

1985

## Chapter XV: Policy

Hyman P. Minsky Ph.D.

Follow this and additional works at: [https://digitalcommons.bard.edu/hm\\_archive](https://digitalcommons.bard.edu/hm_archive)



Part of the [Macroeconomics Commons](#)

---

### Recommended Citation

Minsky, Hyman P. Ph.D., "Chapter XV: Policy" (1985). *Hyman P. Minsky Archive*. 248.  
[https://digitalcommons.bard.edu/hm\\_archive/248](https://digitalcommons.bard.edu/hm_archive/248)

This Open Access is brought to you for free and open access by the Levy Economics Institute of Bard College at Bard Digital Commons. It has been accepted for inclusion in Hyman P. Minsky Archive by an authorized administrator of Bard Digital Commons. For more information, please contact [digitalcommons@bard.edu](mailto:digitalcommons@bard.edu).

	<u>Page</u>
A. Introduction	1
B. Big Government	8
C. How Big and What Kind of Government	18
D. Financial Reform	30
I. Introduction	30
II. Corporations and their Financing	37
(a) Introduction	
(b) Constitutional Weaknesses	
(c) Entrepreneurial Involvement	
(d) Prices, Monopoly Prices and Debt Validation	
III. Banks and Banking	57
IV. Central Banking	73
E. The Investment Bias in Policy	96
F. Taxation: The Pro-Investment Bias	112
G. Alternatives to Corporate Dominance	135
H. An Employment Strategy	150
I. Conclusion	172

## CHAPTER XV

### POLICY

#### A. Introduction

The policy problem is to change the institutional structure so that a closer approximation to full employment with stable prices than is now possible can be achieved. The twenty years between the end of World War II and the middle 1960's are a success story for capitalism: These years may very well be the "Golden Age" of market capitalism. Not only was a great depression or even a serious recession avoided but widely diffused and substantial improvements in those strands of living that are closely affected by private disposable income took place. This era of tranquil progress proved to be transitory: financial instability, inflation and rising unemployment have taken over in the years since the middle 1960's. The trend of annual improvements on a broad front of living standards has been halted and in some cases reversed: squalor and private impoverishment are now more common in otherwise affluent economies than was true not many years ago.

The contrast between the successes of the first twenty or so years after World War II and the increasingly unsatisfactory performances since the middle 1960's is striking; the development of an effective program of reform is made more difficult by this shift from success to failure. Reform cannot be based upon a categorical repudiation of what exists. Some of "what is" helped make the success of the fifties and early sixties possible, ~~and should be sustained~~. Other aspects of "what is" led to the failures of the late sixties and seventies, ~~and need to be dismantled and changed~~. The parts of the post-world War II economic struc-

ture and policy synthesis that led to the early on success need be sustained even as those structural and policy characteristics that are responsible for the succeeding "breakdown" are excised. Simple minded programs of reform, such as can be summarized in slogans, like "deregulation" or encapsulated in a formula like "money supply growth" just won't do. A subtle and sophisticated understanding of the strengths and weaknesses of modern capitalism, <sup>that</sup> have been revealed during the post-war era, ~~is necessary.~~ From the experience of these years it is evident that in a realm of overall financial robustness, when the financial system is stable, the apt use of fiscal and monetary policy - what the popular and standard text book usages characterizes as Keynesian policy - can steer the economy to a close approximation to full employment at stable prices. Under such robust financial conditions such policies lead to an overall performance of the economy that is not perfect but is good enough. In the late 40's, the 1950's and the early 1960's the combined response of the rather modest transfer payments system and the fairly progressive but not oppressive tax system acted as a well nigh automatic steering wheel that successfully sustained employment and aborted strong inflationary thrusts. // The success of this process by which fiscal measures "steered" the economy, depended upon the size of government. Government throughout the first twenty years after the second World War was big by the standards of the 1920's and 1930's, although not especially big by the standards that rule in the 1970's. Thus government may now be too big or it may have taken the wrong form. // Furthermore the financial environment changed. Even as big government is seemingly necessary for stability in a financially tranquil

economy, too big government, or a big government that does the "wrong" things or impacts markets in peculiar ways, may abet economic turbulence in a financially fragile environment. The "how big" and "what kind" questions with regard to government need to be faced. Big government sustains profits and stabilizes demand against downward pressures when private investment or consumption demand falls, even as, big government or more particularly growing government puts an upward pressure on prices, especially if, as has been true since the middle 1960's, government grows as lender of last resort interventions are forced by increased financial turbulence. The combination of a fragile financial structure, lender of last resort interventions and increasing government may be responsible for the change to apparent failure from apparent success of the economy and of policy.

