

1980

## Chapter XIV of "Financial Instability and the Strategy of Economic Policy" -- The Institutional Setting

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### Recommended Citation

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## Chapter XIV. The Institutional Setting

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## Chapter XIV

### The Institutional Setting

Every policy strategy has two facets: one, structural, the other, operational. The first encompasses legislation aimed at modifying or guiding existing institutions that defines the "environment" within which day to day policy actions are carried out; the second encompasses fiscal and monetary policy actions as well as direct governmental interventions, such as income, regulatory, and tariff policies.

Day to day policy discussions tend to center on operational issues. This is adequate in times of economic stability, but in times of turbulence it unduly limits the field of vision. Because structural change and policy are usually treated separately, their interdependence, whether the structure and the operations are compatible tends to be ignored. It is my aim to focus on that very aspect, to investigate the compatibility between the structure of the economy and monetary and fiscal policy, to examine whether operational policy actions can achieve their objective within our existing structure without untoward side effects. If they cannot, we must ask whether there exists <sup>an alternative</sup> ~~affirmative~~ structures in which narrowly defined policy actions can achieve a closer approximation to policy goals with fewer adverse side effects.

That is, we have to shift focus of the policy discussion from questions of manipulating monetary and fiscal policy measures to whether there exists an institutional structure that will permit a capital-using capitalist economy to attain greater price stability and fuller employment than has been the case in the recent past.

The structure of an economy defines the legal and institutional conditions and constraints under which market functions; corporate law and the law system determine the position of markets along a competitive/monopoly axis; labor laws determine whether particular wages will be determined by collective bargaining. The institutional structure ranges from big questions such as the competitive or monopolistic nature of markets to smaller localized issues like zoning ordinances. Since markets determine the details of the economy, the institutional factors that affect market operations dominate in the determination<sup>cf</sup> of the nature, quantity, and prices of commodities, the type of labor employed and wages paid, the nature of capital assets used and the cash flows generated by capital-assets.

The structural characteristics of the economy at any time reflect both legislated changes and the results of evolution that takes place in response to various market pressures and opportunities. Thus the legislated labor costs set down the conditions under which trade unions can organize, no law determined the existing pattern of organized, partially organized and unorganized workers. Similarly the legislated history and the various anti-trust activities of the Department of Justice and the Federal Trade Commission set the environment within which the structure of particular product markets have evolved. The structure of the automobile industry with a "dominant" General Motors was nowhere legislated, it was the product of market forces within broad legislated guidelines.

Monetary and fiscal policy affects interest rates, after-tax incomes, the availability of financial assets and credit without explicitly affecting the structure of markets. Thus, although monetary policy affects the financing of investment it does not directly affect the monopolistic or competitive nature of industry. Similarly, while fiscal policy can affect aggregate demand, it

does not directly affect the power of a trade union in a particular labor market. The degree to which monetary and fiscal policies that bear on total demand effects prices or production depends on market structures which yield market power and on the political factors that affect the exercise of market power. An economy in which units and organizations wield market power in some particular way will react to a change in aggregate demand in a different way than one in which such power does not exist or is exercised in a different way. The institutional structure, whether the result of internal evolution or of legislation, affects the operation of a decentralized market system.

As an example of how legislation can affect the economy we can look at the banking system. One of the institutional features of our economy that could easily be changed is the parallel existence of commercial banks which are members of the Federal Reserve System and banks which are not member banks. This dual banking system limits and in part determines the policy actions of the Federal Reserve System. Moreover, it gives rise to special markets, practices, and institutions that coordinate the two parts, and these usages in turn affect the channel and therefore the effects of the Federal Reserve's operations.

The evolution of the banking and financial system through the twenty postwar years of economic tranquility changed the way financial markets and thus the economy reacted to monetary--and fiscal--policy actions. As was made clear in Chapter \_\_ the evolution of banking practices from "asset management" in the 1950s to "liability management" in the 1970's affected the impact upon financing activity of Federal Reserve monetary policy actions.

Economic institutions created by legislation obviously reflect the economic analysis, perceptions of what was happening and policy objectives that reigned

when they were established. Subsequent modifications, whether evolutionary or legislated, just as obviously reflect later ideas and experience. The twelve regional banks of the Federal Reserve System mirrors the populist fears that existed in the first decade of the twentieth-century, when the Federal Reserve was set up, that a unified, centralized bank would facilitate the development of a powerful money trust. The regional Federal Reserve banks still exist; however, in practice they exercise little or no authority. It is difficult to find a valid excuse for their being. For all practical purposes, present-day active monetary policy is decided upon in Washington and executed in New York. The other eleven regional banks are little more than bystanders.

The Federal Reserve System of today comes close to being a unified central bank such as the populists feared, and it indeed seems more at ease with and sympathetic to giant money-market banks than to smaller local institutions. Because in their economic theory the banking structure does not affect production and labor-market processes, the neoclassical theorists tend to ignore the effect of banking system structure upon system performance. However there is a natural customer relation between giant business and giant banks: A structure of law and banking system regulation that form giant banks also form giant corporations.

Our economic structure is the result of responses to problems of the past and perceptions that ruled in the past, while the policies carried out within it are responses to current issues and reflect current attitudes. This gives rise to a possible conflict between inherited institutional structure and today's understanding, policies, and objectives.

The first six years (1933-38) of the Roosevelt administration were a great creative era of legislated structural reforms, innovations that still form the

legislated base of our economic structure. Today's organization of markets and the pattern of governmental intervention are the products of legacies from legislation in the 1930's. Subsequent legislation and evolution modified, but has not changed the institutional structure set up then.

#### The Economics of the Early Roosevelt Years

The Roosevelt years stand out as an era of creative response to challenges. The humane, liberal orientation of one of those years deserves to be cherished. When Roosevelt took office economics as a scholarly discipline was in disarray and was held in low esteem as a source of public advice. Just as the neoclassical synthesis cannot explain the malfunction of the economy in the 1970's, the standard theory of the twenties and early thirties could not explain the Great Depression. Compared to Harding and Coolidge, Hoover was an activist, intellectually sophisticated president, but his anti-Depression policy relied on the supposedly self-equilibrating properties of free markets. For the farmers, workers, and businessmen caught by the Depression the road to recovery mapped out by these natural economic forces, if it existed at all, led through hell. Between 1929 and 1933 each seeming remission of the downward path of the economy was a pause before a new disaster.

Roosevelt's character and politics committed him to an activist economic policy which led to far-reaching changes to the institutional structure. These changes reflected the conviction that there existed a structure of capitalism that would prevent depressions even as it assured a greater measure of equality and opportunity. The standard economic theory of the day had not addressed the problems of equity and cycles and hence could offer no guidance to structural reforms. The structural reforms of the Roosevelt era proceeded by trial and error in an atmosphere of crisis and reflect no consistent theory as to how a

capitalist economy functions. Pressed to find quick solutions, the new administration initiated reforms and just as quickly abandoned them, perhaps without giving them a fair trial. In spite of the atmosphere of crisis the years from 1933 to 1936 were a period of sustained business expansion, but given the initial "pit" of 1933, conditions were far from satisfactory when the 1937 recession hit early in Roosevelt's second term.

On the whole, the twin objectives of the Roosevelt revolution have been achieved: The American and (capitalist) economy has not suffered a deep depression since World War II ended and political and economic opportunities have opened up to many previously excluded groups. Both socially and politically, the democratic base has broadened.

Franklin Delano Roosevelt was inaugurated as the thirty-second president of the United States on March 4, 1933. In the next hundred days an enormous volume of legislation was enacted.

"On adjournment on June 15, 1933, the President and the exhausted 73rd Congress left the following record:

March 9--the Emergency Banking Act

March 20--the Economy Act

March 31--establishment of the Civilian Conservation Corps

April 19--abandonment of the gold standard

May 12--the Federal Emergency Relief Act, setting up a national relief system

May 12--the Agricultural Adjustment Act, establishing a national agricultural policy, with the Thomas amendment conferring on the President powers of monetary expansion



May 18--the Tennessee Valley Authority Act, providing for the unified development of the Tennessee Valley

May 27--the Truth-in-Securities Act, requiring full disclosure in the issue of new securities

June 5--the abrogation of the gold clause in public and private contracts

June 13--The Home Owners' Loan Act, providing for refinancing of home mortgages

June 16--the National Industrial Recovery Act, providing both for a system of industrial self-government under federal supervision and for a \$3.3 billion public works program.

June 16--The Glass-Steagall Banking Act, divorcing commercial and investment banking and guaranteeing bank deposits

June 16--the Farm Credit Act, providing for the reorganization of agricultural credit activities

June 16--the Railroad Coordination Act, setting up a federal coordinator of Transportation."<sup>1</sup>

Three major thrusts can be discerned in the above list of major legislation; (1) the reopening, reform and restructuring of the banking and financial system, (2) the imposition of "organization" upon industry, agriculture and labor, and (3) the development of government employment, spending and transfer payment schemes. Of the 14 items, eight dealt with money, banking and financial practices: the Emergency Banking Act, Abandonment of the Gold Standard, the Thomas Amendment

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<sup>1</sup>Arthur M. Schlesinger, Jr. "The Coming of the New Deal," Vol. II of The Age of Roosevelt, Houghton-Mifflin Company, Boston, 1959, pp. 20-21.

to the Agricultural Adjustment Act, the Truth-in-Securities Act, abrogation of the gold clause, Home Owners Loan Act, Glass-Steagall Banking Act and the Farm Credit Act. The Agricultural Adjustment Act, the National Recovery Act, the Railroad Coordination Act, and the fair employment portions of the N.I.R.A. Act were designated to "organize" industry, agriculture, transportation and labor. The acts which set up the Civilian Conservation Corps, the Federal Emergency Relief Act and the public works portion of the National Industry Recovery Act, and the construction part of the Tennessee Valley Act were starts on the transfer payments, income maintenance and public spending that now characterize government.

