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## Chapter XV of "Financial Instability and the Current Economic Policy" -- An Agenda for Reform

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Chapter XV. An Agenda for Reform

I. Introduction	1
II. Big Government	6
III. An Employment Strategy	17
A. Transfer Payments and Barriers to Labor Market Participation	18
B. CCC, NYA, and WPA	20
C. Money Wages	25
IV. Financial Reform	28
A. Introduction	28
B. Ordinary Corporations as Financial Institutions	32
C. Banks and Banking	40
D. Central Banking	47
V. Taxation	59
VI. Industrial Policy: Alternatives to Dominance by Giant Corporations	65
VII. Conclusion	73

## Chapter XV

### An Agenda for Reform

#### I. Introduction

If a program of reform is to be more than a reflection of prejudices it has to be based on a critique of the "system". This critique needs to identify "what is wrong" and explain why "what is wrong" happens. A program of reform emerges out of an identified problem and a theory; it is the theory that identifies the handles that can be manipulated in the attempt to do better.

Our identification of what is wrong is straightforward. Turbulence in the form of financial instability, inflation and trendwise rising unemployment along with a sharp slowdown in the pace at which living standards improve have characterized the economy since the mid-1960's. This stands in sharp contrast to the tranquil performance and consistent improvement that ruled in the prior twenty years. Our diagnosis is that turbulence--especially financial instability--is normal in a capitalist economy; the tranquil era was the anomaly. Our institutional arrangements and policy measures have succeeded in substituting the stepwise accelerating and cyclical inflation and the trend of rising unemployment rates for a deep depression. The policy problem is to devise institutional structures and policy measures which remove the thrust to more inflation, more unemployment, and slower improvements in the standard of life without increasing the likelihood of a deep depression.

After World War II and until the mid-1960's demand management that conformed to rules derived from the Hicks-Hansen interpretation of Keynes seemed to be successful. The best that can be said about recent years is that demand management and lender of last resort interventions have staved off a deep depression.

That there has not been a deep depression in the thirty-five years since World War II marks a substantial improvement over the earlier history of capitalism. In our theory we impute this success to the impact on profits of the deficits that are possible with big government. It was the plunge of profits in a small government economy that increased debt burdens. The increase in debt burden that led to large scale repudiations is an essential part of the process that leads to deep depressions.

This leads us to two policy propositions: (1) Big government is necessary if deep depressions are to be avoided. (2) Stabilization policy must stabilize profits so that on the whole, but not in every case, debts are validated and capital-asset prices are sustained.

That big government is necessary does not mean that government need be as big as our present government nor that today's structure of government spending, taxes and regulation is either necessary or desirable. Each structure of government has systemic effects and our present inflation is largely a result of particular features of the big government we have.

Big government stabilizes profits by way of government deficits. To effectively stabilize profits tax and spending schemes need be constructed so that a fall in investment quickly leads to a rise in the deficit. As an immediate impact of a fall in investment is a rise in unemployment, government spending and taxes must be such that the deficit quickly increases when unemployment rises.

The shift from tranquil to turbulent behavior of the economy is related to the emergence of fragile finance. Reform of financial practice and institutions to attenuate the thrust to instability is needed. Banks are central to the financial structure and a banking system whose rate of expansion is controlled is necessary if we are to achieve and sustain a tranquil and progressive economy.

All taxes affect demand and supply conditions and all taxes show up in prices. The traditional arguments to the effect that some taxes are progressive while others are regressive have very little merit. Tax reform should be aimed at simplicity and efficiency. In general taxes can be avoided by adjusting behavior. Taxes therefore can be designed to induce particular types of behavior but all too often the behavior induced by the propensity to avoid taxation is ignored in the design of taxes.

Industrial policy is related with the structure of financial institutions and tax policy. Market power is often the result of the protection against price flexibility that bankers and financiers require when they finance firms. A main theorem that emerges out of our analysis is that a capitalist economy with sophisticated financial practices and expensive capital is flawed because from time to time decentralized markets become incoherent. Once aggregate profits are stabilized by big government the usefulness of grants of market power as a device to induce investment diminishes.

An agenda for an integrated program of reform is examined under five headings: Big Government, An Employment Strategy, Financial Reform, Taxation and Industrial Policy. The details of the programs suggested are of course "negotiable"; the hard contention is that one dimensional or gimmicky programs of reform will not do. These policy suggestions are outgrowths of a theoretical perspective which recognizes the inherent and inescapable flaws of capitalism. However even though capitalism is flawed we can develop a capitalism that does better than we have been doing the past fifteen years.

A program of reform needs to come to grips with the strengths and limitations of the market mechanism. Decentralized markets are fine social devices for taking care of particular output and price details of an economy, but they are

imperfect devices for assuring stability and guaranteeing efficiency where large expensive capital assets are used in production. But most important market processes that determine the prices of capital assets and the flow of investment introduce strong destabilizing forces into the system. If we can achieve an institutional structure in which upward explosions from full employment are constrained and profits are stabilized then the details of the economy can be left to market processes.

Because of limitations of the capacity of government to administer, competitive markets are a preferred mechanism for coordination and control. Because what happens in competitive markets is determined by profit opportunities, easily administered tax and subsidy measures should be part of the arsenal of policy measures.

The proposition that "capitalism is inherently flawed" because it breeds inequality, inefficiency and instability takes us quite far in setting out an "ideological" background for policy. However inequality and inefficiency, though serious, have never been a barrier against the continued functioning of an economy. Instability and with it "... the haunting terror of unemployment." (Orwell, George, "Looking Back on the Spanish War" in Homage to Catalonia, Penguin p. 244) is the damning weakness of capitalism. Once the technical problem of eliminating the "terror of unemployment" is solved, that economic program is best which minimizes inequality. This means a preference for a low investment, high consumption full employment economy with a favorable disposition towards organizations that are small. Small may not be beautiful but like the market it tends to minimize bureaucracy. Profits that are distributed as the salary of the bureaucrats of business are disruptive of stability. Minimizing such costs will tend to constrain instability.

The decentralization of power and the removal of the haunting terror of unemployment are as far as economics can go in generating the good society. To the extent that policy has bias against power, policy will favor competitive markets and decentralization.

Efficiency is an elusive goal. Economists jump to the conclusion that a simple minded competitive exchange economy is efficient. The economists peculiar notion of income, in which the costs of treating an environmentally caused disease is income but the value of a "prevented disease" is not, is a trivial illustration of the illusiveness of the concept of efficiency. Long before national income was devised as a measure of economic efficiency, Thomas Love Peacock in Grotchet Castle had The Rev. Dr. Folleott remark: "... the nation is best off, in relation to other nations, which has the greatest quantity of the common necessities of life distributed among the greatest number of persons; which has the greatest numbers of honest hearts and stout arms united in a common interest." Beyond the aim of universal material minimums and a wide dispersion of interesting work, ideological considerations do not carry economic policy very far.

## II. Big Government

Because it makes a prolonged deep depression impossible, big government is the most important difference between today's capitalism and that which gave us the Great Depression. With big government a move towards a deep depression is accompanied by a large government deficit which sustains or increases business profits. But such profits can be earned only if output and employment are sustained or increased.

With profits sustained the prices of capital assets and business debts cannot fall by much; therefore an interactive debt and price deflation cannot occur. This makes those institutions that were designed to prevent wages, output prices and asset prices from falling obsolete. Once we have a big government these features give an inflationary tilt and increased instability to the economy.

A structure of institutions which retains big government but with institutional arrangements that constrain inflation and instability needs to be developed.

Because profits cannot fall precipitously financial intermediaries cannot get into the collective liquidity and solvency bind they were in during the great depression. This means that the flow of financing from financial institutions will not be halted; therefore investment will not collapse. Furthermore government intervention to sustain a particular business or bank by concessionary finance is not urgent. Individual financial institutions can be allowed to fail, for with business profits sustained at a high level a generalized failure of financial institutions cannot take place.

Lender of last resort interventions which keep the total financing that is available and placed from collapsing supplements big government. The orientation of lender of last resort interventions must be to the market rather than to any particular institution. In 1974-75 the Federal Reserve should have supported the total volume of funds available in the New York money market even as



Franklin National Bank was allowed to fail. The Federal Reserve has been abusing its lender of last resort powers by intervening to protect individual institutions thus absorbing or socializing uncertainty due to speculative (and Ponzi) financial postures.

Because a thoroughgoing debt deflation is impossible recessions or depressions are short. Policy can safely endure a deeper recession if this is needed to induce portfolio preferences that will be barriers against subsequent speculative and Ponzi finance. Losses such as stored holders of Franklin National Eurodollar deposits in the face should not be prevented by the Federal Reserve. Deposit insurance from a public agency might very well remain, but the coverage should be restricted to modest size deposits. Large deposits should be assets at risk to keep the possibility of losses by owners of liabilities of financial institutions as a barrier against speculative and Ponzi finance. The Federal Reserve fosters stability by allowing losses to occur that sustains the virtue of liquidity as protection against uncertainty.

Once massive sustained unemployment is impossible, the restrictions upon labor force participation can be eliminated. Child labor is obviously not "desirable"--but neither is an enforced "school only" option for younger adults. Symmetrically the retirement of older workers by "formula" rather than by choice serves no useful purpose once deep depressions cannot occur.

During the Great Depression there was a comprehensive collapse of asset values and cash flows that assets yielded. Many private provisions of income for retirement were "wiped out". Social Security was a response to this collapse of profits and asset values. In today's world the need for Social Security as a "complete" retirement package has vanished. It can become a flexible provider of a base retirement income.

Because profits are earned by outputs and big government stabilizes profits, market demands will not collapse. Measures that intrude into markets to prevent prices from collapsing--such as agricultural price supports and marketing agreements--are redundant.

The emergence of big government capitalism has changed the cyclical behavior of the economy. The institutional protections against debt-deflation, price declines and falling wages that were the response to the 1929-33 debacle are redundant. In today's big government economy many of the institutional legacies of the thirties exacerbate inflation and stagnation. New institutions which promote employment and are effective barriers to inflation are needed. Before the new institutions can be defined we need determine how big big government is and what it should do.

Government must be big enough so that swings in private investment lead to offsetting swings in the government's deficit so that profits are stabilized. This means that as a minimum government must be as large a percentage of the economy as investment.

Between 1929 and 1930 private investment fell by more than one third. Between 1974 and 1975 private investment fell by 11%--a far cry from the 1929-30 experience but the "best" we can exhibit from the era of big government. In both 1929 and 1930 the Federal Government ran a deficit of \$.9 billion. Thus the sum of private investment and government deficit fell by \$6.1 billion, or well-nigh 40% of the \$15.3 billion of 1929.

In 1974 the deficit was \$11 billion and in 1975 it was \$71 billion. The \$60 billion increase in the deficit more than offset the \$24 billion fall in private investment. The difference between 1929-30 and 1974-75 is most striking

Table 15-1

Private Investment and The Federal Deficit

1929-30 and 1974-75

	<u>1929</u>	<u>1930</u>	<u>1974</u>	<u>1975</u>
Private Investment	16.2	10.1	215	191
Government Deficit	- <u>.9</u>	- <u>.9</u>	+ <u>11</u>	+ <u>71</u>
Total	15.3	9.2	226	262

Source: Economic Reports of the President.

in the behavior of corporate profits. In 1929 corporate profits were \$10.1 billion and in 1930 they were \$6.6 billion. In 1974 corporate profits were \$83.6 billion and in 1975 they were \$95.9 billion. In 1930 the Federal budget was not able to sustain profits whereas profits were sustained in 1974-75. With profits sustained the recession was quickly halted and reversed.

