic conditions, after having been given a boost by the public economy in the form of added purchasing power, requires the quite untenable assumption that the mere increase of purchasing power has destroyed the basis for the previous development of undesirable economic conditions. A much more acceptable position would be that, after the needed changes in the relationships of different economic factors have been made, a boost of the pump-priming type would restore desirable economic conditions until other serious maladjustments develop; after these maladjustments had been corrected also, another boost would be required.

The idea of pump-priming does not require that the government expenditure be small; rather, the basic requirement of the program is that the portion of government expenditure determined by a desire to increase the income stream should be made for only a short time. The criticism which has often been leveled at previous pump-priming activities has been that government expenditure has been too little and too late. The basic difference between compensatory spending and pump-priming is not one of size of expenditure but rather of duration. It is, as has been previously mentioned, assumed that pump-priming expenditure will be made for only a short period of time; the duration of compensatory expenditure is uncertain.

Compensatory Spending

A program of government compensatory spending developed out of the failure of the pump-priming programs to ignite the spark that would enable the private economy to continue to employ the factors of production without the aid of large govern-

ment expenditure. The theoretical basis for the necessity of the program was found in the failure of private expenditure (consumption and investment) to be sufficiently great to maintain full employment after it had been attained by either a public or private expenditure stimulus.* (It is generally assumed, under all three theories of government expenditure, that to obtain desirable economic conditions the financing will have to be largely accomplished through government borrowing operations.)

The most common measure of the amount of government compensatory spending needed has been the difference between the amount of saving which is expected from a national income that would represent full utilization of the resources of a nation and the amount of new investment opportunities that are expected to arise. Statistics gathered during the 1930's showed that at various national income levels that represented something other than depression conditions the amount of savings expected exceeded the investment opportunities.† Under these conditions the expenditure stream is insufficient to maintain the existing employment, and underutilization of the factors of production will arise unless the income stream is implemented. This implementation may be brought about through compensatory expenditure by the government.

Assumptions Briefly Considered. It is readily seen that a government compensatory-spending program based on the above type of explanation of need could continue indefinitely, and the fact that the program is followed during a number of years does not necessarily reduce the need for its continuance in future years. The program does not provide a corrective for the difficulty that

* "For a century and a half it has been a commonplace of economics that the creation of pecuniary values in production cannot be less than the sale value of what is produced. If the total amount of income so created somehow fails to flow into the market, obviously something must have happened to it.... In that event the re-creation of money values by deficit financing up to the amount of purchasing power necessary to absorb the product of industry at full employment would only be a salvage of purchasing power already lost by its former owners and so to the whole community." C. E. Ayres, *The Thoery of Economic Progress* (Chapel Hill, University of North Carolina Press, 1944), p. 276.

† Cf. Professor Alvin H. Hansen's testimony opening the Hearings before the *Temporary National Economic Committee, Congress of the United States,* Part 9, "Savings and Investment" (Washington, U. S. Government Printing Office, 1940).

makes it necessary, namely, the excess of savings during periods of full employment over the investment opportunities arising during the same period.*

It was evident during the 1930's that either the reduction in the amount of saving arising from a given national income or the increase in investment opportunities, or both, was necessary to eliminate the necessity for government compensatory spending. Government compensatory spending is the easy way and actually avoids facing the real problem.

In the future, the relationship that existed in the 1930's between savings and investment opportunities may not exist. Certainly, conditions could change sufficiently to eliminate the problem of oversaving, which has in turn necessitated the casting about for solutions to the problem. The England of Keynes was bothered with excess savings; it is very doubtful that that will be an important problem of the Labour government in the near future. The England of Cripps (1948) requires personal saving rates 1½ times as great as in 1938 to prevent dangerous inflation.

Government compensatory expenditures would apparently be most desirable if they increased the purchasing power of those in the lower income brackets.† There is, however, difficulty in working out within our folklore successful means of distributing the funds to these groups.‡

* "Ancient Egypt was doubly fortunate, and doubtless owed to this its fabled wealth, in that it possessed two activities, namely, pyramid-building as well as the search for the precious metals, the fruits of which, since they could not serve the needs of man by being consumed, did not stale with abundance. The Middle Ages built cathedrals and sang dirges. Two pyramids, two masses for the dead, are twice as good as one; but not so two railways from London to York." J. M. Keynes, *The General Theory of Employment, Interest, and Money*, p. 131.

† "Total demand can be increased by a redistribution of income from the rich to the poor. Increased taxes on the rich, offset by decreased taxes on the poor or by greater bonuses to the poor, will increase total demand without unbalancing the budget. The rich will decrease their spending very little while the poor will increase their spending by almost the whole of the reduction in their taxes or the increase in their bonuses." Abba P. Lerner, *The Economics of Control*, pp. 319–320.

‡ "Consumer credits—in effect, money—be provided by the government and distributed gratis to workers in the low income groups regardless of whether they are unemployed, whenever the ratio of unemployment reaches a certain specified figure." H. Gordon Hayes, *Spending, Saving, and Employment* (New York, Knopf, 1945), pp. 207–208.

THE ACHIEVEMENT OF A DESIRABLE INCOME DISTRIBUTION

The General Effects of Expenditures on Income Distribution

The four general types of government expenditure—(1) investment, (2) consumption, (3) increase in individual net worth, and (4) debt repayment—can equalize income distribution most effectively through the provision of more equal opportunities.* The provision of more equal income distribution would arise largely from government consumption and increase in net-worth types of expenditure. The degree of income redistribution that would take place with these types of expenditure would depend to a great extent upon the efficiency of administration and the extent to which the typical individual is stimulated to increase his productive efficiency. An example of poor stimulation would be employment offered entirely on the basis of family position rather than training and ability. An example of bad administration would be an individual unable to use effectively his increase in net worth to improve his productive efficiency. This latter shortcoming would exist if additional good low-priced housing, education, and medical facilities were not available. The increase in individual incomes, under these conditions, would be largely dissipated through bidding up prices of the old and inadequate facilities and the purchase of low-utility goods and services. Rather than using all of its funds to provide individuals directly with additional purchasing power, the government should make extensive prior expenditure aimed at stimulating the production of goods and services needed to expand efficiently the scale of living.

The Ability of Government Expenditures to Change Income Distribution

Vertical Redistribution of Income

Vertical redistribution of income is used here to refer to the change in the portion of national income obtained by persons

* The three basic causes of unequal vertical income distribution are: (1) unequal distribution of capital ownership, (2) too large a portion of national income paid to capital owners, and (3) unequal opportunity for acquiring skills and adequate nutrition and medical care.

within the different income brackets that arises from government fiscal activity. The part of the income that individuals of the different income brackets receive is made up of government expenditure that increases net worth and government provided goods and services that can be definitely allocated to persons of certain income brackets. Government expenditure of this type can be allocated quite accurately to the different income brackets and, if compared with revenues collected, will largely show the amount of income redistribution arising from public-finance activities. However, a large portion of the expenditure of government, particularly the national government, is indivisible. It is impossible to use the benefit basis in allocating indivisible expenditure to any particular income group or to determine an acceptable basis for arbitrary allocation. Examples of indivisible expenditures would be the money spent to maintain the court system or military establishment of a nation.

This necessary tentativeness of any data attempting to show the redistribution of income arising from government expenditure has discouraged attempts to measure it statistically. In 1941, a study was made of the redistribution of income in the United States through public finance activity. The study showed in a very summary fashion the net effect on income redistribution of Federal government expenditure from 1930 through 1939.*

This study indicates that in 1929 the working classes of the United States paid $781.3 million in taxes and received only $600 million in special benefits. In 1936, the working classes of the United States paid $1,180.5 million in taxes and received benefits of $6,273 million. The year 1936 was unusual because of the large war-pension payments. The conclusion of the study is that considerable redistribution of income took place as a result of public-finance activities. This redistribution arose, however, largely from government deficit-finance activity rather than the assessment of high taxes on some income brackets and large expenditures directly related to other income brackets.†

A study of the effects of public-finance activities on the re-

* "The Effect of Governmental Expenditures and Tax Withdrawals upon Income Distribution, 1930–1939," by Charles Stauffacher, in *Public Policy* (Cambridge, Mass., Graduate School of Public Administration of Harvard University, 1941).

† *Ibid.*, p. 260.

distribution of incomes in Great Britain shows the results in that country in 1937. If public income or indivisible benefits are allocated in proportion to income above the subsistence level, the British redistribution through government revenue-raising and expenditure is as presented in Table 4-1 given below.* An examination of this table reveals that the proportion of income redistributed changes progressively with income—that is, with the increase of income the gain is reduced, or the loss is increased as a percentage of income.

TABLE 4-1. Redistribution of British Income through Public Finance in 1937.

Income brackets	*Redistribution as percent of income*
Under $500	+18.7
$500–$1,000	+ 4.0
$1,000–$2,000	+ 0.3
$2,000–$4,000	− 6.7
$4,000–$8,000	−12.6
$8,000–$40,000	−23.8
$40,000 and over	−52.6
Under $1,000	+11.0
Over $1,000	−14.2

Source: Tibor Barna, *Redistribution of Incomes*, table 65, p. 230.

The direct redistributive effect of government expenditure for social welfare purposes is reduced if the payment is closely related to the taxes collected. A fairly close relationship is often assumed to exist in the United States between the financing and payment of Old-Age and Survivors Insurance. However, the relationship is not so close as might be expected. A brief glance at the manner of finance and benefit payment illustrates this.

Social Security Expenditures. O.A.S.I. is financed by the levy of a 2 per cent tax on the first $3,000 of wages in a covered industry. (Government, agriculture, domestic, self-employed, and employees of charitable organizations are not covered.) One-half of the tax is paid by the employer and one-half by the employee. It is quite possible that both the employer and employee, par-

* Tibor Barna, *Redistribution of Incomes.* This study distributes public income or indivisible benefits on three bases: (1) in proportion to producers' income, (2) in proportion to income above the subsistence level, that is, progressively in relation to producers' income, and (3) progressively throughout the whole range of incomes.

ticularly if full employment and a sellers' market exist, shift the tax forward in higher prices of goods and services produced. If this is the situation, the cost of O.A.S.I. is borne by the total population in proportion to the consumption of goods and services produced by covered workers. Under these circumstances, uncovered persons would be expected to be bearing as much of the burden of the cost of O.A.S.I. as covered workers; but they would not be eligible for O.A.S.I. benefits, as are covered workers.* Also, although the employer bears 50 per cent of the original impact of the O.A.S.I. tax he receives none of the direct benefits.