The Economy Act and the public ownership aspects of the Tennessee Valley Authority Act fall outside these three divisions. By our present day understanding as conditioned by conventional macroeconomics, the Economy Act which reduced government wages, salaries and pension was inconsistent with the fiscal expansion required by the depressed economy.

The Tennessee Valley Authority Act was the only major example of overt nationalization of industry--covert nationalization occurs when organizations like railroads go bankrupt. Hydroelectric power production remains the only area in the United States economy with a strong nationalized or local authority dominated section. The lack of nationalization is prima facie evidence of the intrinsically conservative nature of the Roosevelt restructuring of the American economy.

#### Banking and Financial Legislation

The banking legislation of the hundred days dealt with three distinct sets of problems:

1. The reopening of the banks after the "bank holiday"

2. The elimination of the gold standard and other external and legislated constraints, so monetary expansion could be attempted

3. Reform of the banking and financial system in an effort to assure that a collapse like that of 1929-33 could not happen again.

The reopening of the banks was accomplished with a great deal of flair by President Roosevelt, but it left no special institutional legacy that need concern us. The bank holiday fixed a view of banking and finance, as a fragile set of institutions and usages that need to be protected and constrained, that has remained to this day. Before they were reopened many banks received infusions of equity or near equity funds from the government's Reconstruction Finance Corporations. The arrangements were such that with recovery the Government's equity stake was paid off. Government participation in the ownership of banks was transitory.

The elimination of the gold standard in favor of a national managed money was of lasting importance. It allowed the Roosevelt administration to pursue its overtly inflationary objective of raising wages and commodity prices. The fall in the prices of both shares and commodities between 1929 and 1933 was held responsible for the debacle and a recovery of prices was viewed as a necessary condition for recovery. In order to set the stage for unilateral expansion--efforts at achieving coordinated international expansion had failed--it was necessary to eliminate the constraints due to the gold standard.<sup>1</sup>

During the fall and winter of 1933 Roosevelt embarked on a program of raising the price of gold by buying gold on the open market. In this manner the price

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<sup>1</sup>See C. Kindleberger, The World in Depression 1929-1939, University of California Press, Berkeley, 1973.

of gold was raised from \$20.67 an ounce to \$35.00 an ounce which meant that a sharp increase in the dollar value of the World's monetary gold stock took place. By quantity theory of money reasoning this should have led to an equivalent rise in prices, and with prices employment. In fact no such thing happened.

However Roosevelt's gold-price experimentation had a lasting effect for it freed both the Federal Reserve and commercial banks from all reserve-shortage constraints on lending and investing. In fact, the increase in bank lending was not large enough to absorb the reserve increases. The connection between the banking system's ability to acquire assets and the actual acquisition was weak. From this experiment the conclusion was drawn that monetary measures by themselves in the situation ruling in the 1930's were not able to eliminate unemployment.

The third objective of the banking and financial legislation of the 100 days was to create a banking structure that would make another banking collapse impossible. The relevant reforms of the 100 days and the second New Deal (1935-36) concentrated on curbing speculation, simplifying financial structures, forcing corporations to disseminate "honest" information, and safeguarding bank and financial institution assets and liabilities through the extension of government guarantees. In the effort to curb speculation the government barred interest payments on demand deposits, separated investment and commercial banking, prohibited loans for the account of third persons, and allowed the Federal Reserve to set margin requirements on stock collateral. Underlying these measures was the belief that a speculative boom during the twenties had brought on the collapse of 1929, that interest on demand deposits forced banks to seek out borrowers able to pay high interest rates, and that speculators were better able to pay those high rates than productive users of credit. Similarly, it

was felt that when bankers were both investment and commercial bankers they would encourage depositors to speculate and use commercial bank resources to support speculations they underwrite. The restrictions on margin buying of securities and on third-person loans were aimed at eliminating financial practices that abetted instability: the margin practices and loans for the account of others were examples of "Ponzi" finance.

✓ A valid distinction between the speculative and productive use of credit can be drawn ~~that~~ which depends upon the relation of the payment commitment on the debt structure to the source of validating funds. The productive use of credit is a hedge financing arrangement in which operations will generate the cash to repay loans, whereas in a speculative use the cash to pay debt is raised by borrowing or by selling out a position.

✓ The legislation of Roosevelt's first hundred days included government insurance and guarantees of bank deposits and home mortgages. Deposit insurance was the response to the Federal Reserve's failure to live up to its role as lender of last resort during the great contraction of 1929-33. Mortgage insurance not only served to absorb risk, but by insuring long term fully amortized fixed interest rate mortgages it changed the standard home mortgage from an instrument of speculative and Ponzi financing into an instrument of hedge financing.

Along those same lines, various agricultural credit provisions of the Roosevelt era promoted longer-term debt arrangements. Furthermore credit and contingent purchase schemes assured that disastrous price dips of agricultural products would not occur. These credit schemes and price guarantees improved

the "quality" of farmers as debtors. The shift to capital intensive agriculture can be imputed to the improvements in farm credit arrangements.

In addition to restricting speculative credit, the reforms aimed to assure honesty and probity in the sale of securities and in the management of publicly held businesses. This followed from a belief that dishonest practices and unethical manipulations, not inherent attributes of capitalist finance, were popularly held to be responsible for the Depression.

#### Industry, Labor, and Agriculture

Recovery and reform were the twin objectives of the "100 days" legislation on industry, agriculture, and labor. The measures reflected the belief that low and falling prices of capital assets, housing commodities and labor were the result of excessive, unfair or unscrupulous competition and a major cause of the severity of the depression and a barrier to recovery.

In the absence of a theory of effective demand, market processes became the villain that causes and prolongs depressions. In this "logic" prices needed to stop falling and start rising for recovery to take place. Furthermore it was believed that the likelihood of any future deep depression would be diminished if rapid declines and steep falls in prices were not possible. In this way competition and competitive markets were viewed as sources of depression and barriers to recovery.

The set of views that—competition bred falling prices, steeply falling prices caused the depression, low prices sustained the depression, higher prices were necessary for recovery, and the likelihood of future depressions would be diminished if prices could not fall fast or far--underlay the national Industrial Recovery Act. The NRA was the core of the first Roosevelt revolution.

Though ultimately thrown out as unconstitutional and dismissed as a failed experiment, the NRA left an ideological and policy heritage that is felt to this day. One aspect of the NRA was a propaganda drive: the Blue Eagle, parades, posters, etc. The view that what is wrong is mainly due to perceptions which can be changed by propaganda persists to this day in various campaigns against inflation and unemployment, business and labor advisory committees. Such devices are vehicles which make it possible to evade examining and correcting the causes of the failure of the economy.

By setting production standards and techniques, establishing "fair" mark-ups, minimum wages and work hours, the NRA became the sponsor of cartels. The view of competition as the cause of economic disaster led to the belief that production had to be rationalized into larger and stronger units. And so the NRA organized corporations into market-controlling "code authorities". The price extracted from business for this was the legitimization of trade unions and the pledging of fair labor standards. Ever since industries like trucking, steel, and automobiles have stood in a symbiotic relationship with the respective unions. Whatever competition exists within these industries moves within the lines drawn by union contracts.

To a degree, the NRA reflected an awareness of the difference between highly capital-intensive and less capital-intensive production, in that current market prices must contain a significant markup on out of pocket costs and that competitive market pressures can lead to a drastic decline in the markup for productions that are capital intensive whenever excess capacity exists. However it did not reflect the basic relation of a capitalist economy--i.e., that investment plus the government deficit largely determined aggregate profits. This basic relation implies that once investment and deficit are given, the markup

on labor, or the profit per unit of output, determines production. Consequently, the level of employment consistent with the level of investment and government deficits becomes a function of the markup units can achieve. Raising markups through the NRA codes increased the profit per unit of production, particularly ✓ in the capital-intensive, mass-production industries, even as decreased the level of output. Higher markups, legitimized and enforced by the NRA codes, were a barrier to recovery.

The Agricultural Adjustment Act overtly attempted to raise agricultural prices by limiting supply. The Act was struck down by the Supreme Court in 1936, but its main thrust--guaranteeing cash flows to farmers through outright government payments, loans, purchases, or production limits--has remained part and parcel of our agricultural policy.

The NRA programs failed to bring about the hoped-for quick and sustained recovery. Drawing up codes of fair competition proved almost impossible. Company unions rather than independent trade unions dominated the mass-production industries. The successful organization drive launched by the Congress of Industrial Organization in 1935 succeeded as it transformed these company unions into C.I.O. locals.