Throughout the period up to the middle 1960's, monetary policy and changes in the money supply were clearly adaptive, they took place in response to the course of aggregate demand and were not major factors initiating changes in demand. Even though the progress towards liability management banking began soon after the end of World War II, the changes in financial market procedures and practices were not precipitous: they took time to emerge. During the first decade after World War II a general stability of prices was achieved in spite of the availability of excess reserves to banks and in spite of the asset structures that in effect made reserves freely available. At all times it is the "supply" of profit opportunities for banks and other financial institutions, rather than the supply of available financing" as measured by formulas, which set limits to bank deposit creation, that determines the growth of the money supply. This proposition that the causation runs from

profit opportunities in finance to the money supply is valid whether banking practices can be characterized as "asset management" or as "liability management", however it is perhaps clearer and more striking in a regime of liability management banking.

The emergence of financial instability as an attribute of the economy, that at times becomes the dominant factor in determining fiscal and monetary policy, coincides with the change of the behavior of the economy from the tranquility and progress of the first post-war epoch to the turbulence and stagnation, if not retrogression, of the second. In any structure of financial institutions and usages the likelihood of financial instability increases as the weight of speculative and Ponzi finance increases. But a shift of asset and liability structures towards a greater weight of speculative and Ponzi finance results from the reaction of business ~~men~~ and banks to profit opportunities from changing asset and liability structures that arise during a period of tranquil economic progress. Furthermore the normal way investment activity is financed has "Ponzi" characteristics. Thus the weight of speculative and "Ponzi" finance in the total financial structure will show a trend increase as the economy "passes time" in a tranquil prosperous state, even as the weight of "Ponzi" finance increases as a cyclical phenomena when an investment boom takes place.

It is apparent that whatever claims may be made for the stability and self-equilibrating characteristic of product markets cannot be made for financial markets. In particular endogenous disequilibrating forces operate in an economy with private ownership of capital assets and sophisticated financial institutions and usages. Finance cannot manage itself; if destabilizing forces are to be constrained and controlled rules and regulation to contain or offset the thrust towards increased ratios of speculative and Ponzi finance in the total financial

structure are necessary. The emergence of Central Banks as lenders of last resort was a response to the endogenous instability of financial markets; another result of financial instability <sup>was the</sup> intervention of government to define ~~permissible~~ <sup>tted</sup> contracts in financing special types of activity such as home ownership and the ownership of stock market shares. Regular intervention to guide the evolution of financial markets <sup>so</sup> that <sub>1</sub> the thrust towards instability is moderated is necessary.

A program of reform in the light of the successes and failures of the American economy - and other advanced capitalist economies - during the past 35 years needs to come to grips with the strengths and limitations of the market mechanism for guiding and coordinating production. Fundamentally ~~de~~centralized markets are fine social devices for taking care of the "unimportant" details of an economy, but they are highly imperfect devices for taking care of important big economic attributes. First of all even in commodity production and pricing the market mechanism is a weak instrument for guaranteeing efficiency in those cases where large scale expensive capital assets are used in production. In part this reflects the "bankers" insistence upon the protection due to "market power" whenever large scale investment projects or expensive special purpose capital assets are financed; in part this represents the indeterminacy of particular prices when complex capital assets are used to produce a variety of outputs for a large number of markets. But most important is that once capital assets are used in production the labor, output and financial market processes that determine the prices of such assets and the supply conditions of investment introduce strong destabilizing forces into the system. Government intervention and regulations are necessary to keep the instability within tolerable limits.