The primary benefit is very closely related to the amount of O.A.S.I. tax paid. This is the amount paid to a single covered employee. However, a married covered worker who had made the same tax payment would receive half again as much, and in addition a covered worker eligible for benefits would receive one-half of his primary benefit for each dependent child under eighteen years of age. A worker eligible for benefits, having a wife and supporting a number of children, would receive considerably greater benefits in relation to payment than a single worker eligible for benefits.† To some extent these additional payments are in relation to need; however, the need basis is a very rough approximation.

For example, a single benefit receiver may be completely dependent upon O.A.S.I. benefits and also be suffering from a chronic ailment requiring regular medical expenditure. The need in this case would be very great. The married worker supporting several grandchildren may have a considerable fortune and the O.A.S.I. benefits are not required for the financing of a very desirable scale of living.

The effects on income distribution of O.A.S.I. are still more important in relation to collection than expenditure, for collections under the program are still about three times as great as expenditure. (About $1.5 billion is collected and $0.5 billion spent.)

Education Expenditures. Expenditures for social-welfare purposes bring about the greatest redistribution of income if they

* In 1947 about 35 million of the 60 million employed workers of the nation were completely covered under O.A.S.I.

† The benefit payments to the wife plus the husband's primary benefit may not exceed $85.

are financed through the levy of highly progressive taxes or the increase of the government debt. These methods of finance are more likely to exist on the Federal level than on the state or local level. However, the finance of public education (an annual expenditure of over $3,000 million), largely with funds collected by the application of the local property tax, is an example of a local expenditure which may often have important direct redistributive effects.

The manner in which property-tax burdens are distributed, or the incidence of the property tax, is very important in determining the amount of redistribution of income which takes place as a result of public-education expenditure. Most property taxes are collected on the basis of real-estate valuation. The value of real estate is determined by the value of permanent structures on the land and the value of the land. The value of permanent structures during normal times is largely determined by the depreciated cost of the erection of the structure. The value of land is largely determined by the expected net income arising from utilization of the land. The portion of the property tax assessed upon structures will increase their cost and therefore their value; the portion assessed upon land reduces the net income arising from land-ownership and will therefore reduce its value. Also, the tax assessed upon structures will tend to reduce the value of land, for the increased cost of structures will decrease the number of structures and therefore the demand for land upon which to build. This decrease in the value of land will compensate to some extent for the increased cost of structures arising from higher taxes. Under normal conditions, most of the burden of property taxes falls upon the owner of land. However, the burden of the tax is borne largely by the person who happens to possess the land when the tax rate is increased. This latter relationship arises from capitalization.

The person who purchased property after a tax had been collected would pay the capitalized value of the net income. The net income is capitalized by dividing it by the average rate of return obtained on investments possessing a similar risk. The net income would reflect all taxes assessed upon the property, and therefore the price paid would be higher or lower depending upon the existing tax burden. Actually what takes place in

capitalization is to shift the burden, that might have been borne by future owners of the land, onto the person who happens to be the owner at the time the new taxes are levied.*

Taxes that have been levied only upon land and at a particular level for a period of time apparently have very little effect upon the vertical distribution of income. They, however, would reduce the total net income arising from land ownership (rent income). The expenditure of these funds for education would benefit the lower and middle income-bracket persons much more than the higher income-bracket groups. The net effect of education expenditures financed by the levy of the general property tax assessed largely upon land values is to improve the income distribution; the desirableness of this source of revenue decreases as the portion of total valuation represented by structure costs increases.

The state aid provided for the financing of education and any Federal aid that may be provided in the near future have an additional desirable effect on income distribution. These expenditures are made in such a manner that a certain minimum per-pupil expenditure is made in all geographical areas. The source of the revenue is very likely to be such that the larger portion is obtained in the richer areas—for example, this would be true of a general income or sales tax. The provision of equal education opportunities through state and Federal aid increases the total scale of living of the poorer areas or those areas where the percentage of children to adult population is greater.

Indirect Effects. Public finance also causes an indirect redistribution of income. This is in addition to the direct income-redistribution effects which can be partially measured (as shown by the studies that have been quoted of the results in both the United States and Great Britain). The most important indirect

* A may have a plot of land which brings him a net income of $600 a year. Assuming rate of interest of 6 per cent, he calculates that this land is worth about $10,000. If he and other investors can get 6 per cent on investment of equal risk, it is reasonable to assume that $10,000 is not too much to pay for land which ordinarily yields an income of $600. Now, if the taxes on the land are increased $100 so that the net income from it becomes only $500, a prospective buyer who presumably can still obtain 6 per cent for his money elsewhere can afford to pay only $8,333.33 ($500 ÷ .06 equals $8,333.33) for this land.

effects arise from the provision of equality of opportunity and the reduction of the concentration of property ownership. The more equal income distribution that arises from additional equating of these two relationships also tends to expand the total national income, which in turn makes possible a relatively greater increase of the income of the lower-bracket individuals with a relatively smaller decrease of the income of upper-bracket individuals.

A secondary indirect income-redistribution effect is that taxes collected directly from the worker to finance a particular social expenditure or any other tax may not be borne by the worker. The existence of a strong labor union, a well-established custom, or a subsistence-wage level may be able to prevent the reduction of take-home pay. If this is the case, a payroll tax to finance social expenditures will be largely borne by unorganized workers and the general population, which would include both the workers receiving benefits and those not receiving benefits. The effect of expanded social security or expanded government activity of any type under these circumstances would be to improve the relative position of persons able to maintain take-home pay and receive benefits. The members of these groups would be both high- and low-income receivers.

Redistribution of Income by Type and Source

Government expenditure can redistribute income by type through (1) the increase of social income and (2) the decrease of property income. The increase of social income results directly from government expenditures to alleviate privation and to raise the scale of living of the aged and the unfortunate. Since the Social Security legislation of 1935, this type of income has become much greater in absolute and relative importance.

Also, since the inauguration of the Federal social-security program in 1935, the number of persons receiving assistance of this type from the government has continually increased. In 1947, over 2¼ million persons were receiving Old-Age Assistance benefits; 1-⅘ million were receiving Old-Age and Survivors Insurance; 1 million were receiving unemployment benefits, 1 million dependent children were receiving aid; and ⅕ million blind were recipients of benefits.

Government investment in the power industry and the provision during World War II of additional aluminum-, steel-, and automobile-production facilities have tended to reduce the relative income arising from property. The development of atomic energy to the place where it can be used to provide a large portion of the nation's power requirements will reduce the returns to persons owning coal and oil properties. In fact, all government expenditure to reduce monopoly decreases the relative portion of the national income paid to owners of property. It is also true that government expenditure made to increase the productivity of the nation—for example, expenditure on agriculture experimentation—decreases the portion of national income paid to owners of property.

Cheap-Money Policy. The active interest of the Federal government in providing funds at low rates of interest to farmers, businessmen, and home builders has decreased the income from property ownership. Also, the general cheap-money policy which the Treasury and the Federal Reserve System have pursued has decreased relative property income.

The relative portion of the national income going to owners of property increases with the expansion of the quantity of capital goods required in the use of the most efficient production methods. The relative portion of the national income going to moneylenders also increases if the quantity of capital is relatively less abundant than labor. In 1929, with approximate full employment, net interest income was 7.3 per cent of national income; in 1933, with large quantities of unemployment, it was 12.5 per cent of national income. By 1940, net interest was 7.6 per cent of national income; and by 1947 it had gone down to 1.7 per cent. The first cause of the rise in the portion of national income going to property (development of capital-consuming machines) cannot and should not be greatly changed by public-finance activities. It is possible, however, for public-finance activity to reduce the relative scarcity and therefore the portion of national income obtained from property if (1) additional production facilities were constructed by the government or made possible through government loans, and (2) the productivity of property were expanded through experimental and developmental expenditure. This latter type of expenditure reduces property return because monopoly is de-

creased and also because current technical developments have been largely of a capital-saving nature.

The increase in the national debt and the rise of government interest expenditure is, of course, a direct expansion of income to property owners, the owners of United States government bonds, as a result of government expenditure. If it is assumed that if the money had not been borrowed by the government it would have been borrowed by private individuals and groups, the increase of the government debt decreases the portion of national income paid to property owners. The reduction arises from the lower average rate of interest paid by the government on borrowed funds. If, however, it is assumed that the government could have obtained its funds just as efficiently by directly printing more money as by borrowing, the expenditure of interest by the government must be considered a net increase in the portion of income arising from property.

Government expenditure has both increased and decreased the portion of national income obtained from property ownership. On balance it would appear, however, that government expenditure activity decreasing relative income from property outweighs that tending to increase it.

Agricultural Expenditures. The best example of government expenditure redistributing income by source has been the Federal activity in agriculture. The government, through expenditure aimed at increasing soil fertility, removing surplus crops from the market, and aiding in the marketing of crops, has increased the portion of the national income arising from agriculture. Another excellent example of government expenditure expanding a particular source of income is the government subsidy of the different means of transportation. Government expenditure for war expands the portion of the national income arising from agriculture and the iron- and steel-fabricating industries, but reduces the portion arising from the service industries.

A change in the portion of national income arising from different sources is of particular importance if a large portion of the population of an area obtains its net income from a certain industry. The government, through the provision of subsidies, can maintain the income of a depressed area while the necessary shifts in population and economic activity take place. The develop-

ment of atomic energy for commercial use involves a very considerable program of this type.

All government expenditure is likely to cause a simultaneous income redistribution of all three types—that is, vertical redistribution, redistribution by type, and redistribution by source. Different expenditure, however, varies very greatly in the type and the intensity of the income redistribution created. Certainly the measurement of the direct redistribution arising from government expenditure is very difficult. The importance of the indirect effects of each government expenditure, or even all expenditure, can be approximated only very roughly.

CONCLUSION

In the past, the effects of government expenditure have been much more apparent in the provision of a desirable level of employment than in the achievement of a desirable level of prices, consumption, or income distribution. This ability of government expenditure to directly and rather efficiently eliminate unemployment has been the principal reason for the great popularity of government expenditure as a method of creating and maintaining desirable economic conditions. The unemployment that arises and that has been eliminated by government expenditure was caused by undesirable prices, consumption, and income distribution. Government expenditure in the past has played a relatively less important role in the elimination of these important causes of unemployment.

Government expenditure programs of the future should not be in the form of emergency measures to take care of a serious case of unemployment that has already developed. Government expenditure must be planned and made in such a manner that it aids in the continual efficient use of resources. Also, expenditure activity of this type would avoid most of the criticisms that were made of the government expenditure during the 1930's. This attitude toward government expenditure as a part of fiscal policy necessitates that in the future expenditure be less directly associated with unemployment and more closely related to prices, consumption, and income distribution.