The legacy left us by the early New Deal--soft antitrust policies, the corporation as the dominant form of business organization, the symbiotic relation between industry and organized labor, and agricultural guarantees--effectively bars declines in prices. The specific form of the barriers may have changed in the course of years, but the policy objectives have not.

Recovery, the goal of the NRA and AAA, proved elusive. What had to be overcome was not only fear, but also the economy's inability to generate profits in the absence of investment. True, the government was running a deficit which



helped prop profits, but by comparison to the decline in investments after 1929 the deficit was small. The increase in markups that followed the NRA's granting of market power to self-governing industries attenuated the effect of the deficit on employment and production; raising profit margins lowers the multiplier on both the government deficit and private investment. Thus, by 1935 and 1936, when the Supreme Court struck down the first New Deal, it had already been judged ineffectual.

#### Transfer Payments and Other Government Expenditures

The Civilian Conservation Corps, the Federal Emergency Relief Act, the public works program of the NRA, and the crop purchase programs of the AAA were the only ones that involved overt government spending--pump-priming as it was then called. Furthermore, of these, only the public works program was rationalized as spending per se, and even then its administrator, Harold Ickes, made sure that the government got value for its money. The Federal Emergency Relief Act was considered a primarily humanitarian effort, and the CCC an attempt to ameliorate social conditions due to youth unemployment. All these programs had one thing in common--work relief rather than transfer payments, even if the value of the output was relatively minor.

Despite the increased government spending during the early New Deal, spending in itself was not considered a goal but rather a transitional though necessary phase. Big government did not become a permanent feature of our economy until later. The New Deal tried to solve the problems thrown up by the Depression through monetary expansion and the restructuring of existing institutions.

### The Roosevelt Revolution

By March 1934, a year after Roosevelt's inauguration, it had become clear that the recovery had not materialized. The New Deal had made adjustments in the financial system; government spending, and with it the deficit, had increased, even if not at a conscious expansionary effort but rather as a by-product of humanitarian and emergency undertakings. Neither the first nor the second New Deal was Keynesian in the narrow sense of the conscious use of fiscal policy to stimulate demand, and certainly not in the broader sense of recognizing the inherent flaws of an investing capitalist economy. The overt acceptance of what is generally referred to as Keynesian economics--i.e., the use of monetary/fiscal policy to steer the economy--is a post-World War II development. Roosevelt's reforms aimed at changing the way in which markets operated; his policies were both not classical and pre-Keynesian.

The United States since World War II has been using so-called Keynesian policy operations in an economic structure that reflects pre-Keynesian views. The views that entered into the structural reforms were pragmatic; the academic economists of the day had stood by helplessly, while the economy fell into the Great Depression.

In the eyes of both the classical economists of the 1930's and neoclassical economists of today the Great Depression remains an anomaly, out of keeping with their theory. ~~But~~ the Great Depression was a tragedy with which political leaders had to cope. ~~But~~ history and experience indicated to politicians and those economists not blinded by the narrow views of standard theory, that the causes of the collapse lay in the financial system of capitalism and the way it interacts with the production and consumption facets of the economy.

Even though they lacked a persuasive theoretical base to support their views, many perceptive economists of the thirties, men like Henry C. Simons of the University of Chicago, argued that though monetary and financial reforms were needed if the depression was to be mastered and that continuing restraint upon the evolution of the monetary and financial system was needed to assure another "Great Depression" would not happen, Simons also held that what we today would call an expansive fiscal policy was needed. The idea that the budget could best be "balanced over the cycle" rather than annually, that deficit financing was needed in the emergency and transfer-payment schemes were essential as permanent devices was much discussed in those days. The only thing that was lacking was a theoretical foundation to explain why these approaches would work.<sup>1</sup>

In 1933, as Roosevelt took office, one obvious characteristic of what had taken place in the economy since 1929 was that the price level and money wages were now sharply lower. In these years large scale excess supply in commodity or labor markets usually led to price and wage declines. Trade Unions which might have slowed such developments were mainly weak and ineffective.

Within the neoclassical theory price and wage flexibility is supposed to assure that full employment will be achieved and sustained. However the experience of 1925-33 shows that the more prices and wages fell the worse things got: as wages fell precipitously unemployment increased rather than decreased.

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<sup>1</sup>Perhaps the best statement prior to the second New Deal of a program for a working capitalism is "A Positive Program for Laissez Faire," in H. C. Simons, Economic Policy For a Free Society, Chicago, University of Chicago Press, 1948. "A Positive Program For Laissez Faire" was first published as "Public Policy Pamphlet No. 15, ed. Harry D. Gideonse (Chicago, University of Chicago Press, 1934). Thus Simons' proposals were contemporary with the first, and predates the second New Deal.

✓ ~~However,~~ it can be argued that the reason why wages and prices continued to fall was that the fulcrum around which the neoclassical system revolved, the money supply fell during these years. ✓ ~~However~~ During the years 1929-1933 the money supply--but not the reserve base of the banking system--fell by some 25%: largely as a result of the bank failures. Over these years prices fell by 24.4% and money wages by 21.9%. Thus the fall in the money supply was of the same order of magnitude as the fall in prices. Over the same time period gross national product in current prices fell from 104.4 billions in 1929 to 56.0 billions in 1933--a decline of 46.4%. The decline in money could explain the fall in prices but it could not explain the decline in national income.

During 1929-33 the behavior of the price level, money wages, and the quantity of money relative to gross national product were consistent with the conditions that need be satisfied if the mechanism of the neoclassical theory is to sustain demand: 1929-33 constitutes a test of one aspect of the relevance of the neoclassical system. The neoclassical synthesis fails that test of history. The view that money is a particular type of bond that finances activity, and not an eternally valid voucher whose supply is externally determined, seems relevant to an explanation of what happened in 1929-33. Because of the nature of money and the financial system, the financing of private activity through the banking system decreased rapidly over this period.

Classical economic theory does not admit the proposition that the normal functioning of the economy demands prices that can generate surpluses large enough to validate debt and sustain the prices of capital assets. Debt validation implies that cash flows from debtor firms to creditor households and financial institutions. The required cash payments of 1933 were to validate debts contracted during the prosperous years of the 1920's when prices were substantially

higher. But the money to validate the debts had to be obtained through markups on out-of-pocket costs measured in current prices. Thus the decline in prices and wages raised the required percentage markups on prime costs at the same time as excess capacity worked to lower the markups. The growing burden of the inherited debts was a barrier to recovery, and every decline in prices exacerbated an already onerous condition. The neoclassical theory ignored the possibility of over indebtedness affecting income determination, especially in periods of declining prices.

The role of over indebtedness in the Great Depression was documented in a series of studies by the Twentieth Century Fund.<sup>1</sup> They conclude that "Our debt difficulties were not the sole cause of the great depression, of course; nor was the depression the sole cause of our debt difficulties. But debt contributed to the lack of balance from which the depression came; and it was largely the weakness of our debt structure which made it possible for the business decline to go to such unprecedented length." ("Debts and Recovery," p. 254.)

The institutional reforms of the Roosevelt years were based on two propositions that emerged from the Twentieth Century Fund and other studies: (1) that wage and price levels must never again become so flexible that they could fall as quickly and as deeply as they did between 1929 and 1933, and (2) that speculative and fraudulent use of debt had to be controlled.

The Twentieth Century Fund's Committee on Debt Adjustment recommended reducing the use of debt, broadening the eligible asset lists for savings banks

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<sup>1</sup>The Internal Debts of the United States, ed. Evans Clark, with George B. Galloway. The MacMillan Company for the Twentieth Century Fund, New York, 1933. Twentieth Century Fund: "Debts and Recovery" [the Factual Findings by A. G. Hart, The Program by the Committee on Debt Adjustment] The Twentieth Century Fund, New York, 1938.

and life insurance companies to include the equities of "companies having no substantial bonded debt" (p. 257), and to tie the life of debts, such as mortgages and bonds, to their economic life expectancy. Today's fully amortized, fixed-interest-rate mortgage is the child of the Great Depression reforms.

The structural reforms advocated by the Twentieth Century Fund's commission biased the economy toward hedge finance. Many of its detailed recommendations sound very up to date. What is missing from them is an understanding that the events of 1929-33 were a logical outcome of the workings of our economy.

In the absence of a tenable theory about the causes of financial instability, policy was guided by the view that fraud, deception, and human error were responsible for the collapse and so many of the banking and securities reforms focused on the prevention of fraud. The Securities and Exchange Commission, the Holding Company Act, and the provisions of the Glass-Steagall Act divorcing commercial and investment banking grew out of the desire to eliminate fraud and deception.

Human error posed a more difficult problem. Roosevelt had inherited a banking system in a virtual state of collapse. The Federal Reserve, preoccupied with its own liquidity and solvency, had failed to intervene and support the commercial banks. As a result, the Federal Reserve's lender-of-last-resort role was split in two: (1) the deposit insurance function was given to the Federal Deposit Insurance Corporation, and (2) control of the money supply went to the Federal Reserve.

In acting as the lender of last resort, the Federal Reserve first makes funds available at its discount window to ailing institutions and then funds the discount window through the FDIC. The FDIC's ability to carry out its part of the two-step operation depends upon its ability to raise funds through the

sale of Treasury securities and by borrowing. In the case of a substantial operation the Federal Reserve must actively intervene in the money markets. Thus the FDIC's ability to carry out its part obviously depends on prior and concurrent action by the Federal Reserve. Equally obviously the Federal Reserve could do the job of deposit insurance without the FDIC.