Investment is closely associated with profits. Government, either by intervening to sustain or increase investment or by running deficits when investment falls short of that which is required to yield full employment, sustains and augments the profit share in income. Any government policy toward investment or its <sup>also</sup> deficit is a policy on the share of <sup>in income</sup> profits. Thus in a modern economy - where intervention exists - government always has an incomes policy, whether it knows <sup>it</sup> or not. In particular, any government policy which aims at increasing the proportion of investment and of the government deficit in income tends to raise profits as a proportion of income. If the profit <sup>and deficit</sup> proportion is increased <sup>even as the supply of consumer goods remains fixed or declines</sup> when the economy is working at a close approximation to full employment, there will be a tendency for the real wages of workers to fall. In ~~our~~ modern economies any tendency for real wages to fall because prices rise will induce a tendency for money wages to rise.

There are therefore are at least four principles that should guide economic reform:

(1) Big government is essential if business cycles which entail depression are to be avoided, but too big government, especially if the growth of government take place when lender of last resort interventions <sup>are</sup> as required, can be disruption.

(2) Financial markets and institutions require supervision, guidance and control if the thrust towards financial instability is to be constrained.

(3) Competitive output and labor markets are efficient and effective coordinating and control devices ~~to~~ the extent that the capital asset requirements in production and trade are modest.

(4) Once government is big the thrust of its policies will affect the distribution as well as the size of income.



In addition to principles to guide policy derived from economics considerations, policy need reflect a vision of the "good society". There are alternative ways to conform to the "policy principle" derived from economic theory.

It is necessary to set this vision of a good society out in at least broad form before a program of reform can get down to specifics.

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

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

Efficiency is an elusive goal. It is easy to jump to the conclusion that a simple minded competitive exchange economy is efficient. In the process of reaching this conclusion the very special assumptions of economists about the nature of "man" limit efficiency ideas to efficient in what is bought and sold on markets. In particular the peculiar notion of income, in which the costs of treating an environmentally caused disease is income but the value of ~~the~~ "disease prevention" due to environmental controls <sup>es</sup> do not enter measured income is ~~but~~ a trivial illustration of the illusiveness of the concept of efficiency. Long before national income was firmly set as a measure of economic success and thus efficiency, Thomas Love Peacock in Crotchet Castle had The Rev. Dr. Folleott remark: ". . . the nation is best off, in relation to other nations, which has the greatest quantity of the common necessities of life distributed among the greatest number of persons; which has the greatest numbers of honest hearts and stout arms united in a common interest." Beyond defining the aim of economic policy as the attainment of universal material minimums and a wide dispersion of interest sustaining work, ideological considerations do not carry economic policy very far.

#### B. Big Government

The most important difference between the capitalism that rules in the United States and other capitalist economies in the years since the second World War and the capitalism that ruled at the time of the Great Depression is that government is now big. The existence of big government has implications for those dimensions of economic policy that deal with institutions and market structures. In many cases the existence of big government has made government and private institutions and usages that were adopted in an effort to prevent a plunge

of the economy into deep depression obsolete. This is so because with big government a sustained deep depression cannot occur. Furthermore many institutions and usages reflect what can now be characterized as "false", erroneous or obsolete ideas about how capitalism works. Many institutions and usages reflect ideas about how small government capitalism worked and are quite irrelevant for contemporary big government capitalism.

However there are endogenous destabilizing forces at work within big government capitalism which have resulted in the generally unsatisfactory performance of the years since the middle 1960's. This unsatisfactory performance has been variously labeled as "stagflation" or "slump flation" in which there are sharp threats of a debt deflation process followed by lender of last resort and fiscal intervention which lead to periods of high unemployment and rising prices. Thus a big government capitalism needs an institutional structure which minimizes the thrust towards fragile financial structures, assures a close approximation to full employment, and encourages competitive market behavior which tends to put downward pressure on prices. Thus even as a good part of the institutional structure which is a legacy of the 1930's needs to be dismantled a new institutional structure consistent with the demonstrated power of big government capitalism to avoid deep depressions and the obvious susceptibility of big government capitalism to chronic inflation and persistent unemployment needs to be erected.

Big government with its automatic massive deficit makes a thorough going debt deflation impossible because big government sustains business profits. With profits sustained on the whole the cash flows to sustain primary business debt will be forthcoming. With primary business debt validated, the mass

of the debt of financial institutions will be validated. Thus financial intermediaries will never be in the collective bind that they were in during the great depression. This means that the flow of financing from private financial institutions will not be halted.