In Table 15-2 the comparative size of gross private domestic investment and Federal Government outlays in various years are sketched. In 1929 the Federal Government was 2.5% of GNP; in 1940, with the country arming for World War II, the government was 10% of GNP. Since World War II the ratio of Federal Government outlay to Gross National Product had risen from about 14% in the early years to around 23% in the recession year 1975.

It is interesting to note that the ratio of private investment to Gross National Product was about the same in 1979 as in 1929, 1955, 1960 and 1965. Only in 1940 and 1975 was the ratio substantially lower. There is no evidence that "investment" as a percent of GNP has decreased.

It is clear that a Federal Government in the neighborhood of 2.5% of GNP is not capable of generating a deficit that can stabilize profits in an economy where investment is 16% of GNP. It also seems reasonable to infer that the expansion of total government outlays above 20% of GNP and the chronic government deficits are responsible for at least part of the acceleration of inflation in the past decade.

The best way to approach the how big question is in terms of the percentage of GNP; numbers become quickly obsolete in an inflationary economy. In 1979 each 1% of GNP was about \$25 billion. Thus in that year a Federal Government that was 15% of GNP would have been \$375 billion, a 20% government would have had outlays of \$500 billion. The actual outlays in 1979 were 21.4% of the GNP

Table 15-2

Gross Private Investment and  
Federal Government Outlays

<u>Year</u>	<u>G.N.P.</u>	<u>Gross Private Domestic I</u>	<u>Federal Government Outlays</u>	<u>Percent to GNP</u>	
				<u>Private I</u>	<u>Government</u>
1929	103.4	16.2	2.6	15.7	2.5
1940	100.0	13.1	10.0	13.1	10.0
1950	286.2	53.8	40.8	18.8	14.3
1955	399.3	68.4	68.1	17.1	17.1
1960	506.0	76.4	93.1	15.1	18.4
1965	688.1	112.0	123.8	16.3	18.7
1970	982.4	140.8	204.2	14.3	20.8
1975	1528.8	190.9	356.8	12.5	23.3
1979	2368.5	386.2	508.0	16.3	21.4

Source: Economic Report of the President, January 1980, Table B1 pg. 263 and Table B72 pg. 288.

of \$2,400 billion. A target size of government might well be 19% to 20% of GNP, especially if the elasticity of government taxing and spending is large enough so that a "large deficit" is offset by a decrease of income.

It can be argued that there is no need to have a "big government" in being for whenever the need for government deficits arises, discretionary government policy can increase profits. However, this will not happen automatically: there always will be legislative and program start up times. Furthermore a small government means that a reduction in tax receipts will not create part of the deficit.

The symmetric use of a surplus to constrain inflation argues for a tax system that gathers a significant proportion of gross national product and is responsive to changes in prices. The greater the responsiveness of taxes and expenditures to a shortfall or excess of unemployment rates from a stable price full employment level, the smaller the relative size that government could be.

The "government" can be divided into three parts. One part consists of expenditures which are not responsive to variations in income. This includes the costs of general government, defense and any base income transfer system. The second part consists of government expenditures which vary with income and employment. Unemployment insurance reacts this way as would a permanent structure of public employment that constitutes an employment strategy. The third part of the government consists of tax and other revenue measures. A government budget that is some 19% to 20% of Gross National Product need not require oppressive taxes. The tax system should be responsive to variations in income and employment.

The what kind side of the big government question is that the government need not be big by way of nationalized industries or by means of extensive administrative interventions into economic and social life. There may be ample

grounds, in efficiency and in concern for public safety and well-being, to nationalize all or part of various industries such as nuclear electricity generation, railroads and oil. In these "public enterprises" the government involvement, aside from chartering, and selecting the executive should be the furnishing of equity capital and well-defined subsidies. Only the subsidy becomes part of the government's input into the economy.

In 1979 national defense was \$108.3 billion or some 4.3% of GNP and the civilian Federal Government purchases of goods and services was \$58.0 billion or 2.3% of GNP. It is unfortunate but in the foreseeable future the "sterile" national defense expenditure will be some 5% of GNP. The Federal Government purchase of goods and services will be 7.0% of GNP.

Government should be big by means of two base transfer payment schemes. One is a children's allowance and the other is social security. A children's allowance of some \$50 per month would cost approximately \$40 billion, or 1.7% of the for example GNP. In 1979 old age survivors benefits and health insurance were \$132.4 billion or 5.3% of the base GNP.

In addition to government purchases of goods and services and transfer payments the government needs to pay interest on the debt. In 1979 interest payments were about 2% of GNP.

The combination of a civilian government at the size of 1979, a somewhat larger defense effort, a children's allowance, social security and health insurance and debt servicing add up to 16% of gross national product. An employment program for youth, adults and the aged that will replace much of welfare and which would increase GNP should be budgeted at 2% of GNP when the economy is functioning well. Another 1% of GNP might well be budgeted for transfer payments to states. This

leaves us with a government that is some 19% of GNP. Because of the substitution of work for welfare the measured GNP will be at least 2% greater than with earlier measuring techniques.

In fiscal 1979 the Federal Government Budget receipts were \$465.9 billion or 18.6% of the GNP "base" of \$2,500 billion. Of this the individual income tax was \$217.8 billion (8.7%), the corporate income tax was \$65.7 billion (2.6%) and social insurance taxes and contributions \$141.6 billion (5.7%). Income taxes and the value added tax on labor added up to 17% of the base GNP.

A tax system that collects some 19% of GNP can be simple. Although it is beyond the central scope of our study, the oil dependency of the United States calls for an amplification of the OPEC supply price of oil by a substantial excise tax. The target oil excise tax revenues--whether on every barrel of oil however used or on the gasoline component alone--should be \$100 billion or 4% of GNP. Because our analysis indicates that the standard arguments which define progressive and regressive taxes are not valid, a value added tax that yields some 5% of GNP should replace the social security payroll taxes and the corporate profits tax. The progressive personal income tax will be the main federal government revenue source; it should aim at collecting 10% of gross national product.

<u>Budget</u>			
National Defense	5%	Oil Tax	4%
General Government	2%	Value Added Tax	5%
Transfer Payments	7%	Income Tax	10%
Employment Program	2%		
Transfer Payments to States	1%		
Interest on Debt	<u>2%</u>		
	19%		<u>19%</u>



The general government, defense and the base transfer schemes (social security and children's allowances) should not vary with income and unemployment. Unemployment compensation and the "employment devices" will vary sharply and in an appropriate way when income increases or decreases. On the tax side, neither the oil tax nor the value added tax will do more than vary proportionately with income. The main deficit generating device when income falls is the progressive income tax.

The budget should be designed to balance at a low unemployment rate, where the employed include those on the base level of the instrumentalities of the employment strategy. If it is decided to increase "base" government outlays on defense or transfer payments then the income tax take should be increased to retain the budget balance.

Macroeconomic stabilization policy mainly depends upon the size of government and the impact of variations in private demand upon the deficit. Once it is recognized that stabilization policy works by way of profits, then the big government can be simple in the sense that only a few well-designed taxes and straightforward spending devices are necessary. Note that because defense expenditures are always offset by taxes, a world in which defense spending is not necessary may get along very well with a government that is some 14% of gross national product.

If the budget is balanced at a 4% unemployment rate (6% counting those in the employment program as unemployed) then for each 1% increase in unemployed we can expect a rise in the WPA costs of 1/2% of GNP and a fall in the income tax receipts of .6% or a deficit of 1.1% of GNP. A recession that sees a rise in the private unemployment rate from 6% to 9% would see a deficit of 3.3% of GNP or \$82.5 billion. The recession will be short. Because this deficit is

not the result of any emergency cut in tax schedules a rise of income will see the deficit disappear.

### III. An Employment Strategy

Although stabilization policy operates upon profits, the humane objective of stabilization policy is to achieve a close approximation to full employment. Although full employment is the objective, the guarantee of particular jobs is not an aim of policy. Just as with profits the aggregate is the policy objective, not the particulars.

The current strategy seeks to achieve full employment by way of financing demand. The forces used are financing conditions, fiscal inducements to invest, government contracts, transfer payments, and taxes. This policy strategy now leads to chronic inflation and periodic investment booms that culminate in financial crises. The policy problem is to develop a strategy for full employment that does not lead to inflation and instability.

The main instrument of such a policy is the creation of an infinitely elastic demand for labor at a "floor" or "minimum" wage that does not depend upon long and short run profit opportunities. Only government can divorce the offering of employment from the profitability of hiring workers. The infinitely elastic demand for labor must be created by government.

A government employment policy strategy will yield outputs that provide well-being even as the outputs are not readily marketable. Because the employment programs are permanent, operating at a base level during good times and expanding during recessions, the tasks to be performed will require continuous review and development. Many of the particular items of an employment strategy are in being; for example the "work study programs" are very much what the N.Y.A. effort to be described will undertake for in-school youth.

An employment strategy will affect labor markets, industrial structure and tax policy; the industrial structure and tax policy aspects will be considered in subsequent sections. In this section we will take up labor market aspects.

There are four labor market aspects to an employment strategy:

1. The development of public, private, and "in-between" institutions that furnish jobs at a non-inflationary base wage.
2. The modification of the structure of transfer payments.
3. The removal of barriers to labor force participation.
4. The introduction of a measure that constrains money wages and labor costs.

The faces of the employment strategy are linked. If the massive transfer payment apparatus is to be dismantled, then alternative sources of income must be "guaranteed" for the recipients of transfer payments. If the barriers to labor force participation are removed then jobs have to be available for those who enter the labor market. Constraints upon money wages and labor costs are corollaries of the commitment to maintain full employment.

We will first take up the second and third points--the modification of the transfer payments structure and the removal of the barriers to labor force participation. We will then sketch a program of government employment schemes and ways to constrain money wages in a full employment economy.

#### A. Transfer Payments and Barriers to Labor Market Participation

The United States has embarked on a course which will lead to a major modification of the Social Security system. The legislation that forbids the "involuntary retirement" of workers before the age of 70 implies that in time the benefit will be a variable that depends upon the age of retirement. Alternatively beneficiaries will draw social security benefits even though they continue to work. A barrier to labor market participation, the constraint upon wage income allowed to social security recipients, is now politically untenable.

Because of compound interest and life expectancy the social security retirement income increases rapidly with a delay in the retirement age. Thus flexibility in social security will both induce labor market participation and decrease the chronic inflationary pressures for increases in social security.

The most significant status tested transfer payments scheme is the aid to families with dependent children program. In December 1976 some 3.6 million families, which contained approximately 12% of the children under 18, were beneficiaries. (In 1955 only 3% of the under 18 were beneficiaries.)

At the time AFDC was instituted the "social norm" was that women with children, especially young children, would not work. Legislation for the support of dependent children quite naturally reflected this norm so that eligibility was restricted to mothers who did not work. With today's labor market participation rates the sociological assumptions underlying aid to families with dependent children do not apply.

Aid to families with dependent children is a "minor" government program in support of children; the major program is the "children's exemption" in the income tax, which yields a "return" that increases with family income. A universal children's allowance should be substituted for AFDC and the children's exemption. The level might well be at \$50 per month or \$600 per year. This provides a net benefit for all parents whose marginal tax rate is less than 60% and a substantial benefit to the working poor with large families. For a "working poor" with four eligible children \$4,000 in exemptions (or \$800 in taxes) is exchanged for \$2,400 in children's allowances; the net gain would be \$1,600 (\$30 a week).