Why, one may well ask, did the Federal Reserve bide its time while the economic structure was crumbling? One reason must be the absence of a theory that explains the relation between financial crises and the nature of our system, combined with a lack of understanding of the effect of lender-of-last-resort operations on the economy.

The Federal Reserve has always been concerned about being an engine of inflation. Its record of fighting inflation is poor, yet it sees itself primarily in the role of inflation fighter. By a curious twist of logic inflation, which according to the quantity theory is the result of too much money, is identified as the too rapid creation of money. Not the level of prices but the supply of money becomes the hallmark.

The successful execution of the lender-of-last-resort function in the late twenties and early thirties would have required a substantial increase in the reserve base, which in turn would have meant an increase in the money-creating potential of the banking system. To the Federal Reserve this spelled inflation. And so, because of its anti-inflation bias, the Federal Reserve stood by and let things run their course. Today's complex federal structure overseeing banking is the direct result of the Federal Reserve's failure to fulfill its responsibilities in 1929-33.

### The Second New Deal

The first New Deal which had the NRA as its "centerpiece" failed to achieve a close approximation to full employment. Even though the wave of bankruptcies had been checked, the newly established institutions and newly formulated measures were clearly unable to speed recovery. Moreover, the administration of the various NRA codes taxed the administrative capacity of the government; the NRA was floundering even before the Supreme Court administered the final blow. These developments gave rise to a spate of legislation that created institutions and structural arrangements that form the framework of the economy to this day. Social security, unemployment insurance, wage and hour laws, housing, the National Labor Relations Act, rural electrification and road building programs, industrial and agricultural controls, direct employment, and public works programs, were the backbone of the second New Deal. Some of them--the WPA, PWA, and CCC, for example--have since disappeared, although today's comprehensive education and training programs (ETA) are in part modeled on them. Other legacies of the New Deal are still very much with us: the soft antitrust policies combined with regulation of business; labor-market legislation that constrain participation, affects conditions of employment and protect trade unions; transfer payments; housing programs; agricultural controls. They are legacies of the belief that downward price movements had to be checked. Today's market and institutional structure was designed to attenuate or prevent the downward price movements that accompany a failure of aggregate demand, even though our monetary and fiscal policies effectively prevent any such failure from taking place.

### The Sponsoring of Market Power

Except by omission in the form of soft antitrust policies, the second New Deal did not preserve the techniques of industrial self-government that had



marked the NRA. However, it set up or rechartered existing numerous regulatory agencies--the Federal Communications Commission, Federal Power Commission, Civil Aeronautics Board, Federal Trade Commission, Interstate Commerce Commission--which control markets by administrative or judicial decrees. Although initially it was argued that legislation was necessary to control power, the regulations of the mid-1930's and after intruded controls on potentially competitive markets. In effect, market power was legislated into being, often by putting licensure or other restrictions on entry.

Market power, whether the result of market processes or regulation, tends to constrain or attenuate risk. In industries that require large-scale investments, the financiers (the investment bankers) typically look for some attenuation of risk via grants of market power before they will agree to finance the production or ownership of capital assets; a monopoly, however local, is an aid to financing. This was well understood by J. P. Morgan who fostered and promoted the oligopolistic organization of industry and cartels arrangements. By the same token, regulation, licensing, and guaranteed market prices are conducive to high market prices for the particular capital assets that benefit from such arrangements as well as to the financing of facilities that operate in protected markets. When government intervention creates monopoly power, the relative price and financing terms become more favorable for investment than would otherwise be the case. One way of interpreting such grants of market power is that the government intervention absorbs "uncertainty".

In some conditions, especially where there is strong competition among the suppliers of capital assets to the "organized industry" and where the "organized industry" consists of many independent units, such a grant of monopoly power may be conducive to technical progress and accelerated increases in

productivity. The growth in productivity of American agriculture, at least in part, can be imputed to the attenuation of market uncertainty by means of various price supports and market organization programs. American agriculture shows that programs of risk absorption by state intervention may be useful, but it also shows that the capital asset structure of a "protected" industry may become such that ever increasing levels of price support and ever increasing grants of market power are necessary to sustain the investments induced by the absorption of uncertainty.

The introduction of market power tends to increase the profits from the ownership of capital assets by the units that acquire power, which in turn tends to increase the capital intensity of the regulated industry over which it otherwise would have been. In the 1930's it might very well have been desirable and rational for government to intervene to lessen the risks from investments--particularly since the intervention was taking place before the doctrines of effective demand had gained currency, but in an economy suffering from both inflation and unemployment such a policy seems neither desirable nor rational. In granting market power the second New Deal was following a conscious inflationary strategy, the survival of such market power in an economy where aggregate demand is sustained gives an inflationary "thrust" to the economy.

#### Labor Market Intervention: Trade Unions

The failure of the NRA by no means laid to rest the notion that falling prices, and consequently competition, had caused the Depression. The regulatory mechanism that created market power was one way of checking competition; another approach was to set a floor on labor costs. This was done in two ways: by

facilitating the organization of trade unions and legislating minimum wages and standard hours. It was accepted as gospel that in 1929-33 money wages in industries with effective trade unions did not fall as rapidly as in those without such unions. The fact of the matter is that in 1929-33 unions had only a feeble foothold in American industry. It was believed that unions would prevent or slow any future downward pressure on money wages brought on by massive unemployment. Furthermore, reflation was a felt need, and the initial unionization of a firm was usually accompanied by substantial wage increases. This persuaded the administration of the economic benefits of unionization.

Accordingly, the National Labor Relations Act, which defined "fair" procedures in the organization of trade unions, stipulated conditions for the selection of union representation, provided a measure of protection for trade union activities, and called for bargaining in "good faith" became law. In spite of their official sponsorship, during the New Deal days unions were only partially successful. They made inroads into the established mass-production industries (steel, automobiles, rubber, electrical appliances), as well as into some decentralized industries that to this day rely on the political power of unions for support in Congress (trucking, construction). But except for special periods such as the brief, emotionally charged successful CIO drives in the thirties and World War II, unions have not had great power in the market.

The power of organized labor in the United States is quite limited. Only a minority of eligible workers belong to unions, and in relatively few industries do they wield market power. They do have political clout, probably because in a society with limited political participation the ability of labor to get out the vote is a potent force.

The unions' lack of economic power explains their devotion to such labor-market legislation as minimum wages and social security. As long as minimum wages do not fall too far below the average wage, an employer does not benefit very much from using nonunion labor. High minimum wages protects organized labor against potential competition. Similarly, expanded social security coverage distributes at least part of the costs of fringe benefits among all employers--union and nonunion shops alike. Every legislative victory for higher minimum wages and social security benefits weakens the workers' dependence on trade unions, but at the same time diminishes the employer's incentive to resist unionization.

#### Labor-Market Intervention: Minimum Wages/Fair Labor Standards

After the death of the NRA an effort was made to salvage some of the regulations on fair competition by the introduction of minimum standards: minimum wages, standardization of working hours, abolition of child labor.

As originally conceived, minimum wage legislation was overtly inflationary, which was presumably a good thing in time of deflation. But in time of chronic inflation, legislated minimum wages are paradoxical, particularly when the legislated minimum is regularly raised to sustain a high ratio to a rapidly rising average wage.

Just as the minimum wage was designed to keep wages from falling still further in the Depression, the institutionalization of the 40-hour week was an attempt to spread available work among a greater number of people.

Minimum wage and maximum hour laws are acts of resignation. They reflect the view that periodic downward pressures on wages due to unemployment are inevitable, and that we are unable to manage the economy so as to provide jobs for all those who want to work.

Let us take a brief look at the course of the minimum wage. Throughout World War II it was pegged at 40 cents per hour; in 1950 it rose to 75 cents. In 1949 the average hourly earnings in manufacturing were 3.45 times that of the minimum. The 1950 increase reduced that ratio to 1.92. The minimum wage remained at 75 cents through 1955. During that period, this minimum, deflated by the Consumer Price Index (1967=100) fell by some 10 percent, from \$1.04 to 95 cents, and the ratio of average hourly wages in manufacturing to the minimum wage rose by 29 percent, from 1.92 in 1950 to 2.48 in 1955. This period of price and minimum wage stability was accompanied by a substantial increase in the purchasing power of industrial wages.

In 1956 the minimum wage was raised to \$1.00, and there it remained through 1961. This increase was tantamount to a 30 percent rise in the deflated minimum wage, to \$1.23. However, because of the rise in the consumer price index between 1956 and 1961, the deflated wage fell about 10 percent, to \$1.12, in 1961. The ratio of the average hourly wage in manufacturing to the minimum wage fell to 1.95 in 1956 and rose to 2.32 in 1961. In terms of the manufacturing wage/minimum wage ratio, the experience of 1956-61 paralleled that of 1950-55.