With a thorough going debt deflation impossible the constraints upon bankruptcy that were intruded into the economy can be eliminated. In particular special government intervention to sustain a particular organization by concessionary finance is not necessary. Individual banks and non-bank financial institutions can be allowed to fail, for no matter how serious the individual failures may be the sustaining of business profits at a high level will prevent a generalized failure of banks and other financial institutions. In particular the Central Banks of this world should not intervene to protect any particular institution from the folly of its operations, but should only intervene when a market fails. To use history as a guide, Franklin National should have been allowed to become insolvent when the run occurred on its London liabilities and marketable certificates of deposit. Intervention should have taken place to support the total volume of funds available in the London ~~market~~ and ~~the~~ New York wholesale certificates of deposit markets. Furthermore with overall liquidity sustained, the Federal Deposit Insurance Corporation should have stayed within the letter of the law in its treatment of Franklin National's liabilities. Once again with a comprehensive debt deflation impossible, the need to protect against debt deflation by protecting individual units becomes not only unnecessary but "perverse".

Another aim that government policy with respect to debt deflation and bankruptcy should pursue is to revive the possibility of "depositors loss" due to the poor performance of any particular financial institution. If depositor loss is possible, then depositor surveillance over institutions will be

revived. Just as all "bonds" do not have the same "rating" so all bank certificates of deposit will not have the same rating. In particular ~~uncovered~~ market participants, <sup>not covered by insurance</sup> will be concerned about the capital adequacy, assets and liabilities of the institutions they patronize. Thus a strict statement of what is covered and what is not covered by deposit insurance should be written into the law and <sup>the</sup> F.D.I.C. should not use its resources to facilitate a total validation of the liabilities of failing institutions.

Because big government makes a thoroughgoing debt deflation impossible it means that any recession or depression that takes place because of financial instability will not last long. Thus policy can safely hazard a bit deeper recession if the deeper recession encourages portfolio preferences that act as a barrier against speculative and Ponzi finance in the subsequent expansion.

Thus because big government makes a serious debt deflation impossible policy can use the possibility of losses by the owners of liabilities of financial institution as a barrier against the relative growth of speculative and Ponzi finance. In a world where banks are allowed to fail even as profits in the aggregate are sustained and lender of last resort operations prevent the failure of financial markets because of runs deposit insurance from a public agency might very well remain, but the coverage should be restricted to household size deposits. Deposit insurance can very well become a rather minor function of the Federal Reserve Systems. Large deposits by households and business should become assets at risk; the assumption should be that if you are ~~rich~~ <sup>rich</sup> you are sophisticated enough to select the institution at which you leave funds and the form in which you hold funds.

Big government makes massive sustained unemployment impossible. This is so not only because big government is an

employer but also because output must be such that the profits on output offsets any government deficit. Thus given the level of "mark ups" per unit of output the level of consumer and investment goods output must be such that the volume of output times the mark ups equals the deficit plus investment (with corrections for the balance of payments, workers savings and consumption out of profits, etc.) Given the level of output the level of employment is determined. As long as profits cannot deteriorate too far, employment will be sustained.

Once massive sustained unemployment is impossible, then the various institutions and usages designed to restrict labor force participation can be eliminated. Child labor is obviously not "desirable" - but neither is the enforced "school only" option for young adults. As long as the junior college system is in place opportunities ~~will~~ exist for adults to resume their education even though it had once been interrupted. A move towards an earlier entry into the labor force might be highly desirable. Devices that aid the move from schooling to the labor force need to be developed for those who find continued schooling unappealing.

Symmetrically the retirement of older workers by "mechanical formula" rather than by choice becomes an obsolete institutional usage once employment can be adjusted to fit labor force participation. Thus social security can be reformed to allow a series of options for retirement: in particular <sup>fully</sup> ~~actually~~ sound differential social security payments which allow for choice of the retirement age <sup>needs to</sup> ~~can~~ be developed. Just as an economy in which a fairly close approximation to full employment is assured can welcome the young into the labor force, so such an economy need not force older workers into retirement.