A universal children's allowance means that AFDC can be eliminated. With AFDC the barrier to work can also be eliminated. For this approach to succeed jobs must be available.

Over the postwar years there has been a strong trend in retention rates in secondary schools and in beginning rates in colleges. This trend means that the full labor market participation of young adults has decreased.

Through the middle 1960's additional uninterrupted schooling onto and beyond high school was taken to be an unambiguously good thing. It now is clear that an alternative to continued schooling in the form of a job is preferable for many young adults. However any program which points towards the alternative of a job must assure that jobs are available. Although young adult unemployment rates will always be higher than those of older workers, it is obvious that the alternative of a job does not exist when younger worker (16-19 years) unemployment rates are 17.3% for white males, 16.4% for white females, 35.4% for black males, and 39.0% for black females.

Managing demand through monetary manipulations, government contracts, transfer payments and taxes is an inefficient way to attack unemployment of the young, old, and welfare poor. The "demands" that have to be managed are for labor that is unemployed even as total employment is at a "satisfactory" level.

#### B. CCC, NYA, and WPA

For income from work to be available to all, the demand for labor must be infinitely elastic over a wide range of labor types and geographical regions. This infinitely elastic demand must not unduly decrease the supply of labor to other occupations and employers and thus create upward pressure on wages. Furthermore the employer, while willing to hire all who offer to work, is not committed to hiring any particular number of workers. This can be achieved only by government funded employment at wages below those in private employment.

As the programs offer jobs to all a minimum wage is effectively set. Once the power of big government to stabilize the economy against severe downturns is established, minimum wage legislation is an anachronism. A world with measured unemployment and minimum wages is internally inconsistent; an effective minimum wage program must guarantee that jobs are available to all at the minimum wage.

An employment strategy needs deal with youth and adult unemployment and the provision of jobs for older adults. The instruments of an employment strategy can be identified by labels drawn from the 1930's: The Civilian Conservation Corps (CCC), the National Youth Administration (NYA) and the Works Progress Administration (WPA). In the New Deal days these programs were viewed as transitory. In the light of the inherent instability of capitalism they will now be conceived of as "permanent".

The CCC and NYA reflect an enduring characteristic of our urban society: We manage the economic transition from being a youth to being an adult poorly for all except the professions for which schools are the transition mechanism. The CCC and the NYA were youth oriented. A major benefit of an employment strategy is that it provides institutions that facilitate the transition to adult employment.

The third New Deal program, WPA, was oriented towards adults. Full employment cannot be achieved under present constitutional arrangements without engendering serious inflation. For the foreseeable future there will be a "cadre" of unemployed workers who will be available for government employment at the "minimum" wage.

The Civilian Conservation Corps was the most popular job program of the Roosevelt Administration. The CCC was "poor-mouthed" because the administrative and housekeeping details were by the military. The projects were selected and administered by the Agriculture and Interior Departments. The organizing experience and discipline provided by the Army were important in making the corps effective.

The youths enrolled in the CCC were taken into an ordered and controlled living and work situation. The CCC was not a "training" school, it was job and project oriented. The learning that took place was by doing. The principal tasks in the 1930's were the maintenance and improvement of the national parks and forests: In the 1980's the CCC could take up where it left off 40 years ago.

In the 1930's the CCC enrolled about 250,000. Today it might aim at an initial program of 500,000. The target group will be youths 17 through 19. The program would be a means of transition from being in school to being at work.

The CCC should provide "keep" and a modest income. Some \$3,000 a year and keep--with a major portion of the \$3,000 coming in a packet at the end of a year's enlistment--seems an apt rate. Presumably the keep will run to under \$3,000 per year per person, so that labor costs would be \$3.0 billion or 0.12% of GNP per year.

Half a million is some 4% of the 12 million in the target age groups. As 1.5 million aged 16-19 were unemployed in 1979, the CCC will have a sizeable impact on youth unemployment.

The problems of youth, especially of youth employment, so evident today existed during the great depression. The NYA was a response to these problems. Like its depression predecessor, a resurrected National Youth Authority should take a number of forms because of the varied problems of the young. The basic target populations should be 17 to 22 years of age, in and out of school, as well as those in school who are older.

The National Youth Administration should provide jobs which will enable the "children's allowance" to be dropped at the 17th birthday. It should provide work/study employment for high school, college and university students. These jobs would simultaneously aid colleges and universities by paying for work which



needs to be done. It should also provide jobs for out of school youth as well as summer employment. The NYA out of school programs and summer employment might well provide training.

There are six age groups in the target population (the target population overlaps with that of the CCC) or some 24 million. The program should only have labor costs; the schools, colleges and government units that use the labor will supply the material and supervision. At an average of \$3,000 per recipient a program level of 1% of GNP will hit some 8 million or one-third of the target population. Because of the overlap, NYA and CCC might be targeted at 1% of GNP.

WPA will provide jobs in lieu of adult welfare and extended unemployment insurance. One cannot eliminate welfare unless one puts something in its place. Jobs can replace welfare only by an open ended employment scheme. A full employment economy is an unknown exotic environment. Before the program begins there is no way of really knowing how many welfare recipients, present measured unemployed and those out of the labor force will "sign up".

In December of 1976 there were 11.2 million recipients of aid to families with dependent children: Some 3.6 million adults and 7.5 million children were receiving this form of welfare. There is no way of knowing how many of the 3.6 million adults would be on WPA. There is a conflict between being humane and the need to end programs that are as debilitating as the term welfare dependency implies. The transition will be eased by the shift to a universal children's allowance and an open ended WPA. The combination of WPA plus children's allowances will feed a larger cash income to a welfare family than hitherto available. At a \$6,000 per year WPA income the pre tax income of a present welfare family of one adult and three children would be \$7,800.

Social Security is an inflationary burden which, given the demographic changes that are clearly visible, will become greater. Social Security reveals a weakness in our economy in that the transition to less demanding jobs is poorly managed.

The reliance upon early retirement to constrain the size of the labor force has created a large politically active population that pressures for ever larger benefits. The reform of social security, that allows a recipient to work will induce labor market participation by older workers. To facilitate this the WPA should be required to provide full and part time jobs for older workers that supplement Social Security and other retirement incomes.

Any estimate of the size of a tax employment WPA when the economy is functioning well, especially as WPA will replace the existing welfare programs and will supplement social security, is an act of faith. If we exclude youth unemployment, which CCC and NYA will attack, and assuming that a base thirteen week unemployment insurance will likely continue, some 2 million working for WPA when unemployment, aside from CCC, NYA and WPA, is measured at 6% seems an ample first estimate. If we use \$6,000 per year as wage of a WPA worker, the direct labor cost of a 2,000,000 WPA program will be \$12 billion or 1/2% of GNP. For WPA we might add a supervision and materials cost of \$12 billion, so the cost will be 1% of GNP.

In principal WPA should not be means tested. Furthermore because WPA will provide supplementary income to older adults as well as income for women with child care responsibilities, the WPA might well have a mandate to develop part time programs.

The WPA, NYA and CCC will provide income through jobs for all who are willing and able to work.

The permanent WPA, NYA and CCC will produce output. Almost all of the output will be public services and improvements of the kind that a "transfer payment" government can not afford.

In our urban centers, where there are concentrations of unemployed and welfare recipients the improvement of the public environment should be marked.

WPA, CCC, and NYA will succeed exactly as they are job programs that are performing useful tasks and yield outputs that are visible.

### C. Money Wages

The standard analysis of the relation between money wage rate changes, price level changes and unemployment is based upon an assumption that a decrease in unemployment is derived from an increase in demand for goods and services. This implies that increases in employment will follow upward pressures on prices.

In the current policy strategy an increase in unemployment leads to increases in inducements to invest and transfer payments, a decrease in tax rates and an easing of financial market conditions. The current policy strategy follows a path from a rise in aggregate demand to a rise in particular demands to a rise in employment; this path is conducive to price and wage increases.

Once the shift to an employment program has been assimilated cyclical variations in employment will be replaced by variations in the proportion of workers "on WPA". When demand for investment and consumption goods falls, private employment will decrease and the lower wage WPA employment will rise. When demand for labor by private employers increases then the proportion of workers on WPA will decrease. With WPA, etc., a fall in aggregate demand will not be turned around by increasing inducements to investment, increasing the money supply or lowering tax rates. Because labor demand and wage income at a low rate are the primary impact points of policy, the inflationary potential will be less than with the current policy.

The employment strategy will lead to tight labor markets but as wages in WPA are lower than in private employment the supply of labor to private employers

will be "infinitely elastic" at the existing differential between the two sets of wages. Under these circumstances market and institutional factions will not give rise to chronic and even accelerating pressure on wages; neither the money wage rates nor the markup need be increased by the cyclical swings in WPA employment.

In the investment/contract/transfer payment structure of public policy, aggregate demand is sustained by sustaining the pace of investment. The demand for labor that produces investment output is maintained. This sectoral emphasis leads to an accretion of market power by the producers of investment output and their labor force. This leads to upward pressure on wages in investment goods production (construction and machinery workers) which leads to higher markups in consumer goods production. Chronic rising wages in investment goods production which is a product of the current strategy leads first to a rise in markups and then to a rise in money wages in consumption goods production.

The employment strategy for achieving full employment has a lower inflationary potential than the technique that uses monetary and fiscal policies to manage demand.

In a WPA, CCC, NYA strategy there will not be any pressures on money wages through induced investment demand and easier financing terms. The base WPA wage should be rarely changed. If unemployment increases because wages in private employment are "pushed up" by trade union pressure then the supply of workers to WPA increases and the budget deficit increases. However if the wage in the WPA employment program stands fast the money wage increases in private employment are likely to be undone; the differential between private and WPA wages will tend to be reestablished.

Of course weak administration or a policy that the WPA wage should be some ratio to the average wage could make an employment strategy a handmaiden of

inflation. However if the aim is wage stability and gradually falling prices that reflect productivity increases, the WPA wage as well as the wages in normal government employment and in military contracts must not rise in response to mild inflationary pressures.

#### IV. Financial Reform

##### A. Introduction

Laws and policies that affect financial institutions and usages of a capitalist economy must reflect an awareness that an economy with capitalist financial practices is unstable because normal functioning leads to conditions that are conducive to booms and depressions. Under capitalism policy must aim to make the best of a flawed system.

The greater the extent of external finance and the greater the variety of financial institutions the more unstable the economy. Even though all capitalist economies are unstable, the consequences of instability depend upon the institutional structure. Instability led to a deep depression after 1929 and stagflation after 1966. The policy objective is to eliminate or attenuate instability. Standard monetary and fiscal policies are attempts to ameliorate cyclical tendencies without overtly modifying or controlling financial practices and institutions. Reforms of finance in recent years look to improving efficiency and perhaps equity. They were not concerned with designing a financial structure that enhances the stability of the economy.

Economic policy--which includes the design of institutions--must be based upon an awareness that business cycles cannot be eliminated as long as an economy is capitalist. The best that can be achieved is to attenuate the thrust towards serious instability and ameliorate the pain due to residual instability. However as long as an economy is capitalist there will be costs due to instability; policy can reduce and affect the allocation of the costs.

The history of capitalism is punctuated by deep depressions during which financial relations were ruptured and institutions were destroyed. Each big

depression "reformed" the institutional structure. Furthermore big depressions were often followed by legislated reforms designed to "correct" the structure. The history of money, banking and financial legislation can be interpreted as a "search" for a financial structure that would permanently eliminate instability. Recent experience showed that this search failed and our theory argues that the search is fruitless.