After 1961 the minimum wage lost its relative stability: in 1962 it was raised to \$1.15, in 1964 to \$1.25, in 1967 to \$1.40, in 1968 to \$1.60, and it remained at \$1.60 until 1972. Then, in 1973, it went up to \$2.00, in 1974 to \$2.20, and in 1975 to \$2.30. Although it rose from \$1.60 in 1968 to \$2.30 in 1975, inflation wiped out the increase. Throughout the twenty-five year span 1950-75, the purchasing power of the minimum wage increased at an annual compound rate of 1.25 percent; however, this breaks down into a 1.59 percent growth rate during 1950-65, and 0.73 percent in 1965-75. In fact, its purchasing power peaked at \$1.54, in 1968, and declined to \$1.42 in 1975.

Since 1973, when increases in the minimum wage became more frequent, the average wage/minimum wage ratio has been held in the neighborhood of 2.0. However, over the five-year period 1968-72, when the minimum wage remained at \$1.60, the ratio rose from 1.88 to 2.38. The experience of the 1950-55 and 1956-61 periods was repeated in 1968-73.

The evidence would seem to indicate that if a minimum wage is sustained over a period of time its deflated value and the ratio to market wages will fall, and that legislation that sets and sustains a minimum wage in the neighborhood of half the average wage in manufacturing sets up a disequilibrium. A rise in the minimum wage increases unemployment, and government policies aimed at increasing employment first affect demand for the already employed workers. Their wages go up, and this in turn leads to higher prices. As the legislated minimum wage declines in relation to the average wage and prices, its effect on employment is attenuated. In other words, the mechanism of our economy resolves the disequilibrium by "inflating away" the increase. Rising prices and even higher average wages in manufacturing are reactions to economic policies that seek to offset unemployment created in part by high minimum wages.

Thus, if the behavior of the money wage rate influences the course of inflation, it follows that the course of the minimum wage and the ratio of manufacturing wage (as well as other wages that enter into the price of products) to the minimum wage are important determinants of the price level. On the whole, our recent experience with minimum wages has been an exercise in futility: neither the absolute nor relative income of the lowest-paid workers is improved by this device.

Once the powerful instrument of fiscal policy in the context of big government becomes a policy tool runaway wage and price deflation ceases to be a threat.

The experience of 1974-75, when prices continued to rise in the face of rapidly rising unemployment, indicates that even inefficient fiscal devices, that depend primarily upon transfer payments and tax reductions, prevent wage and price declines during periods of serious slack.

The presumed purpose of a minimum wage in an economy in which the shape of the business cycle has been changed by policy measures that rule out the possibility of strong cumulative debt deflations is to set and sustain a minimum living standard. But if there is to be such a minimum, there must be job or income guarantees. Replacing a legislated minimum wage with a "tap" employment device could turn the minimum wage into a guarantee of income, for the wage standard set by the tap employment agency becomes the effective minimum. But such a minimum wage will reflect budget considerations: that which the tax system is able to bear becomes the effective determinant of the minimum wage.

The trends of 1950-55, 1956-~~61~~, and 1968-72 clearly indicate that a minimum wage pegged at 50 percent of the average manufacturing wage is too high for price stability. Our evidence indicates that a minimum wage in the neighborhood of one-third or 40% of the average wage is compatible with price stability. We can therefore assume that a modest minimum wage does not do much harm but an ambitious one can be inflationary.

#### Transfer Payments

The extensive transfer payment system that today looms so large in our economy was ushered in by the Social Security and unemployment insurance acts of 1935. They form the foundation of the welfare state, and the welfare state in turn reflects the awareness that the unconstrained market mechanism has failed to provide a socially acceptable minimum of income and services. The welfare

state compensates for this failure by providing income, either in money or services, to those who meet certain standards of entitlement.

Except for universal schemes that provide specialized services (such as inoculation programs), transfer payments affect the labor market. The regulations governing these always specify whether recipients may and who may not participate in the labor market, and the payments finance exclusion from the labor market. Aid to families with dependent children, school lunches, food stamps, etc., are in fact if not in logic corollaries of child labor laws they are ways to support children barred by law from work. There are alternative possible methods, such as a universal childrens allowance, to finance the support of such children which do not have the impact upon labor market participation of current laws.

Unemployment is the difference between the number of labor market participants and the number employed. The unemployment rate is the ratio of the unemployed to labor market participants. Any social or economic device that reduces labor-market participation tends to lower the unemployment rate for any given level of employment. If one divides a population into demographic groups--by age, sex, race, or place of residence--the labor-force participation rate for a specific demographic unit represents the ratio of the number of those in the labor force to that population group: these particular labor force participation rates reflect institutional considerations.

Social security, unemployment insurance, and other such schemes affect participation in the labor force and determine how income is to be provided for those excluded from it. Social security legislation by setting <sup>standards</sup> ~~ing~~ a retirement age. As the act matured this reduced the number of older persons in the labor force. By reducing participation in the labor market, retirement tends



to lower the unemployment rate. In 1935, when jobs were scarce, reducing the size of the labor pool through retirement seemed like a good way of reducing unemployment.

In the life cycle of a family a large part of its net worth accrues from savings out of freely disposable income (this excludes savings through insurance, pension funds, and mortgage retirements) in the later years of active work. The Great Depression greatly reduced or wiped out much of the privately accumulated savings and spread unemployment throughout the land. This created a class of impoverished older adults who became a political force that put old-age pensions and the insurance schemes of the social security system on the political agenda.

The alternative to social security are job or career progression programs within a full-employment economy, plus private pension funds for retired workers through ownership of financial and real assets. The Keynesian analysis of income determination makes it possible to develop policies that generate a demand for labor regardless of the size of the labor force: policies and institutions that restrict participation in the labor force based on arbitrary decisions of who should and who should not have access to the limited number of available jobs are not consistent with the employment possibilities held out by Keynesian analysis. Labor market participation need not be hampered by restrictions designed to alleviate the problems caused by unemployment. Approaches that promote career advancement and labor-market participation are consistent with Keynesian policy; approaches that promote exclusion from the labor market are not.

The collapse of the financial system and of asset values in the Great Depression contributed to the development of social insurance, i.e., the creation

of retirement benefits through forced savings. The cash flows presumably being purchased by savings and the acquisition of assets in the 1920's did not come forth after asset values and financial institutions collapsed. But under big government, the automatically generated large deficits protect cash flows, asset values, and financial institutions from any such collapse. The problem in today's economy is not the cessation of cash flows but the erosion of fixed nominal-value instruments through inflation. In terms of the safety of the nominal value of private accumulations the problems that gave rise to social security are no longer with us.

Given our understanding of the causes of employment and profit flows and our presumed ability to prevent mass unemployment and financial instability, the time has come to reconsider the proper scope of social security. However, we are faced with a paradox: the large government deficit that guarantees the continued cash flows from the ownership of capital and financial assets even in times of declining investment and employment is due mainly to large deficits <sup>largely</sup> ~~mainly~~ caused by the system of transfer payments. But once these cash flows are assured one of the reasons for the existence of the government schemes is gone. That is, as long as government-based transfer payments are large they are not necessary, but in a capitalist economy, when private investment, employment, and thus income, fall, a large deficit must be generated to sustain asset values. Thus it follows that if massive transfer-payment schemes have deleterious effects, and if large deficits are needed when a financial crisis threatens, a capitalist economy must look for an alternative deficit generation.

Certain of the attributes of social security, and of transfer-payment schemes in general, are common to all programs and others are unique to a particular

scheme. One peculiar and perverse characteristic of our social security system is its tax on labor that acts against employment. Both employees and employers pay a tax on wages, but only on a portion of the wages, under a ceiling set by legislation. Obviously it is not necessary to finance social security by a tax on wages only, and a portion of wages at that. There are other ways. A value-added tax, for example, being a tax on the difference between revenues and purchased inputs other than labor, taxes the income from capital assets at the same rate as the income from labor. Such a tax at a rate well below the current combined tax on employers and employees could finance the existing social security system while removing the penalty on employment.

Another feature of the transfer-payment schemes--particularly social security and aid to dependent children--which could readily be changed is the requirement that recipients be either completely or partially out of the labor force. The retirement provisions of the social security pension system are especially bizarre. Nothing in the concept of social security as such prevents a recipient from deciding when and under what conditions to retire.

In view of the fact that full employment is feasible, and the safeguards against financial collapse that now exist, the possibility of a collapse of job opportunities and private, personal retirement funds should not figure large in policy considerations. The public concern need not extend beyond the maintenance of a floor on disposable income of the aged. By offering people the possibility of remaining in the labor force, coupled with the assurance that asset values will not collapse, we could decrease the role of social insurance without any adverse effect on the well-being of even the poorest of the aged.

Housing

legislated,  
 Housing as a national ~~issue~~ concern is another legacy of the second New Deal. The main emphasis ~~has been on housing~~ <sup>in housing programs was and continues to be</sup> construction and the financing of home ownership rather than on the maintenance and improvement of the ~~existing~~ housing stock. Housing policy ~~is~~ <sup>is</sup> concerned mainly with the well-being of the construction industry and its financing agents, not with sheltering the population. ~~Building construction seems to have become~~ <sup>the related industry</sup> an end in itself. In the name of urban renewal and model cities vast acres of decent, useable housing ~~has been~~ <sup>have been</sup> demolished.