QUESTIONS AND PROBLEMS

1. Briefly point out why it is always necessary to include expenditure when the fiscal effects of a particular revenue measure are considered.

2. What is meant by built-in expenditure flexibility? Do you think it is desirable? What are its advantages and disadvantages?

3. Briefly point out a number of ways in which government expenditure can directly aid in the achievement of desirable prices.

4. In what two principal ways does the government purchase of gold differ from the purchase of other commodities?

5. Give the four general categories of government expenditure.

6. Utilize the four general categories of government expenditure to show how government expenditure may be used to achieve a desirable level of consumption.

7. Briefly compare the advantages and disadvantages of government or social consumption and private consumption.

8. Briefly point out the interrelationship between government expenditures aimed at obtaining a desirable level of consumption and those directed at attaining a desirable level of employment.

9. What are the basic differences between government-expenditure theories included within the concepts (1) public works, (2) compensatory spending, and (3) pump-priming.

10. How have government expenditures been able to effect a desirable income distribution? Distinguish between the effect on vertical redistribution and redistribution by type and source.

11. What are the disadvantages and advantages of government expenditure as compared to government revenues in the accomplishment of fiscal-policy goals? Which fiscal-policy goal do you think is best accomplished by government expenditure? Why?

12. Select a particular type of government expenditure and show how the effects of the expenditure can be changed through different methods of obtaining the funds spent. Also select a particular government revenue and show how the effects can be changed by different types of expenditure. Finally, take this expenditure and this revenue and show how the desirableness of the effects would change depending upon the existing and expected level of economic activity.

13. Government expenditure can have a great effect on prices. Briefly show how expenditure affects the general price level and particular prices. Why is this type of fiscal activity desirable in attaining an efficient use of resources?

14. What are the ways in which government expenditure indirectly affects the distribution of income? Do you believe that democracy and capitalism will be weakened by extensive redistribution of in-

come? Why? What do you believe would be an ideal distribution of income?

15. Do you believe government expenditure can affect the rate of interest and the quantity of private investment? How? Develop a plan for co-ordinating government expenditure and revenue-raising activity so that private investment would be encouraged.

CHAPTER 5

Administration of Government Fiscal Policy

INTRODUCTION

This chapter will analyze only that portion of public administration directly concerned with the management of expenditure, debt, and taxes that is fundamentally related to the achievement of the fiscal-policy goals discussed in the previous three chapters.

The effectiveness of fiscal policy in obtaining its legitimate aims will be determined by the type of administration provided. It can be stated on the basis of economic principles that revenues raised in a particular manner, and expenditures made for particular purposes, will bring about certain results; but the realization of the expected reaction will be obtained only if the programs recommended are properly administered.

The basic requirements for effective government action aimed at obtaining and keeping favorable economic conditions are:

1. The establishment of a council of economic experts who have had sufficient experience in the handling of economic data to enable them to give the government expert professional advice on any specific fiscal problem.
2. An accurate forecast of future economic conditions if the

government takes no action or if the plans of the moment are carried through.

3. A determination of the type of government action that is desirable to prevent the development of unfavorable conditions.

4. Provision for quickly changing the manner in which the government obtains its revenues and also a provision for quickly putting into effect an extensive, well-planned expenditure program.

5. Sufficient control over political pressures so that a program aimed at preventing the development of a boom period can be put into effect as well as a program aimed at preventing a depression (the problem of the two-headed dragon).

In the past, dominant political pressures have often favored government action the reverse of that required to maintain tolerably acceptable economic relationships. For example, during the period after World War I, when profits were adequate and business was prosperous but the accumulated demand developed during the period of the war was being dissipated, the dominant political pressure was for reduced profit and income taxes and reduced government expenditure, rather than for the maintenance of income-tax rates and increased government expenditure. When the depression of the 1930's was at its worst, January, 1933, the administration program of the Federal Government called for a Federal sales tax and reduced expenditure with a balanced budget. The program should have provided for a reduction of excise taxes, an increase of expenditure, and a Federal government deficit. It is hoped that recommended economic programs will be a little more intelligent in the future. Recent experience, which includes the elimination of excess-profit taxes for 1946 and the reduction of income, estate, and gift taxes during 1948, is not particularly encouraging. However, it is encouraging that the veto of the tax-reduction bill of 1947 was sustained by Congress, although the 1948 veto was not. President Franklin D. Roosevelt's veto of the Revenue Act of 1943 labeling the tax legislation "not a tax bill but a tax-relief bill providing relief not for the needy but for the greedy" was not sustained, and as a result World War II finance got off to a bad start.

Forecasting

An important part of all administration is forecasting. Forecasting is particularly important in the determination of activity aimed at providing a desirable level of economic activity. Economic forecasting at its best is an uncertain undertaking. A recent example of bad forecasting was the prediction by a group of economists that widespread unemployment would develop during the period of postwar reconversion. An example of good forecasting was the prediction that the removal of O.P.A. would not quickly bring about adjustments that would prevent prices from rising and staying high. It is difficult, except on the basis of hindsight, to determine which forecasts of economic conditions are accurate and which are inaccurate. Yet it is upon economic forecasts that plans aimed at the preservation of a desirable level of economic activity must be made.

After the best economic forecasts are obtained, it is necessary to translate these into desirable executive and legislative action. There is less uncertainty regarding desirable government action to correct a particularly undesirable economic development than there is in forecasting what the economic development will be that will need correcting.

THE EMPLOYMENT ACT OF 1946

Federal legislation passed in 1946 provided for the setting up of a large portion of the administrative machinery required for a successful government fiscal policy directed toward the maintenance of desirable economic conditions. The most important step was the enactment of the Employment Act of 1946.

Provisions of the Act

The Act sets forth the policy of the Federal government to be:

> to use all practicable means consistent with its needs and obligations and other essential considerations of national policy, with the assistance and co-operation of industry, agriculture, labor, and state and local governments, to co-ordinate and utilize all its plans, functions, and resources for the purpose of creating and maintaining, in a manner calculated to foster and promote free competitive enterprise and

the general welfare, conditions under which there will be afforded useful employment opportunities, including self-employment, for those able, willing, and seeking to work, and to promote maximum employment, production, and purchasing power.

This aim of Federal policy is desirable and is actually a statement of intention to provide full employment and stable economic conditions and to prevent the development of economic crises. The principal weakness of the Employment Act of 1946 is that it does not set down ways in which this responsibility of the Federal government is to be discharged. The Act does, however, make provision for the gathering together into one place the best information available regarding what is happening in the nation's economy. It also provides for the interpretation of these data and making the interpretation available to the President and Congress for action.

The Employment Act of 1946 does not use the phrase "full employment"; rather the phrase "maximum employment" is substituted. The Murray Bill, which was the basis for the Employment Act of 1946, used the phrase "full employment." The British White Paper which set down the aims of the British government in regard to the provision of economic stability used the phrase "high and stable level of employment." It is perhaps well that the term "full employment" is not used, for it is doubtful that the efficiency of government fiscal-policy tools and democratic methods of allocating labor are as yet sufficiently well understood to eliminate the arising of a considerable quantity of unemployment in a dynamic economic society.*

The Economic Report is a new type of Presidential message. Previously, the Presidential message at the opening of Congress was largely political and dealt only incidentally with economic matters. On January 8, 1947, for the first time in the history of the nation, the President submitted to Congress a "comprehensive picture of the state of the economy and an integrated program for promoting national prosperity and soundness in the year ahead." † Since the first report, two midyear reports and another

* Professor Alvin Hansen is of the opinion that if not more than 4 to 5 per cent of the labor force of the nation is unemployed conditions of full employment should be considered to exist.

† *The Economic Reports of the President* (New York, Reynal & Hitchcock, 1948), p. vii.

annual report have been given. In addition, the Council made recommendations regarding the impact on the national economy to be expected from the Economic Co-operation Act of 1948. The law requires the annual report, and undoubtedly the midyear report will become a tradition.

In the preparation of the report, the President has the services of all government departments; the advice of representatives of industry, agriculture, labor, consumers, educational and research institutions, and state and local governments; and the continuous and immediate service of the Council of Economic Advisors.*

The Employment Act instructs the President to appoint three well-trained professional economists as members of the council. The council has not set up an elaborate organization for the gathering of information but rather has utilized economic data gathered by the various departments of the government and private agencies. If the council desires additional or more elaborate data of a particular type, it can obtain this needed assistance from the appropriate government department.

The Employment Act provides for the establishment of a joint Congressional committee called the Joint Committee of the Economic Report. The basic function of this Joint Committee is correlating legislative activity arising from the Economic Report. Also, the Committee is to correlate existing legislation and contemplated legislation in various fields with the recommendations set forth in the Economic Report. This type-of-action recommendation is predicated on the assumption that the recommendation of the report is the basis for the best fiscal policy under existing circumstances. The Committee also has the responsibility of transmitting once a year to Congress its recommendations regarding means of most efficiently carrying out the policy of the Employment Act.

The annual report of the President on the economic state of the nation is divided into four general sections. (1) The report contains a general summary of the existing levels of employment, purchasing power, and production of the nation. This first section also includes an estimate of the level of economic activity re-

* A midyear report was made to Congress on July 21, 1947; and the second Economic Report of the President was made on January 14, 1948, the second midyear report was made on July 30, 1948.

quired to carry out the provisions of the Act. (2) The report also contains a summary of the expected economic developments during the next year and during the foreseeable future. (3) The third portion deals with the current fiscal policy of the government that is related to the maintenance or the obtaining of desirable levels of employment, purchasing power, and production. (4) The logical concluding portion of the report includes measures for implementing the present fiscal policy with recommendations for additional legislation that the President might consider desirable.

Usefulness of the Act

The Employment Act has already been a very useful administrative addition and has implemented Federal fiscal policy aimed at full utilization of the nation's economic machine. But in order for the machinery to accomplish the aims of the Act, it will be necessary that both the Executive and the Congress have a genuine desire to use the powers of the government to provide economic security. If the President and particularly Congress are of the opinion that the economic well-being of the nation can be best provided by the government doing nothing and in this way permitting the economic forces of the nation to work themselves out, the Act will be of little importance.