In a capitalist economy, in which debt deflations and deep depressions cannot occur, Central Bank actions and legislation need control and guide the financial structure so as to constrain the tendency for cyclical inflation.

The financial structure "begins" with the financing of investment and positions in the stock of privately owned capital-assets. In our economy business corporations dominate in controlling capital-assets and ordering investment output. The financial powers and practices of corporations are starting points for policies to constrain instability.

The Federal Reserve was organized to control instability. Inasmuch as the Federal Reserve system has to intervene whenever a serious debt deflation threatens the Federal Reserve must take the initiative and intervene to prevent the development of practices conducive to financial instability. The Federal Reserve has to be concerned with the effect upon stability of the changing structure of financial relations. This definition of responsibility stands in sharp contrast to the hands off policy with respect to financial usages and institutions that the Federal Reserve has followed. The Federal Reserve need guide the evolution of financial institutions by sponsoring stability enhancing and discouraging instability augmenting institutions and practices.

Financial reform can be effective only as part of a system of reform. As long as the main objective of policy is to facilitate investment, then institutions

and ways of doing business that facilitate the financing of investment and capital asset ownership will be fostered. But the financing of investment and capital asset ownership are the major destabilizing influences in a capitalist economy. The substitution of employment for investment as the proximate objective of economic policy is a precondition for financial reforms that aims at decreasing instability.

Between corporations and the Federal Reserve there is a complex structure of financial institutions. The policy problem is to design a system of financial institutions which dampens instability. Obviously the world may impose a trade-off: A financial system which is hospitable to instability may be conducive to investment whereas a financial system which dampens fluctuations may also dampen investment.

Therefore financial reforms will reflect views as to the desirability of investment. If "the better use of what is" is now the preferred route to betterment, reforms which develop a financial structure that is less conducive to investment will be in order.

Banks are the central financial institutions of a capitalist economy. Banking is a business encased in myth: it is almost a "mystery wrapped in an enigma". In conventional economic theory, with its rudimentary treatment of capital-assets, the emphasis in banking theory is upon the bank liabilities that function as money. Our emphasis is different, it is upon the way debts are used to finance activities. Bankers are professionals in "arranging" the liability structures of business organizations that own capital-assets and invest by either acquiring debts on their own account or by finding others who will acquire debts or equity interests.



Bankers are fiduciaries who advise and act in the interests of clients even as their own income depends upon the services they sell to these clients. Lines drawn among commercial, investment, and savings banks are aimed at moderating the conflict between the fiduciary and private profit aspects of banking. However the line now drawn between commercial banking and investment banking cannot and should not be sustained. Restrictions upon the investment banking activity of smaller banks, which of necessity have to service smaller businesses, works to the advantage of giant banks and the larger corporations.

Policy about banking structure is simultaneously policy about industrial structure. A highly decentralized banking structure, with a large number of smaller and no "giant" banks, is conducive to a competitive industrial structure that consists of small and medium size firms.

## B. Ordinary Corporations as Financial Institutions

Corporations own most of the capital-assets that are used in production. This corporate dominance is a relatively recent development. Following the recession of 1937 a major investigation into the structure of the American Economy was undertaken by the Temporary National Economic Committee (a joint Congressional and Administration Committee). That investigation challenged the legitimacy of the corporation as the major form of business organization by arguing that corporate dominance adversely affected stability, efficiency and equity of the economy. The TNEC reformers urged that constraints were needed on the use of the corporate form and the powers of corporations. This did not occur and since World War II the constraints on using the corporate form have virtually vanished and the dominance of form has increased.

Because corporations own most of the economy's capital assets they collect "most" of the gross capital income, which is then "apportioned" by law and the liability structure to taxes, debt servicing (principal and interest) and gross equity income. Equity income may or may not be retained by the corporations. Corporations are a financial institution that have special powers which enable them to collect equity funds from a large number of units. Corporations, by limiting liabilities, make the divorce between ownership and management possible.

Because corporations can go into debt in their own name and not as "agents" of their owners, corporations facilitate investment and the use of large scale capital assets.

As Keynes pointed out (General Theory, Chapter XII) "... The Stock Exchange revalues many investments every day and the revaluations give a frequent opportunity to the individual (but not to the community as a whole) to revise his

commitments. It is as though a farmer ..., would decide to remove his capital between 10 and 11 in the morning and reconsider whether he should return it later in the week" (G.T., p. 151). Once corporations dominate in owning capital assets and stock exchanges exist the holding period of investors can conform to their changing preferences even though the corporation's commitment to the ownership of capital-assets can be for the expected productive life.

If capital-assets are cheap, so that those needed for a business can be easily acquired, then simple proprietorships or partnerships will do. Once capital assets become expensive and the expected profitable life exceeds the life expectancy of a mature individual, only corporations with their perpetual life can have holding periods that match the useful life of capital-assets.

There are two classes of capital-assets. One is like agricultural or urban land, in that the assets can be used for a wide variety of outputs and there are many who are capable of making profits by using these assets. These assets have a price or value that is independent of the particular owner. Because these assets generate cash in an "impersonal way" they are suitable for mortgage financing, i.e., for financing tied "to the asset" rather than "to an owner". Assets which flow through the production processes and the channels of commerce (inventories) are also suitable for "to the asset" financing, as the funds to meet the debt will be obtained when the inventories are sold.

For both long life general purpose assets and short life commercial assets that are fit for the asset financing the payment commitments on the debts that are used can be closely related to the cash flows that these assets are expected to yield. The financial flow relations are those that characterize "hedge financing".

The other class of capital-assets consists of plants and equipment which have no significant value outside of particular uses. As they can generate cash flows only if they are used in a small set of production processes, they have "no" value except to firms that use these processes. These capital-assets are not suitable for "to the asset" financing. The debts used to finance such special purpose capital-assets must be of the organization which owns and operates the capital-assets. If the period over which the asset is expected to yield cash exceeds the life expectancy of a representative proprietorship or partnership, then the ownership of such capital-assets cannot be hedge-financed by a proprietorship or a partnership.

If such capital-assets are to be used then either the principal's personal funds must finance ownership or the financing is speculative. Hedge financing is possible only if the holding period can be as long or longer than the period over which the asset is expected to yield cash; an organization whose expected life is not restricted by human mortality is needed.

The corporation is a social instrument which holds and operates expensive special purpose capital-assets whose expected life as an earner of quasi-rents is long. Corporate debts are not tied to the profits that any specific capital-asset generates: They are tied to the earnings of the organization and therefore are like a "to the person" loan. Given that the use of capital-assets with overlapping life expectancies are required, a corporation operating special purpose capital-assets must have an "infinite" life.

If corporations did not exist debt financing of long lived special purpose capital assets would have had to be speculative.

Given that the state is in principle a perpetual organization it is natural that an extension of the state is needed to overcome this constitutional weakness in financing. The corporation is this arm of the state.

Corporations can issue long term debt and equities that are not linked to the cash any particular capital asset generates. Corporations by making the hedge-financing of special purpose capital assets possible stabilize the financial structure.

The corporate form of organization facilitates the divorce of financing from the ownership and acquisition of particular assets. If short term debts are less expensive, corporations which borrow on the basis of their overall profitability will economize by using more short term debt than is needed to finance their short term assets. While corporations began as a vehicle for the hedge financing of expensive, special purpose and long lived capital assets, the ability of corporations to issue debts that are not tied to specific assets means that corporations can borrow short to hold long assets. The corporation, initially a device for extending hedge financing to long life capital assets can be a vehicle for speculative finance. The corporation is now a destabilizing influence, because it facilitates both capital intensive modes of production and speculative financing.

Thus there are two inherent "constitutional weaknesses" in the financial structure. One is technologically based: The use of expensive capital assets with long lives is best financed by instruments which are "amortized" over a large output, which means over a long term. The second is preference determined: Asset holders want to control their holding period. The corporation is a device for handling the technological weakness. But because corporations have a perpetual life, the preference weakness leads to the need for a market in which individual holdings can be transferred. A stock market is a necessary adjunct to the corporate form of organizing business. But such a market leads to the financing of perpetual liabilities by short term debt.

The corporation can eliminate the constitutional weakness due to the incongruence of the life expectancy of adults and of plant and equipment. The corporation cannot eliminate the constitutional weakness due to wealth owning households preferring assets with a potential for short holding periods. The constitutional weakness due to the ready availability of short term financing remains. This constitutional weakness is strong whenever the demand for financing is high and rising rapidly because short term markets are able to respond to demand for financing by devising new instruments and institutions. Speculative finance and the growth of market institutions that facilitate the rolling over and financing of positions are destabilizing results of good times.

The cash flows that validate business debts and determine the market value of liabilities are the differences between corporate total revenues and the cost of labor and purchased materials. Because of market power, many corporations are tax farmers, in the sense that the selling prices are determined by the cash flows that are needed to validate debt (just as taxes are set by the need for revenue). The determination of prices by the need for cash flows requires that market constraints should be slack. Monopoly or near monopoly market positions loosen market constraints.

Corporations are not necessarily tiny organizations which are forced to accept prices as determined in markets. Operations which are really required to be corporations invest heavily in special purpose capital-assets. To finance these capital-assets cash payment commitments to banks, bond holders, and equity share holders were made. These payments are a large portion of the receipts that the unit receives over a year. For such pledges to be creditable, the debtor must have the control that comes from market power over its unit markup. Now that

government is big, corporations and bankers have implicit guarantees from the state that the mass of profits will be sustained.

The covert government guarantee of liabilities is clear for firms whose output prices are set by negotiations with a regulatory authority. For utilities the major function of profits is to validate debt and to permit further debt financing so that new facilities can be constructed.

If the expected cash flows of a firm with market power are insufficient to validate debt and serve as a basis for financing expansion, the firm will raise markups and prices. Because prices are usually lower than the unconstrained profit maximizing monopoly prices, a rise in prices will lead to an increase in total profits. However there is a possibility that the price will go above the "monopoly" price, so that net revenues do not rise or even fall. When this happens for a giant firm, government subsidies, special tax credits, or purchase of assets will take place. By adjusting prices it pays, overt endorsements, subsidies, purchase of assets, and deficits government validates the private debts of giant firms.

Because the investment decisions of many giant firms are validated by revenues resulting from "private taxes", these investment decisions are public decisions. Each brain scanner shows up in Blue Cross and Blue Shield rates, which are a cost of labor to employers that must be covered in product prices. We have a tax supported medical system in which tax payers have no voice in determining the supply price of the service.

If raising the markup carries price above the profit maximizing price, then the funds required by payment commitments may not be forthcoming from taxes that take the form of market prices. In such cases the authorities are forced to intervene to bail out the distressed financial instruments.

There is a type of contingency socialism in the United States in which the liabilities of particular organizations are protected either by overt government intervention or the grant of monopoly price setting powers. A contingent liability affects choices even if the contingency never occurs. Capital-asset use goes to a lower cost of money margin in the protected industries than in the rest of the economy.

Financial reform needs to confront the "public nature" of much that is private. "Big" or "giant" organizations carry an implied public liability on their debts. This introduces a financing bias favoring giant corporations and giant banks, for the implicit public liability leads to preferred market treatment. Government intervention to validate the cash flow commitments takes place even if investments are inept. One way the government intervenes is by generating a "massive deficit". But these massive deficits are a basis for later inflation even as threats of private default are a basis for unemployment.