Tax laws and construction financing are biased against the improvement and maintenance of existing housing and in favor of home ownership. By permitting the ~~written~~ <sup>amount</sup> writing off of some of the cash flow from rental property as depreciation, without requiring proof that the funds deducted were spent on maintenance, tax laws ~~make~~ <sup>turns</sup> the deterioration of rental property ~~into a~~ <sup>into a</sup> profitable ~~undertaking~~ <sup>undertaking</sup>.

The tax law ~~bias~~ <sup>is</sup> favoring ~~home ownership~~ <sup>home ownership</sup>. ~~concerns the treatment of the~~ <sup>The income in mind</sup> ~~income~~ accruing from ownership, ~~albeit in kind~~ <sup>allowing</sup> and ~~the deductibility of~~ <sup>in</sup> ~~any mortgage interest, taxes, and maintenance costs.~~ The ~~income~~ <sup>costs</sup>, the fair rental value of a house, ~~is not part of a homeowner's taxable income,~~ while the ~~interest, taxes, and maintenance~~ <sup>mortgage</sup> are deductible. If all investment ~~were to be~~ <sup>are</sup> treated equally, ~~then~~ the fair rental value of a house would become part of the owner's taxable income.

The urban sprawl that blights the American landscape and the deterioration of the inner cities are not the result of ~~choice~~ <sup>intrinsic preference systems</sup>, nor are they the inescapable consequence of the changes brought by the automobile. They are, rather, social adjustments to the powerful inducements of ~~the price~~ <sup>our</sup> and tax structure ~~of our system.~~ The presumed preference for suburban living is largely the by-product of the subsidies and tax benefits first ~~introduced~~ <sup>introduced</sup> into ~~the American economy in the 1930s,~~ <sup>then simplified</sup> and ~~solidified as~~ <sup>solidified as</sup> income taxes rose to their present high level.



as income taxes, <sup>rose</sup> rose to their present high level <sup>due to</sup> and ~~home construction mushroomed, the phenomenon became more and more widespread.~~

Housing legislation deals mainly with urban and rural non-farm housing. When the legislation was first introduced in the thirties, the United States was far more rural than today, and a much higher percentage of the rural population lived on farms. Between 1930 and 1970, the farm population fell from about 25 percent of the total population to 4 percent, while the urban population increased from 57 percent to 73 percent of the total. Our urban complexes, whose population has more than <sup>2</sup> doubled since 1930, reflect the impact of the 1930s legislation ~~improving~~ and the ~~special~~ tax advantages enjoyed by home owners.

The state of <sup>reflects</sup> our cities <sup>reflects</sup> reflects the state of mass transportation.

~~With~~ The advent of relatively cheap and efficient urban mass transportation changed the shape of the cities and the pattern of life within them. As the automobile became commonplace the cities began to expand. <sup>Yet</sup> However, the way in which they developed was not <sup>an</sup> the inevitable consequence of the automobile, <sup>but</sup> rather, the outward expansion was the result of conscious decisions to <sup>subsidize</sup> build road networks, <sup>and</sup> the subsequent <sup>relocate</sup> relocation of plants <sup>into</sup> ~~made~~ <sup>turned</sup> commuting by automobile a normal part of daily life.

<sup>Housing construction boomed in the 1920s.</sup> The 1920s witnessed a building boom more than 900,000 housing units were started in 1925, and construction continued at a high rate through 1928.

The value of all new construction in 1927 exceeded \$12 billion. As <sup>was</sup> to be expected in an investment boom ~~debt expanded rapidly.~~ <sup>As is the</sup> case in all construction booms, <sup>and</sup> ~~existing~~ <sup>debt expanded rapidly.</sup> Existing financial institutions expanded at a fast <sup>types</sup> and new ones sprang up at a rapid rate. Total ~~expenditures~~ <sup>spending on new construction</sup> reached a new peak in <sup>at</sup> 1926, ~~when~~ <sup>at</sup> \$12.6 billion. The index of construction costs in the 1920 was remarkably stable: from 1923 to 1930 it remained at 30.

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The <sup>shape</sup> ~~state~~ of our cities reflects the available modes of urban transportation. The advent of relatively cheap and efficient urban mass transportation changed the shape of the cities and the pattern of life within them. As the automobile became commonplace the cities began to expand. Yet the way in which they developed was not an inevitable consequence of the automobile but the result of conscious decisions to subsidize the building of road networks. The subsequent relocation of plants turned commuting by automobile into a normal part of daily life.

Housing construction boomed in the 1920's. More than 900,000 units were started in 1925, and construction continued at a high rate through 1928. The value of all new construction in 1927 exceeded \$12 billion. As was to be expected in an investment boom and construction boom debt expanded rapidly. Existing financial institutions expanded at a fast pace and new types sprang up. Total spending on new construction reached a new peak in 1926 at \$12.6 billion. The index of construction costs in the 1920's was remarkably stable: from 1923 to 1930 it remained at 30. 1933 saw the start of 93,000 housing units, at a cost of \$3.1 billion.

In 1926, 68,000 non-farm housing units were foreclosed; in 1933 foreclosures climbed to 252,000. Building and loan societies were in desperate straits,

while small local commercial banks reeled under the impact of declining real estate values and the inability of borrowers to meet payment commitments.

The new housing laws granting preferential tax privileges and special protection to mortgages were drafted against the background of an industry that had been hit very hard during the depression. The revitalization of construction was taken to be a pressing need. One of the problems faced by the new administration was the inherited mortgage system. National banks were barred from extending loans of more than five years duration, and many state banking laws contained similar restrictions. The typical mortgage was not fully amortized. Five-year mortgages amortized over a twenty-year schedule were common, but this entailed refinancing at the end of the five-year period. The newly created Federal Housing Authority was given the power to endorse long-term, fully amortized mortgages and National Banks were authorized to acquire such mortgages. The FHA's guarantees changed the standard mortgages to the fixed payment fully amortized mortgage that is the cause of so much difficulty in today's inflationary environment.

The change from short-term to full amortization turned mortgages into hedge instruments, while decreasing the near term cash flow to the lender. To solve this problem the government created discount banks for mortgages in the Home Owners Loan Corporation. In 1934 HOLC acquired \$2.4 billion worth of mortgages--virtually 10 percent of the total outstanding. Through this acquisition from various institutional lenders the authorities refinanced the distressed institutions.

As loan societies, commercial banks, and insurance companies took advantage of the opportunity to exchange the mortgages they held for "bonds" of the Home Owners Loan Corporation, the HOLC became a major mortgage holder. HOLC treated



the mortgages as commercial debts; the mortgages were refinanced but they were not reduced. In time the Home Owners Loan Corporation became a major forecloser of defaulted mortgages.

Public housing, despite much to-do, has never really loomed large on the American scene. Of the 63.5 million housing units in 1970, only about 0.9 million were public housing. In the early days of the New Deal access to public housing was not hemmed in by the stringent means tests of today. The program, modeled on the workers housing of various European countries, was open to employed workers. Many of the social ills and political problems of public housing in the United States could have been avoided had severe means tests not been injected into the housing program.

After World War II, under the impact of high employment and high marginal taxes, fully amortized mortgages and deductible property taxes and interest payments, housing construction and home ownership boomed. The demand for housing has continued to grow and the relative price of houses has continued to rise. Home ownership not only enjoys tax advantages but also holds the potential for capital gains, which, incidentally, also benefits from special tax treatment.

In the years since World War II an enormous number of housing units have been built. Within a regime of tolerably full employment and high marginal taxes the fully amortized mortgage, with property taxes and mortgage interest as tax deductions, has led to a significant expansion of home ownership. As a result of the political pressures and the low level of mortgage losses during this period the terms to maturity of the fully amortized mortgage has tended to increase. Because of this financing development, there has been continuing demand pressure on housing so that, on the whole, the prices of houses have

increased relative to the price level. Thus home ownership has not only received tax advantages but it has also led to capital gains; which incidentally also receive special tax treatment. In many ways the success of the New Deal's reform of the financing relations in housing has been a success in that one third of the United States is no longer "ill housed". But the chronic upward pressure on house prices due to the progressive easing of mortgage terms to maturity, even as interest rates increased, has helped fuel inflation.

The New Deal innovations in housing created a three pronged interest group, contractors, labor and specialized financial institutions, which is mainly concerned with housing. The initial policies of the 1930's were adopted in the face of an extreme depression of the house building industry and a virtual collapse of the financial institutions that specialized in the financing of housing. In this unique situation the house building industry perhaps was deserving of special consideration.

#### Public Employment

According to conventional estimates the unemployment rate in 1933 stood at 25.5 percent: out of a labor force of 50.9 million, 12.8 <sup>million</sup> were unemployed. This unemployment rate was not an isolated peak, the rate continued to top the 20 percent mark for four years in a row, from 1932 to 1935, and to exceed 14 percent for ten years, from 1931, when it reached 16.3 percent, until 1940, when it fell to 14.6 percent. (1929 had a rate of 3.2 percent.) Not until the country entered World War II did unemployment drop below the 1929 level.

These unemployment statistics, however, fail to reflect the effectiveness of the New Deal work programs. Beginning in 1933, different programs at various times gave paid work to various target groups. From a relatively modest start

in 1933, when 471,000 were so employed, the work programs reached a peak in 1936, with 3.65 million employees. In every year from 1934 through 1941, at least 2 million persons worked under the aegis of one or another emergency program.