If it is assumed that the President and Congress wish to use government action to increase the economic well-being of the people, and this has been a rather settled policy since Alexander Hamilton in 1791 called for a "degree of support from the government," the efficiency of the Act in accomplishing its purpose will depend upon (1) the adequacy of economic data available and (2) the caliber of the personnel of the Council and the Joint Committee.*

The Table of Contents (below) of the Economic Report of January 14, 1948, gives a fairly good idea of its scope.

I. Foreword and Summary

II. Levels of Economic Activity in 1947
The course of employment and production

* See Randolph E. Paul, *Taxation for Prosperity*, pp. 229–236; also Alvin H. Hansen, *Economic Policy and Full Employment*, pp. 106–120.

Employment
Production
Productivity
The flow of goods and purchasing power
Consumer income, expenditure, and saving
Business investment, income, and financing
International transactions
Government transactions
Summary: The Nation's Economic Budget

III. Price and Income Trends and the Course of Inflation
Price trends
Wage trends
Profits
The nature of inflationary pressures
Why inflation is dangerous

IV. Levels of Activity and Adjustments Needed in 1948
Needed levels of employment, production, and purchasing power
Employment objective
Production objective
Purchasing power objective
Fiscal policy to combat inflation
The regulation of credit
The need for selective controls
The need for voluntary restraint

V. Long-Range Objectives for the American Economy
Our ability to grow
Development of natural resources and capital equipment
Natural resources
Business plant and equipment
Transportation
Urban redevelopment
Housing
Development of human resources and productivity
Size and composition of the labor force
Education for the modern economy
Research
Good health and productivity
Security and productivity
Fiscal aspects of benefit programs
Development of institutions and practices for a high-production economy
Industrial price-wage-profit policies
Agricultural and food policies
Taxation and debt management
International economic relations
The timing of economic programs to promote stabilization.

Appendix A: The Nation's Economic Budget, the Federal Budget, and the Distribution of Income, prewar and postwar

Appendix B. Statistical tables relating to employment, production, and purchasing power.

This table of contents indicates that the report is largely concerned with fiscal-policy determination. The report deals with what is taking place in the economy and the probable effects of government economic policy; on the basis of these data, it recommends desirable government policy. However, the action recommended by the report has not been taken by Congress. Good advice, if not followed, is just good advice and that is all. The 1948 Report has been criticized as being slanted toward an economic program that best meets the political requirements of the administration. An example of this was the recommendation of this report regarding the cutting of Federal taxes.

The 1948 Report recommended a "cost-of-living tax credit of $40 for each taxpayer and each dependent." To offset this decrease in government revenue, the report recommended that corporation taxes be increased sufficiently to bring in the revenue lost. The report argued that the inflationary effect of the drop in individual income-tax payments would be eliminated by the anti-inflationary effect of the increased taxes upon corporations.

Prior to the Report of the Council of Economic Advisers, a plan for cutting taxes had been developed in Congress; it was believed that this program could be passed over a Presidential veto. It seemed to the majority of the members of Congress as though the tax-cutting plan of the report was not much more than an attempt to get the good will of the voters by cutting the taxes of many people and raising the taxes of a few. The tax recommendations of the report were not followed. The Republican majority in Congress in 1948 passed its own tax law over the Democratic President's veto. This law provided for a reduction by about $5 billion of total taxes collected; the reductions were made in such a manner that considerable greater tax benefits were given to persons in the higher income brackets than in the plan provided by the report.

Actually, the best tax program in 1948 would perhaps have provided for the maintenance of existing tax rates and the levy of

a special tax to cover the cost of the Economic Co-operation Act of 1948 and the rearmament program.

This type of problem arising from the Economic Report is more serious when the Administration and the Congressional majority belong to different political parties. The fact that the report is closely tied to the ultimate judgments of the President is certain to make it a report slanted toward the economic philosophy which appears to be the better politics for the President. A desirable reform would perhaps be the submitting of a majority and minority Economic Report. The differences would usually not be great, but this would enable economists to make available to the public what they think is the best policy—with political considerations thrown out the window—or would it?

THE ADMINISTRATION OF GOVERNMENT BORROWING

The very large Federal government debt of $253 billion (1948) makes government debt-administration activity very important. This is a typical postwar experience, but it is even more important this time because the per-capita debt is greater than ever before and also because our dominant position in the world makes it very important that the value of United States government securities be maintained. Also, the debt must be effectively utilized along with other economic relationships to maintain the prosperity of the United States economy. A badly administered debt can weaken the basis of United States prosperity and prestige.

General Relationships

A government can carry a large debt with much greater ease if the value of the unit in which the debt is quoted decreases. As a result, if a large government debt exists there will be a constant pressure (temptation may be a better word) upon government to maintain prices at a high level and to favor a rising general level of prices. If prices should begin to fall, it would be more difficult to obtain in taxes the funds required to make interest payments, debt repayment would become im-

possible, and refunding of the maturing parts of the debt would be much more difficult.

Under nearly all circumstances when the debt of government is being increased there will be an upward pressure on prices; when the debt is being reduced, a downward pressure is exerted. This relationship is desirable if debt is being increased at a period when the general price level is considered to be too low and decreased when prices are generally believed to be too high.

In the past, debt creation and reduction has not worked too successfully in the stabilization of prices. Debt increase has been frequently determined by a crisis so serious—for example war—that the undesirable effect upon prices has been outweighed by the immediate requirement of quickly marshaling under government control the productive resources of the nation. However, governments have been much less prone to reduce debt, and thus bring about additional deflationary pressure, when the general level of prices has been too low. The act of debt reduction is a much more voluntary act of government than is the act of debt increase. The very fact of falling prices increases the difficulty of bringing about any important debt reduction through the levy of taxes. Dept policy is apt to be fiscally sounder during periods of falling prices than during periods of rising prices.

Borrowing Techniques

An important portion of the administration of a government fiscal policy aimed at obtaining desirable economic conditions is related to the manner in which the public debt is divided among the different holders. This, in turn, is to a great extent related to the rate of interest, maturity date, negotiability, and, in the past, to the treatment of interest for income-tax purposes and conversion rights. Also, the ability of the Treasury to sell certain quantities of securities at different prices (rates of interest) is determined by prior Treasury preparation of the money market.

The sale of securities to individuals and corporations is more time-consuming and more expensive than the sale of obligations to banks. However, careful preparation is necessary to dispose of large quantities of government securities either to banks or individuals and corporations. The borrowing policies followed by the

Treasury during the World War II period were very successful. The more efficient borrowing arose largely as a result of the development of government borrowing tools during World War I and the depression period of the 1930's. The Federal Treasury's efficient use of a "cheap money policy" to reduce the rate of interest enabled the Federal government to obtain huge quantities of borrowed funds at low rates of interest without resorting to the pressure methods adopted during World War I.

Because the typical debt obligation runs for a period of time, the effects of the manner in which the government sells its bonds, notes, and certificates must be carefully considered in relation to expected future conditions.* The ability to take into consideration future conditions is a first requirement of desirable fiscal policy as related to debt administration. This requirement means that the expected effects of the various ways in which the debt could be floated must be carefully correlated with the best estimates of future conditions.

Indirect Effects of Debt Management

One writer recently commenting upon the importance of debt management states:

> The way in which the debt is managed, and the success achieved, will directly affect social security, federal grants-in-aid, banking legislation, the conservation program, and many other matters of public policy that the country has been accustomed to determine with little reference to their effects upon federal finances.†

Another analyst of the effects of the debt sees it also importantly affecting the private sector of the economy. The church, family, and business organizations will be unavoidably affected by the huge Federal debt—and, according to this analysis, largely undesirably.‡

The administration of the debt is accomplished by the Treasury with a good deal of assistance furnished by the Federal Reserve System. It would perhaps be as accurate as most generalizations

* See Donald B. Woodward, "Public Debt and Institutions," *American Economic Review*, vol. 37, May, 1947, pp. 157–191.

† Charles Cortez Abbott, *Management of the Federal Debt*, p. 3.

‡ See Donald B. Woodward, "Public Debt and Institutions," pp. 157–191.

to say that the most important function of the Federal Reserve System for some time to come will be the role that it plays in aiding the Treasury in its work of administering the Federal debt.

General Debt-Management Policy

The beginning of an effective postwar administration program was established when the Treasury decided to compartmentalize the debt. The various types of issues were deliberately determined in recognition of the existing investment institutions, of the broader needs of the economy, and of the differing needs of the many classes of investors.* As has been previously mentioned, desirable debt administration of the future requires that the existing compartmentalization be continually examined to determine whether it still meets the needs of our institutions, investors, and the broader needs of the economy. Because the various types of issues into which the government debt is divided determine to a great extent the effects, it would be undesirable if any particular distribution should become permanent. If economic conditions change, it would be desirable for the debt to affect the economy differently, also.

At present, the composition of the Federal debt can be changed by the Treasury without first obtaining Congressional approval. The only direct control Congress has over the debt is the provision of a maximum. This situation is quite different from that existing in the levy of taxes. The present Treasury freedom in the administration of the debt if transferred to the tax field would mean that Congress would set the maximum amount that could be raised by taxes and the Treasury would determine the various ways in which the funds were to be obtained.

This great administrative freedom in debt management brings with it great responsibilities. The Treasury in its administration of debt policy must consider two general points of view regarding desirable aims of a debt policy. One school of thought, which has been associated with the late Professor Simons of the University of Chicago, holds that the Federal debt should be managed in

* Lawrence H. Seltzer, "The Public Debt—Discussion," *American Economic Review*, vol. 37, May, 1947, p. 193.

a way that minimizes its effect on the economy.* The other school of thought favors using the various facets of debt management to the utmost in affecting the economy in the manner desired. It is quite improbable that Federal government, committed as it is to maximize purchasing power by the Employment Act of 1946, will fail to make use of the help that debt-management policies can provide.

Although the way in which the debt will be managed can be determined without consulting Congress and although the Treasury officials can theoretically do just about as they wish, the amount of freedom possessed by the Treasury is definitely limited by attitudes toward Federal debt possessed by the contemplated debtholders. In the administration of a tax program, individuals can be forced to co-operate with the provisions of the law; and funds can be obtained from certain individuals and groups whether they do or do not wish to pay. Debt, however, is largely held by persons and artificial entities as a result of a voluntary action.