Much of the New Deal was motivated by the view that price declines were due to the forces of competition. As a result the growth of centers of "market power" were supported in the N.R.A. and then tolerated by soft antitrust policies. Corporate power to sustain prices was viewed as a way of preventing any future great contraction.

Because a large government implies that a profit sustaining deficit will take place whenever income and employment falls, a great contraction such as took place in 1929-33 cannot occur. Thus there is no need for policy to foster market power as "price sustaining" devices. A corporation with market power will use any decline in sales as an "excuse" to increase markups, this is a cause of stagflation.



In a world with big government individual bankruptcies can be tolerated because they cannot lead to wholesale defaults. Thus bankruptcy which transforms a nonsustainable speculative or Ponzi financing structure into a sustainable hedge structure should be made easy and cheap. Once bankruptcy is simplified the inflation constraining forces of competition are free to operate. In an economy that is open to bankruptcy, no organization can be so large that its bankruptcy is politically unacceptable.

Corporations are stabilizing institutions when they make possible the hedge financing of special purpose capital assets. They are destabilizing when they make it possible to use short term debt to finance long capital asset positions. To decrease the instability enhancing power of corporations, the bias favoring debt financing due to high rate corporate income taxes must be removed; the corporation income tax should be eliminated. In addition short term corporate debt should be "to the asset", not "to the corporation". Bank lending to corporations by way of documented loan and open market lending to corporations by means of documented acceptances--where the documentation proves that a short term flow through asset is being financed--must be encouraged by giving such instruments a special place in the process by which the Federal Reserve determines the cash base of banks and acts as a lender of last resort; i.e., the Federal Reserve must stand ready to participate, through the discount window, in such financing.

### C. Banks and Banking

Banks are the central financial organization of a capitalist economy. Once the assets and liabilities of banks are set the economy's financing framework is largely determined. As bankers pursue profits they change the composition of their assets and liabilities; in particular during good times the interactions between bankers and their borrowing customers increase the weight of assets that reflect speculative and Ponzi finance in the balance sheet of banks. This means that the financial system evolves from an initial robustness towards fragility. This evolution makes continuous control and periodic reform of the banking system necessary to prevent the destabilizing evolution from leading to a financially unstable economy that cannot readily be contained.

A decentralized banking system with many independent banks is conducive to an industrial structure that is mainly made up of small and medium size firms. Symmetrically a highly concentrated banking system that is made up of banks with branches throughout the nation is conducive to industrial concentration.

The United States has over 15,000 banks, many of which are independent and entrepreneurially aggressive. This is a fortunate consequence of an accident of history: State banks survived the banking act of 1863. The highly decentralized banking system is due to barriers which restrict the ability of banks to cross state lines and to permitting each state to determine whether branch banking is permitted within its boundaries. Furthermore the dual chartering system--both the National government and the states charter banks--has facilitated entry into banking.

There is a correlation between the size of a bank and the size of business it can serve. The maximum lending line of a bank is some percentage of its capital; usually 10%.

A bank with a lending line limit of several million dollars cannot handle the short term financing needs of a giant corporation. Giant firms naturally gravitate to the largest banks. The bank financing needed by a corporation in the "billion dollar" class cannot be handled by any single bank. Giant and even moderate size firms have multiple bank connections and lines of credit. No matter where a very large firm has its headquarters, it will have financing relations with the giant banks.

Over the past decades the geographical autonomy of banking has been eroded. In spite of these erosions, the United States has not travelled far along the road that leads to a banking system dominated by a small number of giant banks. Even though the erosion of the highly competitive banking system has not gone very far, it is desirable that the banking laws and their administration be structured so that they foster and encourage the growth and prosperity of independent, smaller banks. This is not true of the present direction of bank regulation and bank legislation.

Banks, when they finance a business, become a "partner" in the business for the repayment of the loan depends upon the success of what the borrower undertakes. Furthermore banks and their business partners generally do repeated "deals": They have a continuing relation.

As a result bankers are sources of continuing advice and guidance to businessmen. The banker is not motivated by altruism, but by the "partnership" in which the borrowing customer's prosperity determines the banker's profit. To fully serve these customers a banker should have a wide array of "financing" options, both as a lender and as a placement agent, to offer a customer. Restrictions on banks acting as dealers, underwriters and financial advisors are unwarranted; such restrictions are legacies of the 1930's.

Even though giant banks can service smaller businesses, smaller banks can only survive as they service smaller businesses. Thus to the extent that an economy has entrepreneurial smaller banks it has institutions whose success depends upon the success of the smaller businesses. In truth the multitude of smaller banks are a "small business" development agency.

To properly use the energies of the smaller banks for economic development they should be allowed to function as investment and merchant bankers as well as commercial bankers; they should be allowed to underwrite and place equity and bond issues of 'smaller businesses'.

There may be merit in not allowing giant commercial banks to act as investment and merchant bankers. The investment and merchant banking needs of very large firms are well handled by specialized organizations. However Wall Street is not the entire economy. For many businesses the major locally available sophisticated financial advisor and guide--as well as the only practicable underwriter for equity issues or debt placements--is the local commercial banker. If economic policy aims to support competitive markets then commercial banks of modest size should be free to be underwriters, place debts with third parties, give financial advise for a fee and collect fees for arranging mergers, divestures and takeovers.

The Federal Reserve tries to control the aggregate ability of banks to finance or to create "deposits" by controlling the reserves that are available to banks. If banks and financial markets were simply deposit creating automatons and only affected economic activity by way of the "excess" or "deficit" of cash in portfolios, then the attempt to control the economy by controlling bank reserve might have some merit. In fact banks are complex profit seeking organizations which have a multitude of actual and potential types of liabilities and which innovate in response to profit opportunities.

In order to contain the destabilizing effect of banking it is necessary to control the amount and the rate of increase of bank assets. The major control device is the permitted capital-asset ratio and the rate of growth of bank capital.

As things now stand the adequacy of bank capital is a concern of bank examination and supervision, not of monetary policy. In order to constrain the disequilibrating potential, to protect against debt deflation and to remove the bias due to the higher asset/equity ratios allowed to giant banks, the Federal Reserve should be authorized to set a fair and equal asset equity ratio for all banks--i.e., all institutions which have deposits subject to transfer by check or withdrawal on demand. A 5% asset equity ratio seems reasonable, especially if covert bank liabilities absorb capital. The Federal Reserve should have a right to vary the ratio if bank capital is compromised. Certainly a capital adequacy condition should not be administered as a straight jacket and a "penalty" in terms of the rate on the discount window line if credit should be assessed for significant shortfalls of capital.

The ability of the smaller banks to lend and invest will be increased by such a uniform capital/asset ratio. The problem of these banks will be to find assets and to place liabilities.

A more favorable financing condition for the smaller enterprises will result from the higher asset capital ratio of the smaller banks. The smaller banks can now earn their market determined rate of return by a smaller markup on a larger leverage ratio. After reform the markup on money costs at the small banks will fall even as the markup of the big banks rise. An even handed asset equity ratio among banks will go some way towards equalizing the financing conditions of large and small businesses.

At present a well managed reasonably profitable bank can retain earnings so that its capital grows at a rate that exceeds the sustainable non-inflationary growth of the economy. In order to have an internal rate of growth of bank equity which is consistent with the rate of growth of bank financing that leads to stable prices the pay out ratio for bank earnings will have to rise.

Control over the capital/asset ratio and the pay out ratio for banks are powerful weapons for guiding the development of banking. Once set the uniform capital/asset ratio should not be routinely changed. However the authorities regulating banking should be granted the power to vary the pay out ratio if the growth of bank equity is too fast or slow.

Ease of entry or free entry in markets should be an objective of policy. The reforms of banking which remove barriers against flexible financing options from smaller banks will ease entry in business. The regulatory climate should move to free up entry into banking. One corollary of free entry into banking is that both new banks and existing banks are free to raise equity funds by issuing stock. Thus if the Federal Reserve forces a high payment ratio on banks, banks can gather funds by new issues of equity shares.

Banking is not so profitable that "free entry" would lead to an explosion of bank capital. The control of the rate of growth of banking by means of limiting retained earnings is more likely to lead to a non-inflationary growth of available finance than the proven futile effort to control bank assets by controlling bank reserves.

Banks provide a large portion of the in being and stand by credit used by business and non-bank financial institutions. If banks are restricted to "to the asset" financing, then the short term debts of business will lead to payment

commitments that are consistent with business cash receipts due to the assets. If banks make only "to the asset" loans then the bank debts of firms would be part of a "hedge-financing" relation.

The idea that banks should be constrained to "to the asset" financing is a tenet of the real bills doctrine. This doctrine holds that if banks only financed "goods in the process of production", then the right amount of money would be created; this "right amount of money" would lead to stable prices. It was shown that restricting assets of banks to "real bills" could not prevent an inflation inducing growth of the money supply.

However our concern is not so much with assuring that a "non inflationary" quantity of money exists as with assuring the stability of the financial system. This implies that profit opportunities of banks must be biased by the regulatory authorities to favor hedge financing. The "to the asset" short term financing of inventories is a form of hedge financing.

The Federal Reserve Act initially provided that only bank loans that reflected short term to the asset financing were eligible for rediscounting. In the early years of the Federal Reserve rediscounting was a major source of bank reserves. After the crash of 1929 the dominance of rediscounting as the source of bank reserves gave way to the use of open market operations in Treasury securities.

When the Federal Reserve acquires assets then the banking system acquires reserves or the public acquires currency. The assets the Federal Reserve acquires were created when some activity was financed. If the Federal Reserve mainly acquires Treasury Debt, as it does when open market operations are the source of bank reserves, the Federal Reserve cofinances government deficit activities. When the Federal Reserve acquires private business debts through the discount window the Federal Reserve is mainly cofinancing business. If the Federal Reserve

supplies reserves through the discounting of the asset short term business debt the Federal Reserve is cofinancing and encouraging hedge financing.

Thus bank reserves against overt liabilities should be retained much as at present. However the main function of bank reserves has changed; bank reserves are needed because the process of creating reserves makes the Federal Reserve a participant in the financing of particular activities by particular instruments. Inasmuch as this cofinancing increases particular supplies and makes these supplies more assured the Federal Reserve participation will guide business and bank financing practices.

There are pervasive influences that reflect fundamental characteristics of a capitalist economy which lead to instability. Biasing banks in favor of short term to the asset financing will attenuate the thrust towards instability. Other financial institutions such as sales finance companies, life insurance companies, even ordinary business corporations can have direct or indirect access to the discount window by holding paper eligible for discount. The "eligibility" requirement for discounting can be used to assure that "to the asset" financing flourishes.



#### D. Central Banking

For capitalist economies to do better in avoiding deep depressions, inflation and "stagflation", the evolution of financial practices must be guided so that the likelihood of fragile situations conducive to financial instability is small. Central banks are the institutions that are responsible for containing and offsetting instability and by extension they have a responsibility to prevent instability.

Central banks intervene in financial markets. Central banks are responsible for the financial structure, not some subset of financial institutions or instruments. It is wrong to restrict the Central Bank to the regulation of "Member Banks" and to the control of the money supply. Perhaps at some stage controlling commercial banks or money may have been a "good enough" definition of central bank responsibility, but it is not apt once a complex financial system exists.

A central bank must assure that the supply of funds in key position making markets is not disrupted by a run on the market. As the lender of last resort the Central Bank must clearly define the financial markets it will protect. The lender of last resort intervention is a delicate operation which allows particular units and branches of industry to fail even as it assures that the total available financing does not collapse.