As Michael R. Darby has emphasized<sup>1</sup> temporary public employees, who receive wages for working special programs, are counted as <sup>un</sup>employed in the current statistical reports on employment. Darby has "corrected" the official estimates of unemployment during 1933-43 by reducing the number of unemployed by the number employed by the emergency employment programs. Darby's corrections do not appreciably affect the unemployment rates between 1929 and 1932. The estimate for 1932 is 22.5% rather than the official B.L.S. estimate of 23.6%. The correction is substantial in the years beginning with 1933. The unemployment rate, as corrected by Darby, is above 20% in only two years, 1932 and 1933, and is above 14% in only five of the years between 1931 and 1940. Even after Darby's correction the average of the unemployment rates for the five years 1936 through 1940, is greater than 10%, but this is substantially lower than the average unemployment rate in excess of 16% over these five years with the uncorrected data.

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<sup>1</sup>Michael R. Darby, "Three-and-a-Half Million U.S. Employees Have Been Misled: Or an Explanation of Unemployment, 1934-1971," Journal of Political Economy, 1976. Vol. 84, No. 1, pp. 1-16. Darby's paper falls into two parts. In the first he corrects the employment data and in the second he attempts to prove that "the data reveal a strong movement toward the natural unemployment rate after 1933." (p. 15). One "can accept" the validity of the point that Darby makes about the conceptual error in the unemployment data over this period without accepting either the details of his correction, or the way he uses the adjusted data in a correlation study to argue that but for "the heroic ineptness of Federal Reserve policy" both before 1933 and in 1934-37 "there is every reason to suppose that the natural rate (of unemployment) of about 5 percent would have been reached by 1938..." (p. 14). I suppose one can always suppose, but "to suppose" is not the same as "to believe".

The Darby data clearly demonstrate that the recovery program of the Roosevelt administration was far more successful than the standard data would indicate. Given the constraining effects of the emotional reaction to the crash and the various structural reforms of the thirties, it is clear that the expansionary monetary and fiscal policies of the New Deal made a strong impact. Darby's corrections help explain both the "acceptance" of mass unemployment during those years and the vast popularity of President Roosevelt. Things were obviously getting better, and from 1932 until the beginning of World War II, except for the recession of 1937, unemployment continued its steady decline. Furthermore, many of the emergency work programs had considerable turnover. Jobs under the youth programs were meant to be short-term and as employment in the private sector increased, the adult programs also became a revolving door. Thus the number of people directly benefiting from the emergency programs in a year was far greater than the number enrolled in them at any given time in that same year.

Government spending and deficits were of course being attacked, and the opposition successfully reduced the scope of these employment programs. Because there was then little understanding of the way public spending expanded the economy, these programs found few if any champions in the halls of power. The political thrust came from a combination of humanitarian concerns and moral and emotional opposition to a dole. The transition from "make work" projects to useful jobs for the unemployed was a gradual one, and the idea never really won full acceptance. Even though based on Darby's figures the Roosevelt programs were more successful than generally admitted, political obstacles stood in their way, and they never reached the level of effectiveness that could have moved the economy toward full employment.

The emergency work programs not only gave people jobs, they also made a lasting contribution to vital and neglected aspects of American life. The arts benefited, forests were preserved, and young people were helped to bridge the gap between school and work. WPA, NYA, and CCC fell by the wayside in the war, never to return. Unappreciated in their day, these cornerstones of the second New Deal have had no direct descendants. Public employment as a proportion of total employment may have increased, but aside from the vast military establishment, it is restricted mainly to the state and local level.

In many respects the emergency employment programs of the New Deal were its most innovative and radical departures. The major problem of capitalism is its inability to achieve and sustain a close approximation to full employment at stable prices. NYA, CCC, and WPA are models of how this can be done by injecting a not-for-profit sector into the economy. However, unlike many of the socialized or nationalized industries of Europe, which are largely capital-intensive (e.g., electricity, railroads, steel), the WPA, through government intervention, can provide minimum-wage jobs for public and even private, marketable outputs that may require wage subsidies. The philosophy underlying the WPA type of approach stresses the better utilization of that which exists, in contrast to the constant search for more that characterizes conventional policy.

#### The Third New Deal

In the late summer of 1937 the economy went into a sharp recession. Unemployment as conventionally measured, which had declined to 14.37 percent in 1937, jumped to 19.07 percent in 1938. Various explanations have been offered: monetarists tend to hold the Federal Reserve's increase in reserve requirements responsible; conventional Keynesians blame the sharp decrease in the government

deficit, the cutback in government emergency employment, and the ebbing of the stimulus provided by the veterans' bonus of 1936.

The Roosevelt administration was not an ideologically homogeneous group. Advocates of organized markets sat side by side with champions of competition. Laws to organize labor, agricultural and product markets were passed alongside measures such as the Holding Company Act of 1935 that restricted holding companies in the utilities industry. The Holding Company Act was the only serious attempt to redefine the corporate scope in the Roosevelt era. The Securities and Exchange Act concentrated on the relation between corporate stockholders and officers rather than on the market operations of corporations.

The CIO's successful organization of the steel, automobile, rubber, and segments of the electric-supply industries in the mid-thirties brought higher wages, and the improved business conditions of 1935 and 1936, combined with the soft attitude toward market power brought substantial increases in unit markups. For a given dollar value of investment and government deficit, the higher wages and markups the smaller income and employment. Although the technical relation between investment, markup, output, and profit were not central to their analysis, New Deal economists became persuaded that the ability of firms with market power to keep up prices and margins when the economy entered into a recession, and to raise prices and margins when it expanded, worsened recessions and depression and tended to bar or slow recovery.

The view that monopoly and administered prices were mainly responsible for the poor economic performance gained favor with Roosevelt in the 1937-38 recession/depression. He accepted the arguments that (1) the attempt to balance the budget in 1937 had been premature, and (2) the deviations from competitive

markets explained the economy's sluggish recovery. As a result, in 1938 Roosevelt moved toward substantially expanded public works and employment programs and called for the revamping of the economy to make markets competitive "once again." With this objective in mind he proposed a thorough investigation of the structure and functioning of the American economy.

In the spring of 1938, the Temporary National Economic Committee, a joint congressional and administrative body, was charged with investigating the concentration of economic power. It turned out to be the most probing exploration of the American economy ever undertaken. The hearings lasted 18 months and produced a spate of special studies by government economists, trade associations, and individuals. Not only did they broaden our knowledge of how business functions, but they also served as a sounding board for conflicting views about the causes of economic malfunction.

The view that underlay Roosevelt's call for an investigation of economic power was not that monopoly leads to the inefficient allocation of resources, but rather that it leads to administered prices, which in turn lead to price rigidity in recessions and to the exploitation of marketpower in times of expansion. Administered prices thus were held responsible both for the depth of the depression and the shortfalls of the expansion. This administered-price explanation stood in contradiction to the implicit theory and explicit views embodied in the NRA, CCC, Fair Labor Standards Act, and other New Deal legislation.

The TNEC was the forum that brought Keynes to the United States, although in a version lacking the subtle, sophisticated critique of capitalism and its financial institutions that marks his General Theory of 1936. By 1938 these new ideas had filtered through to Cambridge, Massachusetts, where Professor Alvin Hansen found the explanation for the Great Depression and the theoretical

base for prescriptions for permanent prosperity in Keynes' consumption function and investment multiplier. The argument forcefully presented by Hansen in his testimony maintained that any deficiencies in total output, income, and employment due to insufficient investment or overly large savings could be rectified by manipulating public investment and community consumption. In particular, Hansen believed that the administered-price view as the cause of depression and of sluggish recovery was irrelevant, even if the phenomena described existed and had the alleged consequences. This was so because the depressing or constraining effect of administered prices could be overcome by increased public investment or community consumption.

The final report of the TNEC hearings coincided with the massive economic stimulus provided by the rearmament and preparations for war. The effect of these massive expenditures was accepted as proof of the correctness of Hansen's view. According to a view that gained currency in the early postwar years, the pace of recovery from 1933 on was slowed because spending had not been carried far enough. Furthermore, it was concluded that there was no reason for concern about monopolies or other structural features of the economy because adequate aggregate demand could overcome these obstacles. Social security, public housing, public health, and other welfare state provisions were not only desirable in themselves but also provided the community consumption needed to offset the excessive--relative to private investment--propensity to save.

The structural reform aspect of the TNEC program lost out both to the war effort and the simple, straightforward argument of Hansen. His testimony found its way into books that became the basis of much of the graduate study of income and employment determination. As far as the United States is concerned Keynesian



economics and Hansen's interpretation were identical, and his interpretation in turn was disseminated in Paul Samuelson's best selling textbook, whose early editions offered a simple consumption function-plus-multiplier view of the world.

The war began in Europe in September 1939. And even though the United States did not enter until two years later, the era of economic reform and experimentation came to an end. There was no third New Deal aimed at developing a truly competitive market structure. The lessons of the New Deal and war deficits were absorbed and became the basis of the demand-management-through-fiscal-policy-approach to economic policy.

#### The Impact of World War II

Two features of our economic structure may be called residues of World War II: the contract system and the government's proven ability to administer. Both are extensions of trends that began during the New Deal.