The insurance companies have found government bonds having a maturity date of over ten years to be particularly desirable. Over two-thirds of the bonds held by insurance companies are of this type. The commercial banks prefer short-term bonds, and about one-half of their holdings are of bonds maturing in less than a year. Individuals like small-denomination, non-marketable, high-interest securities, and four-fifths of the government bonds held by individuals are of this type. These preferences are important in determining the types of issues to offer to obtain sufficient purchasers and also are basic when the administrative problems surrounding debt renewal are considered.†

The Treasury, in order to have the Federal debt broken up into certain types of issues, must convince individuals that they should hold Federal debt in that particular form. In order to accomplish this, the Treasury must convince the prospective holder that government-debt purchase is the best possible use of funds. The ability of the Treasury to do this is determined largely

* Henry C. Simons, "On Debt Policy," *The Journal of Political Economy*, vol. 52, no. 4, December, 1944, p. 357.

† Seymour E. Harris, *The National Debt and the New Economics*, Table 38, p. 253.

by the terms offered in the debt certificate, that is, terms meeting preferences of prospective buyers. In addition, the Treasury may take other types of direct action or it may induce the Federal Reserve System to act in a particular manner. All three of these types of action will also affect commercial-bank policy. The latter two types of Treasury activity are frequently referred to as an easy or tight money policy.

Debt-management policy could be much more influential if there were no government goals related to debt other than making effective use of it as a fiscal-policy tool aimed at maintaining the proper level of economic activity. There is, however, no prospect that such will ever be the case.

A Treasury policy aimed at getting a substantially larger portion of the debt into the hands of small savers would require a large increase in the interest rate of the debt and strict restrictions against the purchase of government issues by high-income-bracket individuals and business concerns. This policy, however, would not be sufficient to transfer a significant portion of the debt to the masses. In addition, it might be necessary to increase incomes of large groups and restrict the quantity of goods which they could purchase. Obviously, this latter development is outside the administrative powers possessed by the Treasury, and certainly Congress would never pass high minimum-wage legislation or commodity-rationing legislation just to make possible the distribution of the Federal debt among a larger number of persons. The best the Treasury will be able to do is to make different types of issues attractive within rather definite limits to the different segments of the economy.

Government Debt and Inflation

The quantity of government debt held directly by persons in the lower income brackets has been decreasing since the end of World War II. The inflationary possibilities inherent in the expansion of purchasing power through the cashing of government bonds by individuals has been largely spent. Also, the excess reserves held by business firms were largely utilized in 1947, so that it was necessary to borrow from commercial banks or sell new issues to obtain funds required for further expansion of

investment. The inflationary effect of Federal government debt in the future will result largely from the use of debt owned by commercial banks as reserves for loan expansion. The management problem is, therefore, largely concerned with the reduction of this threat.

Responsible leaders of the Federal Reserve System have pointed out that, as long as prices continue to rise, the holdings of government debt by the commercial banks are an inflationary threat. Large quantities of Federal government debt held by Federal Reserve Banks should be retired by the collection of taxes in excess of government expenditure for goods and services; or, through direct control and fiscal tools, the prices of goods and services should be decreased.

The expansion of reserve requirements of commercial banks has the effect of reducing the credit-creation powers of the Federal government debt owned by commercial banks. However, if prices continue to rise, the demand for commercial loans will not abate and the reduction of member-bank reserves will have the effect of increasing interest rates as a method of rationing credit. The rise in interest rates would force government bonds below par, which would be generally considered a breach of faith by the Federal government.

Inflation versus Interest Rate *

In December of 1947, the conflict existing in a policy aimed at maintaining Federal government bonds at par and at the same time restricting the increase of commercial credit became apparent. Government bonds will decrease in price if the rate of interest rises, but an increase in the rate of interest is the conventional method of restricting the growth of commercial credit. It became apparent in the winter of 1947–1948 that the brakes should be applied to the expansion of commercial-bank credit; but interest rates could not be increased without decreasing the value of Federal government bonds, which would be nearly disastrous to many financial institutions.

* The interest rate is considered largely with regard to its effect on general economic conditions and not its direct effect on the distribution of the debt. See footnote on p. 203.

At the end of World War I (1920), the Federal Reserve System withdrew its support from the Federal government bond market and raised the rediscount rates; within a short period of time, the market price of Federal government bonds fell by 20 per cent. This action had a demoralizing effect on the security markets of the period and was a partial cause of the sharp reduction in productive activity in 1921. The Federal government has given assurances that action during the post-World War II period will always be of the nature required to maintain bond prices at par. This policy has arisen because of the undesirable economic effects of the drop in Federal government bond prices at the end of World War I and the tremendous quantity of government debt held by individuals and financial institutions of the nation.

The guarantee that Federal government bonds will not fall below par largely eliminates the possibility of the use by the Federal Reserve System of higher interest rates as a method of restricting growth of commercial credit. The creation of the great government debt to purchase the goods and services required to fight World War II, a fiscal act, has greatly reduced the efficiency of the most important tool of monetary policy. In the spring of 1948, the monetary powers of the Federal Reserve System had apparently been reduced to one—moral suasion.* Actually, through co-operation of private bankers, this was an important brake on inflation; however, it was a far cry from the claims made for monetary powers in the immediate past.

If the amount of credit available in the country should ever tighten, the tendency would be for interest rates to increase as different persons desiring credit bid for the restricted amounts. An increase in interest rates would decrease the price of long-term government bonds and raise the rates on short-term issues; the Federal government, through the Treasury and the Federal Reserve System, would feel required to provide additional quantities of credit. The provision for additional credit expansion at this time would be most undesirable, for it would certainly be

* New legislation passed in August, 1948, strengthened slightly the monetary powers of the Federal Reserve System. Provision was made for a possible 1½ per cent increase of time deposit reserves and a 4 per cent increase of commercial deposit reserves. In addition the Federal Reserve was given the power to institute consumer credit controls.

a period of potential inflation if not actual inflation. However, if the prices of long-term bonds are permitted to fall, many savings institutions, commercial banks, and individuals would experience serious financial difficulties.* The problem of debt management under these circumstances becomes that of restricting credit expansion without reducing the price of Federal government bonds below par.

Any scheme, whether direct or indirect, that reduces the quantity of credit when more credit is desired will raise interest rates. The only effective policy for debt administration within this framework is to reduce the demand for credit. This can be accomplished most efficiently by the use of fiscal tools. The businessman's demand for credit to expand before prices rise even further and while markets are hungry for more goods is likely to be very important during this period. During the last half of 1947, business investment proceeded at a rate over 40 per cent greater than in 1946; a large portion of this advance was financed by the use of commercial-bank credit. This demand can be reduced by a high tax on excess profits, higher taxes on all profits, and reduced government expenditure for goods and services. This action would tend to raise interest rates only under the most unusual conditions —that is, if profits as a source of savings were more important than profits as a stimulator of investment.

If the funds collected from additional taxes were used to retire debt owned by the Federal Reserve Banks, the total demand for goods and services would decrease and the source of the demand for credit, the possibility of continual expansion of expenditures, would disappear. The problem of restricting consumer credit can be accomplished by direct controls similar to those which were in effect during the war, which expired on November 1, 1947, and were partially re-established on September 20, 1948. The restriction of consumer credit can be much more readily regulated by direct controls than can commercial credit. The problem of determining who should get commercial credit is so complicated that direct controls are useful only during periods of great emergency.

* "The financial world should rest easy that the investment market will not be subjected to the demoralization which swept over it in 1920." *Economic Report of the President,* January 14, 1948.

The use of fiscal tools, plus direct controls and the provision for well-considered plans for refunding debt, make possible a desirable debt-management program. A desirable program is considered to be the maintenance of Federal government bonds at par without inflation or a great increase in the transfer problem arising from greater interest payments. This type of a program in 1948 rested largely upon the utilization of fiscal tools; monetary tools were very nearly useless.

A Plan for Flexible Interest Rates

The administration of the Federal government debt has become restricted by the general acceptance of the position that Federal bonds should be freely traded on open markets at a value very close to par or that they should be readily exchangeable for cash, at par. The effect of this is that the government is required to maintain relatively constant interest rates or to issue bonds of a type that will permit an extensive refunding program whenever the rate of interest changes. The maintenance of interest rates has been discussed to some extent on pages 153-154. The second alternative has some attractive features that are frequently neglected. For example, bonds could be issued bearing an annual interest rate that could be changed each year. The annual rate of interest to be paid the next year could be determined on the basis of a formula based on the existing market interest rates of the previous year or month. This would permit changes in interest rates without the dollar value of Federal government bonds being forced either below or above par.

Actually, the maintenance of government debt at par is only important to the different financial institutions as institutions; the persons having their savings in these institutions are much more interested in maintaining the purchasing power of their investment at par. If the dollar value of bonds is maintained at par through an easy money policy that results in an inflation, the holders of government bonds have perhaps suffered more than if the bonds fell considerably below par through a tight money policy. The purchasing power of bonds should remain at par and the money value should remain at par. This can best be ac-

complished through readily changeable interest rates and fairly constant value for monetary units.

It appears quite undesirable to practically strip monetary controls of all power by making the interest rate fixed. It is also undesirable, of course, to have government bonds fall below par—if for no other reason than that it would be more difficult to sell them during the next crisis. However, the idea of a fixed or only very slowly moving rate of interest with all other prices continually moving back and forth to bring about a more efficient allocation of resources as dictated by the market is not a desirable condition. It is worth while that fiscal, monetary, and direct controls be co-ordinated in a manner that will bring about the most efficient utilization of the nation's resources. Monetary controls through tightening or easing of credit can be of great aid in directing the economic machine in desired paths that should not be abandoned because of the other important goal of keeping Federal government bonds at par. The scheme of flexible interest rates presented here, or some other similar plan, can certainly be established to preserve the monetary controls of the Federal Reserve System and the debt-stability goal of the Federal treasury.*

State and Local Debt Administration

State and local debt administration must operate within much narrower limitations than Federal debt administration. The more rigid limitations arise from the necessity that local governments meet the requirements of sound private-finance procedures. They do not have the power to issue money, as does the Federal government. However, it is possible for the administration of local debt to be sufficiently flexible to aid somewhat in attaining the goals of fiscal policy.

* Interest rates as an income source often appear to be quite unimportant in the determination to buy government securities. The large quantity of cash and deposits (increased 200 per cent from prewar totals) indicates a greater interest in the preservation of principal and liquidity. "It may be held that life-insurance companies, banks, government agencies, corporations, and other business units—and to a substantial degree individuals—determine purchases of government securities largely irrespective of rates." Seymour E. Harris, *The National Debt and the New Economics,* p. 252.