Central Banking increases in importance when business liabilities need to be refinanced. Central banking exists because Ponzi and speculative financing exists. Commercial banks and other financial organizations engage in speculative financing. As long as commercial banks do the financing, refinancing and contingency financing of the other speculative financing organizations, the Central Bank need deal directly only with commercial banks. However even if the Central Bank deals only with commercial banks, it need recognize that it is responsible for the "normal" behavior of all of finance.

During the great depression the Federal Reserve System did not succeed in keeping the financial system from breaking down. As a result a number of specialized partial "Central Banks" were created so that the actual Central Bank is a decentralized operation, with the Federal Reserve as the "preeminent" body. A minor but not insignificant structural reform would have the specialized institutions become departments within the Federal Reserve.

In a modern capitalist economy with a complex financial structure innovations result from profit opportunities. Central banking is a learning game. The Central Bank is always trying to affect the performance of a system that is changing. The Central Bank learns about innovations with a lag, and its reaction either encourages or discourages the innovation. Central Banking can be successful only if Central bankers know how the institutional structure behaves and correctly assess how changes affect system behavior.

To be successful central banks have to steer the evolution of the financial structure. Its weapons enable it to affect the profitability or the "risk" characteristics of a usage. Reserve requirements affect the cost of a liability and eligibility for discounting affects the riskiness of an asset.

The Central Bank controls its own portfolio, excepting where law lays down provisions--as the Gold Standard does--that all of some asset offered must be bought. The Central Bank affects how business is financed by its power to define the assets it will protect and by selecting the assets it will use to furnish reserves to the banking system. The assets acquired by the Central Bank in creating reserves finances some activity. When the Central Bank acquires an asset it cofinances some underlying activity which receives favorable terms both because of cofinancing and the protected market for the asset. As long as

banks need Central Bank deposits as reserves and as long as the Central Bank has a monopoly of currency issue the Central Bank can affect bank portfolios.

If finance is robust speculative and Ponzi finance provide a small portion of the financing of business asset holdings and investment and business holds substantial stocks of money and other liquid assets. Robust finance means that bank assets will be heavily weighted by government debt. In these circumstances it is all right for the Central Bank to operate mainly in Treasury debt.

In a robust financial structure open market operations can constrain the financing available without inducing significant present value reversals. When investment in process is largely financed by investor's own rather than borrowed funds the cash needed to fulfill payment commitments does not increase substantially when interest rates rise. Similarly in a robust financial structure long term financing terms will not react strongly to transitory changes in short term rates. In a regime of robust finance variations in financing from banks will have an effect on the level of activity, without having an effect on the viability of financial relations.

In a robust financial structure Central Bank efforts to restrict bank lending by decreasing bank reserves will not lead to a decline in financing available from banks, for banks will substitute business debt for government debt in portfolios. The effect will be on interest rates on Treasury Debt. In a robust financial structure, monetary policy that operates on bank reserves always affects interest rates but quantity constraints are not serious.

Open market operations can have a limited but appropriate effect on bank financing of private spending in a robust financial environment. But a robust financial environment is a transitory state, for it means that credit can expand

more rapidly than the credit base during periods of expansion and can contract less rapidly when the base contracts. However the cumulative effect of such bank credit changes decreases the robustness of the financial system. In the shift to fragility the use of Treasury debt by banks as the position making instrument decreases.

If Treasury debt is not used as the position making instrument even as the operations of the Central Bank are mainly in Treasury debt no direct business contact exists between commercial banks and the Central Bank. If a banking system is fragile, constraint of bank reserves is well-nigh fully reflected in the rate of growth of bank loans; there is no "Treasury Debt" safety valve or shock absorber. A given Central Bank action has a larger effect on available financing and interest rates in a fragile than in a robust financial structure.

When organizations carry longer term assets with short term debt the demand for finance to "roll over" maturing debt is highly inelastic with respect to interest rates. The greater the volume of such speculative and Ponzi positions the more sensitive the financial structure to variations in the level and flow of reserves to banks.

In a fragile financial environment, Central Banks cannot blindly follow rules and apply the techniques that were successful when the financial system was robust. When Treasury securities are of small importance in bank portfolios and are not the position making instrument, open market operations are an inept way to guide the financial system. Variations in bank reserves need to be related to the assets owned by banks. The need for banks to cofinance their assets with the Central Bank in order to acquire reserves is an instrument that can guide the assets owned by banks and thus affect the way business is financed.

If business and banking practices can lead to a fragile financing structure the Central Bank has a responsibility to induce banks to "hedge finance" business. The authorities must look through the veil of the bank's balance sheet to the balance sheet of the organizations that banks finance.

The first question a banker asks a potential borrower is "how are you going to repay me". The same principle should guide the oversight of bank portfolios by the Central Bank. Banks access to Central Bank cofinancing should be only through assets that reflect "hedge financing".

The Federal Reserve should stop relying upon open market operations to determine reserves of the banking system. By open market operations the Federal Reserve determines bank reserves by buying and selling Treasury securities.

As the total Federal Reserve holdings increase, the reliance upon open market operations means that the Federal Reserve cofinances the cumulative government deficit.

As an alternative to open market operations, the Federal Reserve can furnish bank reserves by discounting bank assets. In the discount technique bank reserves are furnished when the Central Bank buys or lends on specified eligible types of paper which arises in financing business. The Bank of England-London money market relations prior to World War I is a model for an apt relation between the Federal Reserve, commercial banks and money market institutions. In this model the reserve base of banks (as well as the currency supply) are largely the result of the Federal Reserves' discounting bank loans (or open market paper) that arise in the financing of business activity which has a short horizon: i.e., in financing inventories. The preferred or eligible paper for Federal Reserve discounting is "to the asset" paper that reflects commercial or manufacturing inventories.

The classical British discount market, in which banks "made position" by varying their loans to money market intermediaries, which held business loans that originated in the financing of commerce, and the Bank of England in effect financed the money market intermediaries is an apt structure for central bank control over the short run supply of credit once the financial system is fragile.

If bank reserves are largely the result of discounting short term paper tied to the ownership of business inventories, then as loans fall due and are repaid bank reserve balances fall. To bring reserves to target levels banks have to discount paper. There is a continuing business relation between each bank and the Federal Reserve. A major reform that is necessary is for the Federal Reserve to shift from the open market technique to a discount window basis. In a fragile financial structure, Federal Reserve power needs to be used to tilt financing towards hedge financing, which means that the use of short term financing for carrying business assets which turn over quickly should be encouraged. The discount window technique for creating the reserve base induces favorable terms for the hedge financing of short term positions. This blunts the tendency for fragile financing structures to emerge.

In the discount window technique the Federal Reserve uses paper that arises as business is financed to create reserves. The Federal Reserve both creates a market for this paper by its purchases and assures that this paper will have a protected status in financial markets. Therefore such paper will be in a preferred risk class. The guidance of the structure of financing relations will run from the Federal Reserve portfolio to a favored interest rate in the market for the "eligible" paper.

Each day a portion of the reserve base is extinguished and the market needs to discount at the Federal Reserve in order to replenish reserves. In a complex

financial structure, each bank will have a variety of ways to make position. However a net deficiency of reserves will lead to some bank borrowing at the discount window. Each bank should have a "line of credit" at the discount window and it can borrow up to its "line" at a preferred discount rate; borrowings above the line of credit will be at a "penal" rate. The bank's line of credit at the preferred rate might very well equal its capital and surplus account; thereby penalizing banks that have high asset-capital ratios.

The interest rate for rediscounting set by the Federal Reserve becomes a critical rate in determining financing terms. In particular bank and money market rates for financing by means of "ineligible" paper will be at a "premium" over the rate on eligible paper. The interest rates on speculative and Ponzi financing will be higher than on hedge financing.

The supply of reserves is infinitely elastic at these terms to all who hold eligible paper, but the interest rate is a variable fixed by the Federal Reserve according to the presumed impact on the economy's behavior.

Therefore the Federal Reserve has two controls over bank financing. One is the capital requirement, the second is the reserve requirement. The capital requirement is envisaged as a "longer run" constraint, with a penalty on the discount rate for falling below target whereas the reserve requirement is a shorter term control.

It is difficult to discover or invent a serious reason for being for eleven of the twelve Federal Reserve Banks in the present system (The New York Federal Reserve Bank is the operating agency for Federal Reserve Operations and therefore has a reason for being). However if the Federal Reserve shifts to a discounting technique then the highly decentralized banking system will require regional

money markets and Reserve Banks. The regional Reserve banks will have meaningful responsibilities for they will be in a lender's relation with the individual banks.

The discounting technique sets up "financing" relations between the central bank, commercial banks and various money market institutions. Bankers well recognize that a "lender" has the right to look over the shoulders of the borrower in order to be assured of the borrower's continued probity and credit worthiness. The Federal Reserve as the potential and actual lender to commercial banks has the right to "look over" the shoulder and comment on the adequacy of a bank's practices. Too great a growth of ineligible paper would be the occasion for a review of the availability of credit for a bank. Bank examination is a natural outgrowth of the banking relation between banks and the Federal Reserve.

The volume of bank holdings of eligible paper may decrease because of a decline in the borrowing needs of business. This is what occurred in the great contraction of 1929-33. However a great contraction such as occurred in 1929-33 cannot take place in a world with big government and the large deficits that occur in a downturn. The deficit means that financial markets have to absorb Treasury securities; even as private debt decreases banks can keep fully invested by acquiring Treasury debt.

Once banks acquire Treasury debt the Treasury Bill market is an effective position making market. If banks are acquiring Treasury debt at a time when the Federal Reserve wishes reserves to grow rapidly, the Federal Reserve can augment the reserve base by purchasing Treasury bills from the open market.

The mechanism by which the Federal Reserve generates the reserve base need adjust when the instruments used by the banking system change. The Federal Reserve has an obligation to oversee and guide, even as it cannot mandate, the



evolution of the financial structure of business by clearly defining the financial instruments it will protect.

The discount window/discount market technique of reserve creation is the appropriate technique for a system in which financial crises can occur because of the development of liability structures heavily weighted with speculative finance. Encouraging paper tied to the assets that flow through the production process is a way of inducing hedge finance, although in a capitalist world a thrust to speculative financing will always exist during tranquil times.

Because a thorough going debt deflation that leads to a deep depression cannot occur as long as the government is big the significance of the Federal Reserve's lender of last resort function changes. After a financial trauma the Federal Reserve needs to facilitate deficit financing by making bank reserves available outside of the "normal" discounting channel. It can do this by engaging in vigorous "open market operations" in longer term private debts.

However because big government sustains profits the Federal Reserve need not intervene quickly and forcefully whenever a financial crisis threatens: the Federal Reserve can stand back and allow firms and financial institutions to go bankrupt before it steps in and refinances threatened institutions. The principle to guide Federal Reserve intervention is that organizations which are fully viable at normal incomes with a restructured debt at normal financing terms, but which are not "solvent or liquid" with the crisis financing terms and recession incomes, are eligible for concessionary refinancing.

The longer the Federal Reserve delays its intervention the larger the decline in income and employment that will follow a crisis. The quicker the intervention the sharper the subsequent rise in prices and the more fragile the financial structure with which the expansion begins.