When Roosevelt sounded the call to defend America by aiding the Allies and to expand the armed forces, our peacetime productive capacity was converted to military uses. At the time armories, naval yards, and air stations were operated by the military, and the needed planes, tanks, guns, and ships could conceivably have been produced within the existing framework. However that was not to be. Military production was parceled out to private corporations. In the scramble for government contracts firms with proven managerial skills enjoyed a certain advantage. In some areas--especially construction--small and medium-sized contractors turned into time operators. A special type of enterprise came into being, and it has remained part of the economic scene: corporations that sell a large or even major portion of their output to the government.

Even though ostensibly private enterprises, they supply mainly government demand.

The war showed that the government and private firms were able to manage large-scale organizations. Considering the scale of operations involved, the civilian price administration and rationing schemes worked quite efficiently; black marketing, though somewhat of a problem in the later stages of the war, was not pervasive enough to destroy the system. One of the legacies of the price and wage controls is a belief that they can constrain peacetime inflation.

The war did not fundamentally alter the structure of the economy. Its financing relations changed the asset holdings of the public and banks, and income tax rates rose to new heights. The war further demonstrated that massive public spending can stimulate demand, so that full employment can be achieved. Thus it left us with the legacy of a belief that government policy can manipulate demand to achieve a close approximation to full employment.

#### The Postwar Era

The postwar years have seen no major policy-imposed structural changes. What has taken place is an evolution and maturation within an economic environment characterized by a more active and massive use of fiscal and monetary policy tools than before. Whatever the reason, the years from 1946 to 1966 were economically successful. Business cycle and financial instability were much less in evidence than in any similar period of our nation's history. These twenty years were years of financial tranquility and economic success unique in the history of American capitalism. In many ways these years constitute a "golden age" of American Capitalism.

It was the belief of politicians, publicists and economists that World War II showed that an aggressive expansion of government demand can bring full

employment within the existing economic structure. In particular, the experience was said to demonstrate that the elementary Keynesian model, in which aggregate demand (i.e., Gross National Product and, therefore, employment) is a "multiple" of investment plus government expenditures, is an appropriate framework for the development of policy measures needed to achieve full employment. Within this framework the major structural problems are to develop government spending projects sufficiently large to allow government spending and taxation policies to act as the steering mechanism of the economy.

The Employment Act of 1946, which embodied the view that an appropriate set of governmental policy actions could achieve and sustain a close approximation to full employment may be seen as a victory for Hansen's contention that fiscal policy can guarantee full employment and that the structural features of the economy are of secondary importance. Trade unions and giant firms in particular were seen as minor obstacles to the success of a full-employment policy. They might impose a slight inflationary bias on a full-employment economy (virtually ignored in earlier policy discussion) and partly attenuate the employment effects of fiscal policy. The arguments of the TNEC that administered prices and rising profit margins can absorb and offset the stimulus from fiscal policy were disregarded in the discussions about the Employment Act and its implementation.

As a result the structural changes that have taken place since the end of the war have been evolutionary. The contract system and transfer payments have blossomed. Social Security payments expanded along with people reaching retirement age. In addition the social security framework was broadened to allow for early and disability retirement, and for the provision of medical

benefits. The evolution and expansion of the Social Security system combined with various special transfer-payment schemes: unemployment insurance, food stamps, government pensions, veterans benefits, etc., so that massive government spending independent of government purchases of goods and services became a major feature of the economy. By the mid-seventies the burgeoning transfer-payment schemes and entitlement programs posed the problem of designing a tax system able to generate the required revenues. The financing of programs that provide up to 15 percent of disposable consumer income by transfer payments predictably produced tax revolts and tax evasion. The victim of the tax revolts unfortunately have been government services provided by state and local governments rather than transfer payment programs.

The increase in transfer payments and in the taxes to fund them have affected labor supply and demand. While a one percent tax on wages and wage income is likely to have little impact on employment and labor supply, the effect of a six to seven percent tax is likely to be more than six times as great. A "retirement" income from Social Security equal to 10 percent of the earnings from employment will reduce labor-market participation somewhat, but a retirement income equal to 50 percent of employment income is likely to have a far greater effect.

Since World War II the contract system first introduced by the PWA and wartime procurement has been extended into new areas. Even as government spending as a percentage of GNP has increased, government employment as a percentage of total employment has decreased. Government spending in the form of contracts to ostensibly private employers rather than through direct hiring practices has created a vast number of private firms whose income derives almost exclusively

from sales to the government. Defense production, space technology, highway construction, medical services are the beneficiaries of government by contract. Under this system, a sort of socialism for the rich, the item purchased matters relatively little; what does matter is government spending as an end in itself.

World War II saw the introduction of higher, somewhat progressive personal income taxes and steep but not so progressive corporate taxes. After the war the tax rates were modified, but they never returned to the prewar level, in part because of the cold war and two active wars. Moreover, the economic success of near full employment and the high tax rates meant that government revenues tended to expand relative to spending during the fifties and early sixties. This introduced the doctrine of "fiscal drag" due to rising government revenues. An argument was made for the federal government's sharing its revenues with state and local governments: In the sixties and seventies federal grants-in-aid to state and local governments were introduced on a large scale. These revenue-sharing devices temporarily relieved state and local governments of the need for fiscal restraint and efficiency. Not only did localities embark on projects of questionable worth, but these programs gave rise to local special-interest groups who latched on to the partially subsidized spending. True, many grant-in-aid programs had desirable social goals, but if the economy were able to generate a close approximation to full employment the need for such programs would be much reduced.

As the postwar years wore on the emphasis of fiscal and monetary policy shifted from full employment to economic growth. This stress on growth had two sources: (1) a simple extension of the naive Keynesian model, and (2) a growing concern with the poor countries and a growing concern to aid in their

development. This change in emphasis brought various tax adjustments, culminating in an investment tax credit against the corporate income tax. The combination of investment tax credit and accelerated depreciation increased prospective cash flows from any level of output and "variable costs". The increase in prospective cash flows in an environment where a close approximation to full employment had been achieved raised the price of capital assets relative to current output and helped assure the safety of existing business debt and the adequacy of business debt-carrying capacity. The emphasis on investment and the steps taken to induce investment increased both the investment (or the investment plus government deficit) necessary for full employment and the willingness and ability of business to incur debt to finance investment.

In addition, the larger cash flows per unit of output that were implicit in current prices after taxes as corporate income taxes decreased fed back on and lowered the cash balances corporations kept as liquid reserves. This reduction in required cash balances meant that some of the financing for investment was made available from adjustments in portfolios.

The emphasis on investment led to an increase in debt financing and a decrease in the overall safety of balance sheets, even as expected cash flows became more dependent on higher investment and government deficits. Thus the stress on growth through investment tended to add to economic instability. Not only do investment-inducing policies tend to increase the share of profits in income--i.e., they have a regressive overall effect on income distribution--but they tend to foster instability by increasing both the amount of investment needed to achieve full employment and the dependence of investment on external finance. A financial structure conducive to instability is a corollary of

the emphasis on economic growth by way of investment introduced into policy during the sixties.

The ostensibly conservative Nixon-Ford administration carried through and extended the policy thrusts of the earlier postwar years. The only significant innovation of that period was the move toward the indexing of various government pensions and of government wages and salaries. The government turned into a passive acceptor of inflation. The various indexing provisions and the growth of programs like Social Security increased the so-called uncontrollable proportion of the government budget. The structure designed in the 1930's in the light of the 1930's understanding of what brought about the Great Depression to prevent another great depression had by the middle 1970's become a structure that was inducive to inflation.

#### Conclusion

The basic structure of business, labor, and agricultural markets that now rule was built during the New Deal and preceded the appearance of Keynesian economic theory as a significant factor in economic policy. This structure reflects the view that great depressions are largely the result of downward price movements and that markets should therefore be so organized that they can resist downward pressure on prices. Toward this end the government sanctioned and supported a wide range of private market power.

Within this structure big government, Keynesian monetary and fiscal policy, and, when needed, lender-of-last-resort intervention by the Federal Reserve have combined to prevent debt-deflation and deep depression. Measured solely by the criterion of the successful prevention of a deep depression, the post-1940 period may be seen as a uniquely successful era in modern capitalism.

True, the success achieved has had side effects, and as we enter the fifth decade of success there are signs that the side effects are becoming more and more serious. In particular, the combination of intractable inflation, the threat of financial instability, and the obvious inefficiency of big government are undermining the forty-year-old structure. The emerging problem centers on developing a set of institutions and practices that will remove the inflationary threat and do away with the more glaring inefficiencies. In pursuit of this goal reform cannot overlook the instability inherent in capitalism. Many proposals for reform assume that capitalism has stability properties which it does not now nor ever did possess.

In any program of reform we cannot ignore the success of the past forty years. We have not experienced a big depression. We have achieved this success with big government and positive derivative Keynesian monetary and fiscal policies within a framework that is pre-Keynesian both temporally and in its ideas about the system behavior of institutions. The institutional structure that would most readily lend itself to the execution of Keynesian policies has yet to be created. It is our purpose in the final lap of this journey to outline the institutional economic structure within which a sophisticated capitalist economy can achieve a closer approximation to a full-employment, stable-price-level performance than has been true since the middle 1960's.