State and local governments should and can avoid following a conscious policy of debt reduction during a period of unemployment and purchasing-power shortage. Also, state and local governments should not attempt to increase their debt during periods of easy money and full employment. The administration of this sort of a policy could be aided by the establishment of a state board of advisers to recommend desirable state and local debt-management policies. Each of these state boards could be greatly strengthened in its co-ordinating efforts if limited guarantees of local bond issues were given by the Federal government during critical periods. It would be desirable, also, if a co-ordinating board on the national level were formed to attempt to prevent the debt policies of the Federal government, of other levels of government, of government corporations, of nonfinancial business concerns, and financial business concerns, from working at cross-purposes. This board would have at its disposal considerable quantities of funds to be used in a period of crisis. This above type of recommended co-operation was established during the World War II period upon a rather informal basis. It would be desirable that administrative machinery be established for a formal continuation of this co-operation during peace.

THE ADMINISTRATION OF TAXES

The effectiveness of the administration of the different taxes is very important in determining the ability of the tax to bring about the correct level of prices, consumption, employment, and income distribution. The method of administration is, of course, a part of tax legislation adopted by the different legislatures. An important cause of the growth of Federal fiscal power has been its efficiency of tax administration.

Flexibility of Tax Rates

Neither Congress nor the state legislatures has seen fit to provide any important degree of administrative discretion in the determination of tax rates. In order for taxes to play the full role of which they are capable in providing the correct level of prices, consumption, employment, and income distribution, it would be

necessary to grant an executive group the power to change rates within various broad limits. It would be possible, as previously indicated, to set up certain criteria to be used as the basis of tax rate changes. Also, legislative provision could indicate the amount which tax rates could be changed if certain conditions arose. These restrictions would assure the legislative bodies that determined principles would not be abandoned, and yet the Executive division would have sufficient freedom for administering the taxes of the nation in the manner best suited to maximize the utilization of the nation's resources.

In 1948, the President could change the tax policy through administrative procedures only to the extent that the executive had been given power to change tariff rates (Reciprocal Trade Agreements Act, 1934) and perhaps by issuing administrative orders that all doubtful cases should be decided either for or against the government. The reductions in tariff rates provided under the Reciprocal Trade Agreements Acts could have and have had a considerable effect on the efficiency of resource allocation in the United States. Tariff reductions would almost certainly increase efficiency of resource use if full employment were maintained. In regard to administrative orders, it is doubtful that a change in official attitude toward an uncertain tax liability could produce any important predictable results.

Effects of New Tax Levies

The Federal government relies primarily upon revenues obtained from the individual and corporate income taxes. Recently, tax bills have been passed at frequent intervals that provided for different effective individual- and corporate-tax rates. Although the rates determined upon, the types of income taxed, and the exemptions provided have important determinable effects upon the development of the economy, the considerations given greatest attention continue to be largely political. The mere frequent passage of new tax bills does not guarantee tax legislation better tailored to the requirements of desirable fiscal policy. For example, the tax-reduction bill passed by Congress in 1947 but vetoed by the President met the economic requirements of desirable tax legislation less accurately than legislation in effect. This was also

true when tax legislation was enacted by Congress in 1945 and again in 1948.

The economy to a great extent becomes adjusted to an old tax and tax rate. The economy requires time to adjust itself to the imposition of new taxes and different rates. It is the situation that exists after these adjustments have been completed that largely determines the long-run effects of a tax. However, the economically disrupting effect of new taxes is important and should be minimized. This disrupting effect should be considered in determining the manner in which new taxes and rates are administered. In some instances it might be desirable to introduce a new tax by degrees. This could be done by making the tax applicable at first only to those sections of the economy which, because of economic resources or method of organization, are well suited to bear the original impact of the tax. This type of procedure was used to some extent in the introduction of social-security taxes.

The effectiveness of new income-tax levies in increasing and decreasing the quantity of purchasing power possessed by individuals has been improved by the introduction during World War II of withholding and quarterly payments under declarations of estimated income. This has meant that within a matter of weeks wage earners received larger pay envelopes as a result of the 1948 Federal income-tax reduction. This more current payment of Federal income taxes applies to all sections of the economy except agriculture. It would be desirable if it were extended to include this area.

The withholding- and quarterly-payment schemes result in prompt changes of tax payments, but provision is not included for prompt repayment of tax overpayment. As matters stand in 1948, if a man is unemployed for a spell, he gets a claim to a tax refund the next year. The administration problems encountered in a more prompt refund method are very great. It has been recommended that personal exemptions be given as a refund by the government, perhaps on a monthly basis, and taxes withheld on the basis of income without personal exemptions. ("Personal exemptions" refers to the $600 of tax-free income allowed to the taxpayer and for each dependent). Then if a man were unemployed he would receive the personal-exemption payments but would be subject to no taxes. The plan would involve making out

millions of small checks and getting them to individuals. The task would be a large one, perhaps too great for the benefits resulting.

State and Local Tax Policy

The ability of the state and local governments to affect economic activity by taxation is greatly limited by the types of taxes which they can administer effectively and by the rates which can be assessed—for example, local governments have difficulty in administering income and death taxes. Each of the different states is to an extent in competition with all other states in obtaining the location of manufacturing industries and also of distribution and management facilities. It has usually been politically impossible for a particular state to initiate a tax program that is greatly different from that existing in other states. This has been the case because of the belief, and proof is lacking, that tax burdens have an important effect upon the location of industries. This factor has been particularly important in regard to state and local taxes levied directly upon business-enterprise profits. A number of states, particularly Mississippi and Tennessee, are active in offering tax inducements to obtain new industries.

THE ADMINISTRATION OF EXPENDITURES *

The administration of an economic Federal program of expenditure correlated with the needs of society for certain services and goods and the maintenance of a proper level of economic activity would require the establishment of an additional Cabinet post. The duties of this new member of the President's Cabinet can be roughly defined on the basis of the previous analysis of the requirements of an effective program to maintain a desirable level of prices, consumption, employment, and income distribution.

A Secretary of National Welfare

This new Cabinet member might be called the Secretary of National Welfare. It would seem logical that those duties of the

* The analysis of this section is largely based upon the excellent study of the International Labour Office titled *Public Investment and Full Employment* (Montreal, International Labour Office, 1946).

Bureau of the Budget which relate to the correlation of the expenditures of the various departments of the Federal government be transferred to the new Secretary. In addition, the new Secretary would have as a portion of his responsibility the working out with industrial leaders of plans for expansion and reorganization of industry which would correlate with those of the government. If a sphere of activity in private hands appeared to require expansion and reorganization, it would be the duty of the Secretary to bring about such expansion through the provision of funds or the use of whatever other means were required. The acceptance of this responsibility by a government department would prevent the use of investment funds in an area of the public economy that, according to all measures of productivity, would be of less value to the community than investment expansion in a segment of the private economy.

The new Secretary should also be responsible for working out advance engineering and finance plans for desirable projects to be actually constructed when the need for the services which they would provide would be best correlated with the type of activity required to maintain the desired level of economic activity. Planning of this type brings with it all of the problems attending the determination of priorities which are discussed in considerable detail in another section.* and the much less difficult problem of providing a reserve shelf which is also discussed in considerable detail in another section.†

The efficient performance of the duties mentioned above as being those properly assigned to the Department of National Welfare necessitate the development of a detailed national plan for the expansion and conservation of the nation's material and human resources.

An examination of these required powers emphasizes the necessity of crossing departmental lines, and of the Secretary being able to place strong pressure upon Congress for the provision of enabling legislation. The new Cabinet post would provide for a new superior member of the executive family. It is very doubtful that such powers as outlined will be extended in an outright grant, but rather that the required activities and co-operation will

* See pp. 215–222.
† See pp. 210–212.

take place on a more or less voluntary basis. If this were the case, the Secretary of National Welfare would be able to perform the functions of his position with greater or less efficiency, depending upon Congressional and Presidential attitudes toward the administration of economic plans.

Local Administration Problems

The problems of local administration of government expenditures are to a great extent the same as those of central administration. In addition, however, local administration would be greatly concerned with the determination of (1) the projects which would fit in best with local conditions, (2) the letting of contracts on an efficient basis, and (3) the problems associated with the acquiring of suitable sites.

The expenditures of all government levels could be made more rapidly if they were executed through force-account projects rather than through the letting of private contracts.* Also, expenditures of higher levels of government could be made more rapidly if lower government levels were not used in the channeling of funds. In the future it is likely that greater expenditures will be made directly by higher government levels, with the work accomplished through force account. The factors that will strongly mitigate against such an administrative procedure are (1) the desire of local and state governments to determine to at least some extent how Federal funds are to be allocated, (2) the contribution by lower governments of a portion of the costs of projects, (3) the desire to maintain considerable decentralization of government and the fear of the development of a strong Federal bureaucracy, and (4) the belief that the letting of private contracts is the capitalistic method of making government investment.

Elaborate advance preparations must be made if government funds are to be spent through the letting of private contracts and local participation in the financing and selecting of projects. This preparation is basic if the expenditures are to be made sufficiently

* In a force-account project: The public investment is undertaken directly by a public authority, with labor hired, equipment owned, and materials bought by the public authority, as contrasted with work done through a private contractor.

rapid to prevent employment, price, and consumption levels falling considerably below what is desired.

The W.P.A. experience indicated that force-account projects were more efficient in putting men to work, and thus more efficient in implementing the income stream, than private-contract programs. The experience gained from W.P.A. expenditure also indicated that if work is to be done through private contracts with an efficiency approaching that of force-account, it is necessary to do the following things beforehand: (1) all legal and financial complications must be taken care of, (2) all plans and specifications must be prepared, (3) all sites to be used must have been acquired, and (4) it would be desirable if a procedure were worked out for the letting of contracts in advance.

A Local Public-Expenditures Board

State and local administrative boards are needed to direct expenditure programs with fiscal-policy aims. These boards must be bipartisan or nonpartisan. Citizens will have relatively high confidence that boards of this type will make expenditures in the most efficient manner. Every effort must be exerted on the national, state, and local levels to prevent the waste of funds either through the (1) inefficient or dishonest letting of contracts or (2) inefficient or dishonest determination of project priority. In order to prevent the embroilment of regular state and local public-expenditure boards in the heated discussions that are certain to arise with the initiation of a project providing utilities previously furnished by private-enterprise or government subsidy grants to certain private industries, it would be desirable if the determination of this type of project were referred to separate boards. This arrangment would prevent the regular boards, which determine most expenditures, becoming involved in these arguments that take a great deal of time and would be certain to create bad feeling and reduce prestige.