When the Federal Reserve steps in and refinances some positions it is protecting organizations that engaged in a particular type of financing. In a subsequent expansion units will feel that the Central Bank will again step in and protect this type of financing. But it is an untoward extent of speculative and Ponzi finance that causes the fragility that leads to a crisis prone system. Thus if the Central Bank quickly steps in and validates the financing practices that led to a crisis it is virtually assuring that there will be another crisis in the near future unless it outlaws the practice as was done after 1933 with thin margin financing of stock exchange equities and short term non-amortized mortgage. Thus Central Bank lender of last resort interventions must lead to legislated changes in financial practices that favors hedge financing.

The Federal Reserve can deliberately trigger a financial crisis by adopting a sufficiently restrictive posture with respect to bank reserves. A "monetary policy" that regularly leads to a near financial crisis introduces uncertainty into portfolios, even as the big government and lender of last resort interventions reduces uncertainty. If Federal Reserve policy instruments are used to force crunches and squeezes then the future growth of portfolios that lead to fragile financial structures is constrained.

However the knowledge that the Central Bank will force losses upon financial institutions, once inflation becomes "too" great, introduces certainty into the system. Organizations will need to pay a penal interest rate for speculative and Ponzi financing once it is clear that any untoward growth of such financing will lead to a "crunch" induced by the Central Bank. The penal rate will constrain speculative and Ponzi financing.

Federal Reserve policy therefore will continuously dampen the use of speculative and Ponzi finance. But Ponzi finance is a "usual way" of debt financing

investment. Capitalism without financial practices that lead to instability may be less innovative and expansionary. To take the possibility of the disastrous cycle out of capitalism might very well take the spark out of the system.

The Federal Reserve leaning against Ponzi and speculative financing does not mean that such financing does not take place. The need to structure deals means that bank loan officers and loan committees will always face situations when the activity they are financing is really a Ponzi deal, in that the next stage's borrowings are expected to provide the funds to meet the loan.

If the Central Bank is "leaning against" speculative and Ponzi finance and commercial banks are authorized to engage in underwriting then bank "loan officers" can arrange for the "funding" of the bank loans into either intermediate term bonds or equities. A financial structure in which commercial banks have access as "middle men" to life insurance companies, pension funds and other money managers for the placement of the debts and equities of their "customers" is conducive to hedge financing.

It is evident from economic theory, history and institutions that if money is right then a close approximation to bliss (however defined) will result are pernicious. Banking, as Henry Simons wrote, is a pervasive phenomena and with banking's pervasiveness, money takes many forms. Thus money is an evolving concept and the supply of effective money is not determined in any simple way by the "authorities". This is one reason why Central Bank operations through the discount window are superior to Central Bank open market operations.

The sustaining of hedge financing by business is a major proximate policy objective of the Federal Reserve. The more the Federal Reserve can tilt banking towards financing "trade and production" inventories with short times to expected cash flows, the more stable the financial system and the smaller the special

refinancing by the Federal Reserve in order to prevent a full-blown crisis.

A financial structure that is supportive of stability need start with the techniques available to corporations to finance capital asset ownership, continue with the biasing of banks to "to the asset" financing and finally change the perceptions and proximate objectives of the Federal Reserve.

## V. Taxation

Once government is big, its tax take must be big to prevent an explosive growth in the markup, i.e., to prevent inflation. Once the tax take is big the structure of taxes becomes a powerful determinant of what happens. Taxes which collect a lot have a large effect on relative prices, supply conditions and financing practices. Whereas the price, supply and financing effects of taxes can be ignored when government is small they must be taken into account once government is big enough so that profits are stabilized.

A government big enough to stabilize profits will be at least 16% and more likely 20% of GNP. Given today's problems and inherited commitments this big government will be about equally divided between transfer payments and purchases of goods and services. Of the spending by big government only the employment program and unemployment insurance will vary with GNP; a major portion of the profit stabilizing deficits has to come from variations in the tax take.

The standard classification of particular taxes into "progressive" or "regressive" has little merit. A sales tax is usually classified as regressive whereas a corporate income tax is considered to be progressive. However investment plus the deficit equals after tax profits and if investment and the deficit are given then any corporate income tax will increase the markup. Corporate income taxes show up in prices. Similarly the employers "contribution" to social security is a labor cost that must be covered by price. Whereas the "market interactions" determine which prices carry the burden of corporate income taxes and social security taxes, presumably the policy makers determine the proximate prices affected by excise and sales taxes.

Any tax system that collects 20% of GNP will have some rates that "hurt": These rates will lead to tax avoidance and evasion. Tax avoidance is a modification

of behavior which leads to a decrease or elimination of the taxed activity, tax avoidance is legal. Tax evasion is the non-payment of taxes even though the taxed activity is "carried out"; tax evasion is illegal. Tax policy needs consider the behavior modification aspects of tax policy and use the expected tax avoidance reactions to foster policy goals.

All taxes have price level effects. Excise taxes; corporate income taxes, value added taxes (total or partial, such as the employer's social security tax) tend to raise prices. Only the personal income tax tends to decrease prices by cutting demand and even this tax may have some offsetting price raising effects by inducing a decrease in the supply of effort. Any tax system that seeks to offset the inflationary effects of government spending will have a progressive personal income tax as its centerpiece. Furthermore because the yield of a progressive personal income tax is responsive to changes in income, this tax will be an important stabilizer of prices and profits.

From our analysis it is evident that policy should aim at achieving and sustaining a robust financial structure. A financial structure is robust when hedge financing predominates. Equity financing is the preeminent hedge financing technique, for it leads to no legally required payments. A corporate income tax which allows interest to be deducted prior to the calculation of taxable income induces debt financing. Thus the policy goal of "financial robustness" indicates that the corporate income tax we now have is undesirable.

Employment is a policy goal. The employer contribution to social security is a value added tax on labor's contribution to value added. Tax avoidance in this case leads to substituting capital for labor in production. Inasmuch as capital intensity and the debt financing to which it leads are destabilizing,

the employer's contribution to social security is a doubly pernicious tax, reducing employment and fostering instability.

In an economy in which capital intensive modes of production are used for jointly produced outputs, particular prices are, to a degree, arbitrary. Furthermore risk averse bankers require the protection of "monopoly power" before they finance capital intensive production techniques. Therefore there are no serious "price efficiency" arguments against the use of excise taxes to promote policy objectives. Although it is beyond the scope of the theoretical, institutional and historical arguments which have been developed here, an elimination of the massive deficit in the United States balance of trade is a policy objective. As the main cause of the balance of trade deficit is the massive dependence on offshore oil, a large excise tax, on either all oil or just gasoline, is called for.

In fiscal 1979 budget receipts were \$465.9 billions well-nigh 20% of GNP. In that year of high inflation budget outlays were \$493.7 billions. The fiscal results of 1979 violated the precepts of fiscal policy for an inflationary situation, but this is not our present concern.

Of these receipts, 76.0% came from income taxes (personal, corporate and the individual contribution to social security), 15.2% from a partial value added tax (employers contributions to social security) and the remainder, less than 10%, from a variety of sources--excise, customs, estate taxes and the Federal Reserve's rebate of profits.

If the total tax take is to be some 20% of GNP then the goal can be achieved with the present tax structure. However the corporate income tax and the employers' contributions to social security are highly undesirable taxes; furthermore the current set of complicated income related taxes may be at a level that is inducing tax evasion as well as tax avoidance.

Budget Receipts  
Federal Government  
Fiscal 1979

	<u>Billions of Dollars</u>	<u>% of Total Receipts</u>	<u>Proximate % of GNP*</u>
Individual Income Taxes	217.8	46.7	9.20
Corporate Income Taxes	65.7	14.1	2.77
Social Insurance Taxes and Cont.	141.6	30.4	5.98
Excise Taxes	18.7	4.0	.79
Estate and Gift Taxes	5.4	1.2	.23
Customs Duties	7.4	1.6	.31
Miscellaneous Receipts	<u>9.2</u>	<u>2.0</u>	<u>.39</u>
TOTAL	465.9	100.0%	19.67

\*Used calendar 1979 GNP of 2368.5.

SOURCE: Economic Report of the President January 1980, Table B-69, p. 285.



Given the desirability of the penal tax on gasoline or oil for reasons of the balance of trade, a set of oil, excise and customs duties that yield some \$125 billion or 5% of GNP seems called for. Of these revenues \$100 billion will be from the oil tax and \$25 billion from existing excise taxes and custom duties.

Some \$70 billions of social security taxes on employers and \$65 billion of corporate income taxes are embodied in the cost structure. A comprehensive though straightforward value added tax designed to yield \$100 billion or 5% of GNP should replace these two taxes.

Eliminating corporate income taxes leaves us with the problem of the use of a corporation as a tax avoidance device. There are a variety of ways in which this could be offset. One is to treat the corporation as if it were a proprietorship or a partnership. This requires a full imputation of per share income to the stockholders regardless of whether or not dividends are paid. If the same rules for operating on business cash flows to obtain profits as applied in 1979 are effective after reform, the taxable income of households would be some \$140 billion higher. At the same tax schedule as ruled in 1979 this would lead to a rise in personal income tax receipts of more than \$40 billions.

Alternatively and perhaps more simply the REIT provision by which the corporate income tax remains but corporations that pay out 85% or 90% of profits in dividends will be "tax exempt" could be generalized to all corporations.

The social security tax on employees can be eliminated along with the social security tax on employers. If we assume that the income tax recaptures some \$40 billion from the personal income tax then the 1979 personal income tax schedule would have yielded about \$260 billion or 11.0% of GNP: Because the social security tax on wage income is eliminated there is room for adjustment of particular tax rates.

In these suggestions for "tax reform" only the stability, employment and price level effects of various taxes were used as a basis for suggested changes. Equity issues, which are obviously important, were largely ignored. The basic point of taxation is simple; taxes have allocational and distributional effects in addition to their overall effects. A government can get the overall budget into a desired relation but because each tax has supply and price effects the result may be perverse. The design of the tax system need take the effect of taxes upon particular supplies and demands into account.

The above ignores the estate and gift taxes, which yield \$5.4 billion to the Federal Government. As now structured these taxes provide an incentive for the sale or merger of a family business into a "larger" public corporation. A revision of the tax so that a realistic sized family business can be left as a legacy is a desirable reform that affects the competitive structure of business.

## VI. Industrial Policy: Alternatives to Dominance by Giant Corporations

In historical perspective, the institutionalized and bureaucratic non-specialized corporations which now dominate business are young. Corporations, as we know them, did not exist in 1776, or even 1876. They became the dominant form of business organization because they have an advantage in financing long lived specialized capital-assets.

A corporation is primarily a financial organization. Its special strength is that it can issue long term debts and equity shares that are not tied to the "fortunes" of specific persons or assets. Because of this the financing costs of long lived, specialized, and expensive capital-assets are lower for corporations than for proprietorships or partnerships. Because they make financing cheaper corporations foster the dominance of capital-intensive production techniques that utilize specialized capital-assets; they tilt the economy towards the use of labor-saving techniques.

In the United States the dominance of capital-intensive production techniques has led to the emergence of a chronic labor surplus. It is now necessary to invent and promote enterprises that put idle but potentially productive labor to work. The decrease in male labor-force participation and chronic high unemployment indicate that our economic development has been unbalanced. Policies are needed which enable labor intensive and capital intensive modes of production to coexist.

The determination of the role of the corporate form of organization is a policy matter. Policy should distinguish between bureaucratic and institutionalized corporations on the one hand and entrepreneurial corporations. A bureaucratic and institutionalized corporation draws its strength from its financial position and market power. The management of a bureaucratic corporation is professional.