At present in order to receive "aid to families with dependent children" the mother recipient either has to be

out of the labour force or her participation is limited. Although this "restriction" is not a device that overtly aims to limit labor force participation, it nevertheless functions as a barrier to participation by those who would lose a guaranteed income if they enter the labor force and take their chances on employment. Comprehensive reform of the childrens allowance and cash grant scheme is obviously called for. One way to approach the problem is to have a universal, tax exempt childrens allowance even as the income tax deduction for children is eliminated. Once this is done then there need be no barrier to the "working" of mothers who are now receiving aid. Programs and institutions which facilitate part and full time work by mothers, whether or not they are welfare mothers, should be intruded into the institutional framework.

Big government makes a massive across the board decline in quasi-rents earned by capital assets impossible. Because a massive across the board decline in quasi-rents cannot occur the "uncertainty premiums" used in discounting quasi-rents cannot rise precipitiously. Thus the value of capital assets and of financial instruments cannot fall very far. Because big government protects asset values in general there is no need for government to protect particular asset values.

One aspect of the great depression was that a comprehensive collapse of asset values and of the cash flows that assets yielded took place. As a result private provision of income for retirement ~~was~~<sup>were</sup> in many cases "wiped out". The socialization of retirement income was a response to the collapse of profits and asset values that took place during the great depression. In a world with loose family ties, it is neither desirable - nor is it politically feasible - to eliminate social security, but social security need no longer be a "complete" retirement package. Social security can become a flexible provider of a

flow of cash receipts. In addition social security should not be a bar to employment. In a big government world social security can be reformed into a relatively modest floor to income for the aged. A floor that can be supplemented by both income from work and income from privately owned assets.

Big government assures that in the aggregate the detailed demands will not collapse. Such on the whole stability of demand conditions facilitates the operations of a free market capitalism. This is so because if in the aggregate profits from using capital assets are assured then the attempt to protect capital asset profits and values by means of market power is redundant and ineffective in the aggregate. Furthermore because the aggregate value of capital cannot fall very far, the value of existing capital need not be protected by restricting entry in order to prevent a collapse in asset values. All of the intrusions of constraints into pricing that were designed to prevent too great price declines are redundant once government is big enough so that a deficit will sustain the dollar value of profits in the face of a sizeable decline in investment.

Thus the "socialization" of investment of which Keynes wrote in The General Theory is largely a way of guaranteeing that the short run profit expectations of business men and bankers are such that production with current resources will yield a close approximation to full employment. The 'socialization of investment turns out not to require that government decide what kind and how much investment should take place; the socialization of investment really takes the form of so setting the structural characteristics of the economy that the size of aggregate profits that capital assets yield is virtually assured. In the United States and the rich European countries the chosen instrument for guaranteeing profits are the transfer payments schemes of the welfare state.



The stability of aggregate demand that is assured by big government leads to market conditions ~~are~~ favorable for the entry of new firms and the adoption of new techniques. If a free market economy is to function well then institutions must facilitate new entrants who, because <sup>of</sup> their limited assets, need economize in the capital they use. These new entrants as they operate to carve out markets will tend to decrease and destroy the value of existing capital assets. In a free market capitalism there is constant pressure by upstarts and new firms on the value of existing capital assets; the new firms and the new men who organize these firms are typically capital poor and thus their efforts will be biased towards techniques of production that economize on capital.

However not all productions can be carried out by techniques that economize on the use of capital assets. There are productions which require expensive and extensive investments - energy production, petro chemicals, communications - come to mind. In some industries - electric energy production, transportation and communications - a large degree of regulation if not public ownership is the norm. As was pointed out, the finance for large agglomerations of capital assets will not be forthcoming unless the "financiers" are assured that prices will exceed out of pocket costs by a goodly margin so that the "bonds" can always be validated. Thus the finance for large capital intensive investment will be more readily forthcoming in a regime in which the possibility of depressions has been attenuated than in a regime where depressions are viewed as "clear and present" dangers. However even in regime ~~of~~ which <sup>s</sup> <sub>4</sub> contains the possible fall of aggregate profits those productions in which most of sales revenues are assigned to the validation of debts and capital asset values will still require some protection against

prices declining towards out of pocket costs.