A Reserve Shelf *

The principal weakness of government expenditure activities to increase the level of economic activity, during the depression of

* "Reserve shelf" means a reserve of planned public-investment projects to be ultimately included in the program of a public authority, but for which

the 1930's, was the lack of a stock of sufficiently well-planned expenditure projects. It is much easier to maintain prosperity than it is to bring it forth after a depression has set in. It would be desirable to establish a timetable of planned expenditures. Expenditures would be made first in those areas where unemployment was developing. Projects that would quickly require a large number of persons would be selected first. At the same time, preparations would be speeded for the construction of important larger projects in any area. The selection of all projects would be determined largely by the need for the development and by types of resources unemployed. It is obvious that this is the efficient manner to plan the use of government expenditure to maintain a desirable level of prices, consumption, and employment. However, it cannot be obtained without an administrative program that recognizes that governments, to perform their newly accepted function of maintaining sound economic conditions, must fully plan *beforehand* the steps to be taken in case of a threatening depression or a threatening boom (the two-headed dragon problem again). The development of a reserve shelf is just a portion of this preparedness. A good reserve-shelf program would provide for the development of fully-planned projects in all areas to meet the various requirements of expenditures aimed at the maintenance of prosperity.*

The reserve shelf should contain projects that not only possess the characteristic of being able to provide employment quickly, but they must also be easy to terminate—that is, it must be possible to reduce government expenditure quickly when the need is gone. The cost of developing such a reserve shelf is not excessive, and the technical knowledge required for its construction so that it will meet the economic, engineering, and legal requirements is available in the United States.

Difficulty of Creating a Reserve Shelf

Fundamentally, the inability to create an adequate reserve shelf has been political. In the past, the majority of the voters have believed that such a reserve shelf was neither necessary nor even

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no funds are expected to be made available during the period in which the program is laid out.

* See pp. 218–222 for a more complete analysis.

particularly desirable. Also, there existed a good deal of skepticism regarding the technical ability to construct one.

The efficient government planning during World War II has removed many of the doubts of technical ability. The waste of labor power during the 1930's convinced many that thorough planning is a necessary prerequisite of economic government expenditure. The great direct effect of government spending in bringing about a full utilization of the nation's resources was thoroughly demonstrated in the 1937–1938 upswing and downswing and in the pre-World War I and World War II periods. The inability of monetary and banking policy alone to rectify a condition of underemployment was very completely demonstrated during the depression of the 1930's. Also, even the most ardent advocates of government tax revision as a method of providing a desired level of economic activity include additional government expenditures as a part of their program. Opposition to a planned reserve shelf nevertheless continues from those groups who believe that periodic unemployment is desirable to eliminate maladjustments and also from those who believe that we have entered a new era and that the nation will not experience another depression.

Legal Bottlenecks

If the Federal government is going to make use of investment expenditures partly financed and controlled by local government, a great deal of preparatory legal and administrative work must be done. In the 1930's, these legal difficulties sometimes arose from incomplete or confused legislation providing for the expenditure. In addition, delays in getting projects under way arose because of time-consuming procedures that had to be followed in the letting of contracts and in the acquisition of sites.

Enabling Legislation

A legal difficulty encountered during the early period of P.W.A. arose from the failure of the Act to set up plain rules for the determination of the lines of authority. A must of expenditure-enabling legislation is the clear establishment of the manner in which the purpose of the act is to be accomplished. If this is

poorly done, much needless delay and confusion will arise and the successful accomplishment of the primary purpose of the original legislation will be endangered.

State and municipal laws, constitutions, charters, and ordinances provide another legal delay. States and cities should be made aware of the necessity of changing their legal requirements for expenditures upon projects largely financed by the Federal government and related to effective emergency action. Local government debt-limitation laws are an excellent example of this type of legal bottleneck. Another enabling delay on the local level arises from the failure to pass legislation providing for state and/or municipal agencies that can co-operate with the Federal agency.

Contract Letting

Many of the delays encountered in the letting of contracts during the period of the 1930's were of a legal nature. Much of this legal protection was found unnecessary during World War II and was eliminated. The irreducible legal protection desired when contracts are let to private firms is that associated with the advertising for bids, checking the bids submitted, and, if they are considered to be legal bids, awarding the contract. At the very best, the use of private contracts requires a delay to meet the minimum legal safeguards. The problem from the legal side could be solved by letting contracts for certain planned projects a considerable period in advance of the time when construction is desired. The solution of the legal difficulty brings with it administrative problems arising from the need to develop methods of handling changes in cost from the period when the contract was let to the period when the construction takes place.* It would seem that procedures worked out during World War II, when great price changes were taking place within a short period of time, would be practical also in the above type of situation.†

* The term "general-escalation" clause is used to refer to contract provision for increase in price of finished product if raw-material or labor costs increase.

† See John Perry Miller, "Military Procurement in Peacetime," *Harvard Business Review* (Summer, 1947), vol. 25, no. 4, pp. 444–461; and "War Procurement—A New Pattern for Contracts," by David Fain and Richard F. Watt, *Columbia Law Review*, March, 1944, vol. 44, pp. 127–215.

Securing Sites

The legal problems involved in the acquisition of land can be as serious as any other in the quick development of a project. The problem involved in the purchase of land by a government to be used for the development of a project has been succinctly stated by the United States National Resources Planning Board:

> Land acquisition on a large scale, especially if the purposes to be served require blocking in of large contiguous areas, is at best a difficult, complicated, and slow process; and unless it is conducted under competent administration, it can become very costly. It requires individual transactions with large numbers of persons.*

Legal title to land could be obtained very quickly if the government were indifferent to the price paid. This, however, cannot be the case. In most cases condemnation is the best method of obtaining land by a government of the United States. In most states the power of condemnation is quite broad and adequate, if it can be shown to the satisfaction of the court that the property when acquired will be used for a public purpose. Condemnation can be obtained through either the so-called (1) judicial procedure or the (2) administrative procedure. The judicial procedure includes bringing suit against the owner; then the court determines if the property is to be used for a public purpose and also determines the value of the property. The great objection to the judicial procedure is that it sometimes requires as long as two or three years to obtain title to needed property. The administrative procedure provides that the government agency makes public its intent to take certain properties. This method gives the government practically immediate possession; but if the owners are unwilling to accept what the government offers, they may appeal to the courts, and the government will have to pay whatever the court decides is a fair value. Under the so-called judicial procedure, the government can refuse to purchase the property if it considers the price, as set by the court, too high. The danger of paying too high a price and the delay

* National Resources Planning Board, *Public Land Acquisition*, Part I: "Rural Lands" (Washington, U. S. Government Printing Office, June, 1940), p. 6. Taken from *Public Investment and Full Employment* by the International Labour Office.

of court condemnation proceedings can be avoided by advance planning through the purchase of land at opportune times and holding it until needed.*

Public-Expenditure Priorities

The determination of public-expenditure priorities is very definitely a portion of the problem of administering a public-expenditure program. The order in which expenditures should be made can be determined by rating in accordance with (1) the utility which is expected to accrue or (2) the process effects.† Usually projects are chosen on a basis determined by assigning weights to these two factors. If the need for immediate stimulation of employment is very great, the second base would be given greater relative weight; if the need is not so urgent, the first base should certainly be the more important. If government expenditures were completely determined by the second base, however, the total cost to obtain a given increase in economic activity would be minimized. However, an expenditure program of this type would be particularly open to the criticism that government funds were being wasted. It is possible through very careful planning and efficient administration to combine the utility and process-effect bases in such a manner that the expenditures maximize both of them.

* The practice of municipal purchase of properties is quite common in Europe. Helsinki owned 13,000 acres and Stockholm 21,000 acres at the outbreak of World War II.

† Process effects include the total increase in national income and employment resulting from the process of securing and financing public-investment projects. These effects are classified as primary, secondary, and tertiary.
Primary effects:
  On-site employment (and income)
  Off-site employment (and income)
Secondary effects:
  Multiplier effects on income and employment
  Relation effects on income and employment
  Effects through induced private consumption
  Effects through induced private investment
Tertiary effects:
  Further increases in consumption arising out of secondary increases in investment, and
  Further increases in investment arising out of secondary increases in consumption.

INVESTMENT VERSUS CONSUMPTION

If a downward trend in economic activity is apparent, the all-important priority consideration is: Will a particular expenditure have important primary, secondary, and tertiary effects and can the expenditure be made quickly so that the stimulation of these process effects will be available immediately? This, in nearly all cases, will mean that the additional fiscal action of government will be of the type labeled "consumption." It will involve the underwriting of consumption by paying subsidies to reduce the price of necessities, by reducing all excise taxes, and by the payment of substantial unemployment benefits. The period of need for the direct increase of purchasing power will be long or short, depending largely upon the completeness with which the reserve shelf of government investments has been planned.

Government expenditures of the consumption type are often considered wasteful and at times are believed to lead to a deterioration of the morale and the skills of the population. As soon as possible, the expenditure of government should be upon projects that are of recognized worth. As quickly as possible, the basis of employment on government projects should be skill and other related factors, rather than need. It is preferable to make direct unemployment payments than to include "projects whose value in themselves is so low as to be almost negligible, but which may be resorted to where a definite amount of relief work has been determined upon and where no better projects can be found." *

Conflict is likely to develop concerning the factors of production to be employed and the projects that have the highest utility value and greatest process effects. Care should be taken that the projects chosen do not require materials in short supply. Also, it is possible that skilled laborers would be unemployed while common labor would be fully employed. It is desirable to immediately make full use of the resources of the skilled-labor pool. There is no reason why skilled laborers, because they have a greater financial ability than unskilled, should have to remain

* John Maurice Clark, *Economics of Planning Public Works* (Washington, National Planning Board of the Federal Emergency Administration of Public Works, 1935), p. 58.

unemployed waiting for the secondary and tertiary effects. The loss to the community is actually considerably greater when skilled laborers remain unemployed than when the unskilled are unable to find employment.

It is sometimes advisable to complete projects completely out of line with any sort of a priority rating system. This would be the case if the completion of a particular project leaves labor and supplies very convenient for the undertaking of this less important project. On occasion it might be desirable to employ within a brief period the largest possible number of persons in a particular area. This would require that projects planned over a period of time be telescoped within a much shorter period. This again would require that high-ranking projects that were not as yet completely planned or that would require too long to complete would be set to one side and replaced by projects possessing a much lower desirability rating.

Increased Government Social Expenditures versus Increased Individual Purchasing Power

Sir William Beveridge, in discussing public expenditures, is very insistent that there should not be a waste of resources. The needs of the people for better housing, better education, better medical care, and better recreation are so great that waste cannot be tolerated. Every dollar spent by the government must be utilized in the most efficient manner in providing the primary needs of the people. However, during a period of developing unemployment, Beveridge would depart to some extent from this criterion for determining government expenditure priorities. He states that: "The outlay which is designed to produce full employment cannot be an indiscriminate outlay; it must be directed to those industries and localities where idle labour and idle capacity can be brought together." * This, of course, may or may not be the most efficient method of providing the primary needs of the people.