Its leading officers either progressed through the ranks or were hired from outside as executives. Furthermore they had little if anything to do with the founding and the growth of the corporation.

An entrepreneurial corporation is largely the extension of the personality of a founder or a founding group. Its present leadership was mainly responsible for the organization's growth and development. Even though it may now be financially strong, its main strength does not rest upon its financial resources.

Competitive markets are devices to promote efficiency and entry is a mechanism that promotes change. The market is a good enough regulator of products and processes except where externalities or market power exist. Overt regulation by the state really has to deal only with externalities, although once market power exists--whether caused by government or by market processes--regulation can be necessary for economic reasons. Regulation, and much of government, are devices for assuring that cross subsidization takes place in the form of guaranteeing some minimum level of services to units that may not be able to cover the out of pocket let alone the capital costs of these services.

Once an open-ended WPA is part of the policy arsenal, then competitive market processes cannot lead to wage degradation as WPA sets a floor to wages. Private employers have to offer a premium on this effective minimum wage.

In a world where profits are cyclically unstable market power arises from the banker's condition, which is that the likelihood of unfavorable outcomes must be constrained if capital intensive production techniques will be financed. With capital intensive techniques a large portion of the total receipts go to validate debts and the prices paid for capital assets. If demand falls short of expected demand and prices are set in competitive conditions then quasi-rents

can quickly fall to zero. With market power a markup on unit out of pocket costs is maintained and profits do not fall to zero unless output falls to zero. Once market power exists it can and has been "exploited" to restrict output, entry and sustain profits. In these conditions government intervenes to set rules of "fair competition" or to create results in markets where power exists that mimic competitive results. At best regulation to control and channel market power has enjoyed transitory success: all too often the regulated becomes the regulator.

The obvious need to regulate because of economic and technical/uncertainty reasons has given rise to various forms of industry self-regulation. The most comprehensive industry self-regulation in the United States was the N.R.A. of Roosevelt's first New Deal. In that experiment self-regulation quite clearly led to increases in profit margins. As a result the power of the first Roosevelt deficits to raise employment was blunted.

In a small government capitalism where aggregate profits are unstable the requirement by bankers that the units being financed have market power is sensible. It is no accident that J. P. Morgan was the initiator of many of the trusts of the age of McKinley. However we now have big government capitalism so that in the aggregate profits are stable. In these circumstances market power leads to markup increases and the dissipation of profits into "business style" overhead costs. The prolix corporation with a huge overhead that is capable of losing a billion dollars a year or more when demand falls is the result of the allocation of profits that result from the exercise of market power to business style overheads.

Once big government stabilizes aggregate profits then the bankers reason for market power loses its force. Obviously with overall profits sustained it

is possible for a particular corporation to make losses; presumably such losses are due to inept management decisions or impersonal and unforeseen developments that affect particular products. Special purpose and long lived capital assets will be able to find financing even in the absence of market power if the prospects for validating cash flows pass a serious scrutiny. Market power makes the job of the bankers (investment and commercial) and portfolio managers easier. Experience with affairs like Chrysler and various nucleating utilities indicates that even market power is no substitute for bankers and investors doing their homework.

Anti-trust as presently operated is a failure, the legal approach to anti-trust has meant that the issues of market power are not addressed. An industrial policy aimed at generating conditions conducive to competitive markets will set a limit on assets or employees that any particular organization can deploy. The size limit may be a variable that depends upon industry.

Much of the growth of corporations to "gigantic size" reflects financing and financial market conditions. The proposal that central and commercial bank financing shift to "to the asset" financing and diminish the availability of short term "to the firm" financing will remove some of the advantages of giant business. The proposal that smaller banks be allowed to act as investment bankers for their customers would also decrease some of the financing advantages of giant firms. In addition, allowing smaller banks to act as investment bankers would facilitate entry of firms into various industries.

Corporations finance positions in capital assets with a variety of instruments. Market power, regulation and the overall fiscal effects of big government are determinants and guarantors of cash flows to corporations. The liability structure determines the cash flow commitments. Tax policy determines the cost

to the stockholder of various liabilities; the central banks technique for creating reserves affects the relative availability of different types of financing.

The corporation income tax biases liability structures toward debt and also makes the government pay part of the price for allocating profits to labor costs or other purchased inputs. By eliminating the corporate income tax the edge given to debt financing and to activities that perhaps yield future profits by current overhead costs is removed. If in addition the corporate gains tax is eliminated, because the retained earnings rationale for the capital gains tax is removed, then the asset which might yield capital gains (common stock) is favored over debts which only yield capital gains as interest rates or risk premiums are reduced.

Open market generation of the reserve base by operations in Treasury debt means that private debts, and especially to the asset private debts, are not cofinanced by the Federal Reserve whereas the rediscount window creation of reserves by way of to the asset private debt means that such financings are cofinanced by the Federal Reserve. Once the Federal Reserve changes its operating techniques then the relative price and assuredness of supply of to the asset short term financing will improve. Business will adjust its liability structure to the new relative price and availability of different financing forms.

The elimination of the corporate income and capital gains taxes and the change in the operating technique of the Federal Reserve will tend to induce hedge financing, which improves the stability of the financial structure.

Once the changes in the corporate income tax and the shift in Federal Reserve operating techniques are combined with the greater availability of investment banking facilities to smaller business because banks can engage in investment banking then entry of new firms and the expansion of existing smaller firms is

facilitated. Tax and financing policies can go far towards creating a more competitive and entrepreneurial business climate.

In the 1930's as the institutional structure we now have was being put into place there was no theory of the determination of aggregate demand. We have shown how aggregate supply is determined by anticipated profits and the realization of profits is determined (proximately) by investment and the government deficit. It is now clear that aggressive price competition cannot affect aggregate profits--all it can affect is the quantity of output and the price level at which the profits will be realized.

If the sum of investment and the deficit fall below anticipated levels, then actual profits are brought down to the realizable levels by price competition. In the 1930's the great depression was largely imputed to the price declines whereas we know it was largely due to the prior fall in investment. Thus there are devices throughout the structure of government interactions with the economy as well as private organizations and usages which are designed to prevent downward movement in prices and wages.

With an effective minimum wage due to the WPA device and stabilized aggregate profits a generalized fall in wages and prices of the dimensions that happened in the early 1930's cannot happen. Therefore these devices in agriculture, labor, manufacturing and trade that constrain downward price flexibility are not relevant to the realm of what can happen; furthermore most of these exacerbate inflationary pressures.

As is evident from the recent history of the railroads, some electric utilities, Lockheed and Chrysler, the present cycles of inflation, interest rates and unemployment lead to an erosion of the financial strength of many corporations. Inasmuch as we start from a position in which many corporations have heavy debt



burdens, the reward of the protections of market power that the tax and financing reforms would lead to will result in financial difficulties for many firms. Furthermore any positive limitation on size of assets managed will undoubtedly begin by making only several of the very largest firms candidates for devolution into several smaller more manageable units.

The United States has a broad and deep capital market. Equity and debt issues of enormous size can be readily marketed. This ability of the capital market to handle large issues means that "socialization" of industries that require financial restructuring can be considered as a transitory step. When a "Chrysler" is bankrupt--when it needs enormous infusions of cash and it cannot meet the market--then the "bankruptcy" should take the form of a "government refinancing corporation" taking over the business and breaking it into parts which are deemed to be viable in the market and parts that cannot generate profits. The first potentially or even presently viable part should be "sold off" in the capital market as a new and independent private entity. The second nonviable part may be viable as a high risk possibility if enough new funds are forthcoming. If the refinancing corporation sees an ability to go "private" at the end of some reconstruction then the funds to rebuild and restructure should be forthcoming.

There are two capital intensive industries that private enterprise manages poorly, railroads and nuclear electric energy. Both are industries which combine capital intensity with enormous externalities. There is no reason why "public ownership should not be tried--where these industries work well in advanced economies they are almost always publically owned. At this writing there is no way the enormous funds needed to reconstruct these industries will be forthcoming except through some government financing device and the simple straightforward way is to have a government agency like TVA manage these instruments.

The railroads not only are capital intensive they are also large scale employers. One of the lessons to be learned from the experiment with revenue sharing in various forms is that subsidies and "free" monies are quite often turned into higher pay and more elaborate bureaucracies for employees. A government employee/government industry wage policy is a necessary ingredient to massive investment by government into and the government operating of industries such as railroads and nuclear electricity generation. Although a generalized wages and income policy is not feasible because it cannot be administered, a government employee/government contract wage policy can be administered.

## VII. Conclusion

The policy failures since the mid-1960's are related to the banality of economic analysis. In turn the banality of economic analysis is related to the academics' transformation of Keynes' economics from a serious critique of capitalism to a series of trivial policy manipulations. The essential Keynesian results, that capitalism is flawed in that it is unstable and that the instability is mainly because capitalism handles capital poorly, nowhere enlightens current policy actions. Policy and the mainstream economists thinking about our economy blithely ignore the lender of last resort interventions by the Federal Reserve. The Federal Reserve's models of the economy nowhere consider the effects of lender of last resort interventions.

Keynes recognized the flaws in capitalism because Keynes more than his predecessors, contemporaries and successors understood the financial and time related aspects of a capitalism that uses capital. The big government "socialization of investment" and lender of last resort mix of policies that followed from Keynes' analysis eliminated the possibility of a deep depression. As a result a regime in which free competitive markets are the instrument for constraining inflationary pressures in prices becomes palatable. The big government that is needed can (and does) put floors that assure minimum levels of living and service to all, thereby making the argument that free market will lead to a degradation of labor standards irrelevant. If we recognize and accept that a government that is big enough to constrain fluctuations in profits is the main prerequisite for a successful capitalist economy, so that once government is big the economy can be restructured to remove the barriers to competition and to simplify liability structures. Because Keynes' economics is critical of capitalism it is a guide to successful policy for capitalism.

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The inflation/unemployment cycle that has marked the sharp deterioration in the performance of the economy since the middle 60's was ushered in by the developments in financial markets that led up to the credit crunch of 1966-67. Whereas the robust financial structure of 1945-66 was associated with on the whole tranquil progress, the deteriorated and turbulent performance of the economy since 1966 has been associated with a fragile financial structure. Tranquil progress requires a financial structure that is immune to financial crises. A proximate aim of policy must be to achieve and sustain a robust financial structure. Institutions and usages that sustain robustness need to be encouraged even as ways of doing business that lead to fragility need to be discouraged.

The policy suggestions that have been produced are best interpreted as an agenda for discussion rather than a non-negotiable program. The analysis argues for a system of changes, not for isolated changes. There is no simple answer for the problems of our capitalism; there is no solution that can be transformed into a "catchy phrase" and carried on banners.

Every gain has a cost. However in an economy that lives in historic time the gain may precede the cost. Between 1946 and 1966 we, along with the other advanced capitalist economies, had the gain of a long period of improvement which left people as a whole substantially better off in 1966 than in 1946. In the years since 1966 the economy has been much more unstable and the further gains have been small and insecure. Furthermore on several occasions a deep depression, which would have undone some of the good of 1946-66, threatened.

A restructuring of the economy which reduces the inflationary impetus due to big government even as it retains the power of big government to prevent

deep depressions is needed. However such a restructuring will only enjoy transitory success. After an initial interval the basic disequilibrating tendencies of capitalist finance will once again push the financial structure to the brink of fragility. When that occurs a new era of reform will be needed. There is no possibility that we can ever set things right once and for all; instability, put to rest by one set of reforms, will, after time, emerge in a new guise.