Given that regulation is an awkward procedure, that massive capital-asset investments will not be forthcoming without a guarantee that price competition will not rule, and that the mark up on out of pocket costs, for outputs in which the revenues needed to validate capital asset prices are the major part of total required revenues, are equivalent to taxes, it is best to opt for outright government ownership of these capital assets.

Government ownership is the only viable option if the operation of a complex expensive capital asset entails a significant risk of external community costs - if there are health and safety considerations in the design and operation of these plants. The Harrisburg incident of the Three Mile Island plants shows that the horrendous interest cost and foregone revenue implications of down time implies that every decision procedure in which shutting down is an option will be biased against the decision to shut down. Instead of an operating anomaly leading promptly to a decision to shut down, an operating anomaly leads to a search for adjustments and explanations that obviates the need to "shut down".

Thus the argument about how the need to validate capital asset prices by profit flows leads to the conclusion that for expensive large unit capital assets which involve large external possible costs as well as external possible benefits the economical and safe alternative is to remove the choice as to whether to build and how to operate such assets from private, profit oriented markets. Nevertheless in the decisions to build such capital-assets and then to operate these assets, the commercial principle that revenues should validate costs - including the return and redemption of bonds - should rule. The mark up

on out of pocket costs is a tax - but the rule that the current operations need validate the past determines the level of the tax. However where externalities exist - either benefits or costs - then the rates can be set lower or higher than that needed to validate bonds and the cost of the investment good.

Once a portion of the capital assets whose output is distributed on the basis of fee for service is formally socialized, then a portion of investment output can be independent of market conditions. However this is not necessarily wise. In a regime of big government the start up and completion time of the investment output that enters into capital intensive production is so long that such outputs are poor vehicles for contra cyclical policy. The relevant socialization for economic policy is the social control of the conditions that determine aggregate profits - not the public ownership of particular capital goods. The argument for the public ownership of operations that involve large expensive capital assets with benefits and costs that are not directly related to the service rendered involve monopoly and the problems of running such plants so that potential external costs are "minimized" or potential external benefits "maximized".

The emergence of big government capitalism has changed the cyclical behavior of a capitalist economy. As a result the protections against debt-deflation, price level declines and falling wages that were intruded in the structure of the economy in the aftermath of the 1929/33 debacle are redundant <sup>and</sup> ~~but~~ they tend to exacerbate the inflation and stagnation problems that have emerged. New institutions are needed which promote employment even as they facilitate falling prices. Thus the policy problem is to dismantle the redundant institutions and create relevant institutions. But first we need turn our attention to the question of how big is big enough and what kind of big government is needed.

## C. How big and what kind of government

The fundamental question for economic policy is how big should government be and what should government do. Government must be big if a market capitalism is to keep disruptive cyclical forces within bounds but simultaneously that government is best which governs least in the special sense that competitive markets are the mechanism that are used to control and coordinate the details of economic life. This apparent paradox is resolved when it is recognized that whereas product markets can often "manage themselves", money and financial markets - and thus the market for capital assets - contain strong endogenous disruptive or disequilibrating forces. Big government is needed to establish a framework which guarantees a floor to profits ~~flow~~ even as it constrains an undue explosion of profits; even as *it is* <sup>recognized that</sup> government intervention, other than by broad and easily administered taxes, <sup>and subsidies,</sup> into the details of prices, outputs, and individual incomes is both difficult if not impossible to administer without waste, inefficiency and evasion.

The question now becomes how big is big enough and what form should big government take. Government must be big enough so that whenever private demands fall short of the level which yields sufficient profits to in general validate business debts and the prices that business paid for capital assets, the government runs a large enough deficit so that aggregate profits are sustained. Symmetrically government must be big enough so that when private demands expand too fast or too far a government surplus is generated which has an appreciable constraining effect upon aggregate business profits. Thus the potential budget deficit or surplus must be a large proportion of gross investment; how large is large?