Most of the experts concerned with the problem of full and efficient resource use believe that both individual and social consumption should be stimulated. Professor Hansen, the best-known

* Sir William Beveridge, *Full Employment in a Free Society*, p. 185.

American advocate of government action to obtain desirable economic conditions, has much more confidence in the mere increase of consumer expenditure than has Sir William Beveridge, who believes that England, at least, must first increase direct government expenditures aimed at the provision of a "social minimum." [6] This theory of expenditure gives the highest priority to expenditures that would provide the amount necessary to raise the scale of living of future generations to a determined minimum level. The government would direct the primary effects of increased expenditures toward the provision of housing, health, education, and nutrition. Sir William believes the mere increase in purchasing power is likely to bring about a waste of resources upon those things that the individual is induced to purchase by high-pressure advertising or by the product's availability. In Beveridge's opinion England, at least, is too short of resources to permit these wastages.

Provision of Full Employment versus Efficient Use of Resources

The analyses of priority must include the requirements of government expenditure to preserve a desirable level of prices, consumption, and employment with those of the most efficient utilization of the resources of a nation. The attainment and maintenance of one of these goals may reduce the speed with which another goal is reached. However, it is largely possible to obtain and retain a particular level of economic activity and at the same time utilize available resources in a manner that will bring about in the most direct fashion and in the quickest possible time a social minimum of the type Beveridge advocates.

The problem of determining the desirability of particular types of investment expenditures is often simplified and placed on a purely engineering basis—that is, the aims, (1) using the resources in a generally recognized useful manner and, at the same time, (2) putting the largest number of persons to work in the quickest possible period of time, are made the sole bases for decisions regarding a certain expenditure. If this is done, it is possible to make quite specific recommendations. The ability to follow even

[6] *Ibid.*, p. 187.

this simplified basis of priority for government expenditures would be a great improvement over the administrative determination of priority used during the depression of the 1930's.*

A good criterion for the speed with which a project utilizes the resources assigned to it is that of determining the number of months required "to absorb say 90 per cent of the total man-hours" required to complete the project. The projects listed below are arranged in order of the speed with which, in an engineering sense, they can utilize 90 per cent of the total man-hours. The first type of project listed requires the briefest period of time and the last the longest.

Water mains
Dredging
Grading and drainage
Flying fields
Concrete paving
Bituminous paving
Sewers and sewage systems
Locks and dams
Levee construction
Post offices and similar buildings
Hospitals
Schools †

The speed at which a program will be completed is also determined by the size of the project. Projects of great magnitude require a greater amount of time to consume the same quantity of money than do a number of smaller projects. This is, however, considering only the engineering aspects of the problem; the administrative and legal bottlenecks of a number of smaller projects may more than consume the time saved through greater engineering speed.

A study which has been made of the time patterns of a number of projects initiated and completed by the government during the period of the 1930's indicates that speed of investment is determined more by the size of the project than by the type. The smaller projects of about $100,000 apiece were most useful in utilizing unused labor resources.

* Administrative here means the dominance of largely political and emergency considerations.

† Taken from *Public Investment and Full Employment* by the International Labour Office.

As a footnote, in a manner of speaking, to this whole matter of government expenditure of various types aimed at providing a desirable level of economic activity, there are the results of both the British and the American studies regarding the mobility of labor. The definite conclusion of these studies is that labor is much more mobile from one type of employment to another than it is from one geographical area to another.* Government expenditures must be aimed at providing additional employment to the particular geographical area in which unemployment has developed.

Toward a Yardstick for Public Expenditures

The failure of the Reconstruction Finance Corporation expenditures of the 1930's to bring forth any sharp increase in employment was due to the fact that the sole judgment basis for a grant of Federal funds was: Is the proposed project self-liquidating? Under the P.W.A., applications for Federal funds were considered upon a very different basis. Projects were accepted and granted funds on the basis of (1) the social desirability of the proposed projects, (2) the extent of integration with other projects in the same state or in that area, (3) the swiftness with which the project could be gotten under way and completed, (4) their nearness to an existing center of unemployment, and, of course, also (5) upon legal, financial, and engineering soundness. Also, (6) attention was given to the extent to which the project would remove individuals from the relief rolls.

The Subcommittee on Publicly-Financed Construction Projects of the Canadian Advisory Committee on Reconstruction has suggested the following general standards to be used in the evaluation of projects, in addition to the financial, technical, and legal factors:

(1) Will the project increase directly or indirectly the economic or industrial efficiency of the region concerned?

(2) Has the project special relationship to additional works which may be necessary for the readaptation of industrial plant or other facilities of the district from wartime to peacetime uses?

(3) Is the project concerned with amenities which increase produc-

* For example: "Work and Wage Experience of Willow Run Workers," *Monthly Labor Review*, December, 1945, pp. 1–23.

tivity or which help to produce a revenue indirectly (such as highways, waterways, pipelines, or other transport facilities, communication facilities, certain conservation or land drainage measures, etc.)?

(4) Is the project concerned with new construction, additional works, or maintenance or repairs deferred owing to the war?

(5) Will the project contribute to the welfare of the community (e.g., in the form of recreational, educational, cultural, public health facilities, etc.)?

(6) (a) To what extent are locally produced materials and equipment available to the project? (b) Will the project compete with existing local industries?

(7) In what other ways, if any, is the project of particular relevance or importance in this particular area? *

These are pertinent questions which must be answered before any government expenditure project should be undertaken.

The test of which expenditure should be made first in the private economy is usually that of the estimated relative profitableness. The public economy does not possess quite such a simple yardstick for the determination of relative desirability of expenditure, or, putting it differently, the greater responsibilities of the public economy do not permit it to use such a simple yardstick.

Various individuals working with this problem of the determination of the priority of government expenditures have developed more or less acceptable criteria.

Professor J. M. Clark believes that (1) time required to complete projects, (2) relation of projects to an organized program, (3) amount of maintenance involved, (4) effect on private expenditures, (5) effect on private capital outlays, (6) proportion of outlay going to direct labor, and (7) relation to future self-maintenance of workers should be the principal factors to be considered in the determination of public expenditures.†

Professor Alvin H. Hansen, in writing of the type of project in which public funds should be invested, stresses those projects that are not self-liquidating in a monetary sense but which "in the nature of the case, cannot be undertaken by private enterprise, yet without them we should not be able to take full advantage of

* Taken from *Public Investment and Full Employment* by the International Labour Office, pp. 126–127.

† John Maurice Clark, *Economics of Planning Public Works*, pp. 57–59.

the level of productivity made possible by technical progress." * It is also true that a project that meets the above qualification may also be profitable to the government in that directly and indirectly it will increase tax receipts more than the amount of direct government expenditure. It is doubtful that public expenditures should ever be determined upon the basis of their direct benefit to the treasury; rather they always should be made on the basis of their benefit to the community.

It has been stated as a generalization that those projects that prevent things from getting worse should be completed before those projects aimed at the improvement of existing conditions. It is doubtful if this sort of a pessimistic attitude would be particularly helpful.

A classification that follows the standard of values held by capitalists of Western Christian nations would give the highest priority to projects essential to life, health, and safety and a very close second to those projects essential to economic activity. More near the end of the list would fall those projects essential to social welfare and, finally, those projects essential for cultural and esthetic development. However, because public expenditures and particularly investments, if they provide utilities falling within the first two categories, are likely to compete with private facilities, public investment is often made in the latter categories while some of the essentials for providing the requirements of the first two categories remain unsatisfied. This could be remedied by closer co-operation between the public and the private economy.

The development of methods for the establishment of government-expenditure priorities is a field of fiscal research that has been only partially explored. If government expenditures continue to expand during periods of normal economic activity and are also used as the most important weapon in the government arsenal of antidepression weapons, then certainly well-tested standards to meet every type of situation should be developed to determine project priority.

* Alvin H. Hansen, *Economic Policy and Full Employment*, p. 191.

CONCLUSION

The experience gained during the 1930's and World War II points toward a large number of ways in which the administration of government fiscal activities may be improved. This experience, of course, was not available during the great depression of the 1930's, and thus many of the mistakes made were excusable; however, the making of similar correctable errors in the future should not be tolerated. Within this category of correctable errors would certainly fall those weaknesses of fiscal activity during the 1930's that arose from failure to have well-planned projects available and from delays in getting an undertaking started because of various legal bottlenecks.

However, future fiscal activity aimed at a desirable level of prices, consumption, employment, and income distribution will continue to be reduced in effectiveness because of fundamental principles of American government organization and the relative undeveloped state of economic forecasting. The Employment Act of 1946 is an important step forward in improving the portion of fiscal-policy administration that is related to the provision of accurate economic information to the President and Congress.

QUESTIONS AND PROBLEMS

1. Outline the basic requirements for an effective administration of fiscal policy aimed at the provision of desirable economic conditions.
2. What are the administrative advantages of using debt management as a tool for obtaining desirable economic conditions?
3. How is the Employment Act of 1946 related to the administration of fiscal activity?
4. Do you believe the administrative problems of a flexible tax rate are important? Why?
5. Do you believe a Secretary of National Welfare should be established? Defend your opinion.
6. Define the following terms: (1) reserve shelf, (2) force account, (3) administrative procedure, (4) tertiary effects, (5) process effects.
7. Point out the principal legal bottlenecks in the administration of government expenditure and the manner in which they can be largely overcome.
8. What is the basic difficulty in determining priority of public expenditures related to obtaining desirable economic conditions?

9. Differentiate between social consumption and private consumption. Which type of consumption stimulation do you believe is most desirable? How is the choice related to the problem of administration?

10. What are the good points and the bad points of determining priority on the basis of speed of resource utilization?

11. Outline the problem of maintaining Federal government debt at par. What would be your solution?

12. Do you think the monetary powers of the Federal Reserve System should be preserved? Why are these powers in danger of destruction? What do you think should be done in regard to this dilemma?

13. What do you think will be the development of the Council of Economic Advisers as a Federal government agency?

14. Compare the ideas of flexible tax rates, flexible interest rates, and flexible expenditures. How much flexibility do you think is desirable? Why?

15. Evaluate the problems involved in the administration of fiscal policy during periods of full employment and peace, full employment and war, and unemployment in a political democracy and in a political dictatorship.

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