We know that the "deficit" was large enough in 1975 to "turn" a precipitous decline around and we know that the deficit was not large enough in 1930 to turn the economy around. In 1974 current dollar gross national product was in the neighborhood of \$1,400, X 10<sup>9</sup> of which gross private domestic investment was \$215 X 10<sup>9</sup>: gross private domestic investment was about 15% of GNP. In 1974 U.S. Federal Government budget outlays were \$270 X 10<sup>9</sup> and the deficit was \$5 X 10<sup>9</sup>. In 1975 budget outlays were 326 X 10<sup>9</sup> and the deficit was \$45 X 10<sup>9</sup>; Federal budget outlays were about 20% of GNP in 1974 and 1975.

In 1929 current dollar gross national product was \$103.1 X 10<sup>9</sup>. In this year gross private domestic investment was \$16.2 billions; again gross private domestic investment was 15% of G.N.P. In 1929 government outlays were 3.1 X 10<sup>9</sup> or about 3% of Gross National Product.

The above sets "limits" on the size of government in our economy. Given that gross private domestic investment - the key private activity that generates profits - is in the neighborhood of 15% of Gross National Product - government whose outlays are 3% of Gross National Product is too small. We also know from the experience of 1974/75 that Government budget outlays that are 20% of G.N.P. can generate a deficit that sustains profits in the face of sharp declines in investment. As the attached table shows

	1929	1930	1974	1975
Private Investment	16.2	10.1	215	184
Government Deficit	- .9	- .9	<u>05</u>	<u>45</u>
Total	15.3	9.2	220	229

in 1929-30 the Federal Government sustained a surplus in the face of a more than 1/3 decline in investment. In 1974/75 when investment fell by ~~less than~~ <sup>about</sup> 15% the government deficit "jumped" by some \$40 billions: the increase in the government deficit more than offset the fall in private investment. Given that the 1974/75 gross national product was in the neighborhood of \$1,500 billions a depression deficit in the neighborhood of 3% of G.N.P. ~~seems~~ <sup>was</sup> sufficient for the job of sustaining income.

If we look at the era of sustained "prosperity" - 1945-65 - we see that government was "big" by the standards of 1929/30 though it was smaller than in recent years. During the first several years of this period, government outlays were distorted by the aftermath of World War II. Thus let us look at five year intervals beginning with 1950.

Year	G.N.P.	Private Domestic I	Government Outlays	Approximate % to GNP	
				Private I	Government
1950	284.8	54.1	43.1	20	15
1955	398.0	67.4	68.5	17	17
1960	503.7	74.8	92.2	15	18
1965	684.9	98.5	118.4	14	17

It is clear that Federal Government outlays in the neighborhood of 15% to 20% of the normal or capacity G.N.P. are large enough to generate a deficit that offsets the effects of investment variations upon aggregate income.

However it is the "deficit" and not the size of government that is important in sustaining profits - in particular the deficit should rise rapidly whenever the other profit generating influences tend to decline and should fall whenever the profit inducing factors tend to rise. Furthermore the government deficit should rise whenever employment tends to decline relative to the labor force and fall whenever employment tends to rise relative to the labor force.

Because the budget deficit relation is stated as an unemployment/labour force relation, policy as embodied in institutions that affect labor force participation will be important determinants of the size of the desired or target change in the deficit. Thus if employment increases rapidly even while labor force participation increases equally rapidly - so that the overall unemployment ratio remains unchanged <sup>and</sup> ~~then~~, if this overall unemployed ratio is deemed unsatisfactory <sup>then</sup> fiscal policy should aim at increasing profits and thus output and employment. Government must be big because only a big government in being can have the automatic expenditure increasing tax decreasing effect that is needed to sustain profits when investment falls. Once it is known that "big government" can turn a threatened recession around, it can be argued that there is no need to have a "big government" in being at all times. Whenever the need for government intervention to support profit does arise, government can increase as needed. However, this will not happen automatically: there always will be a "political" discussion as to whether the intervention is needed and there always will be a start up time for any project. Furthermore a small government in being means that there is no practical possibility that a reduction in tax receipts will do at least part of the job.

Negative income taxes are possible, but the practical possibility of a tax law in being that would provide for large negative taxes is quite remote.

Furthermore the symmetric possible use of a large government surplus to control inflation also argues for a tax system that gathers a large proportion of gross national product and which is responsive to changes in prices and employment. Thus it seems as if a Federal Government budget in the United States that is a somewhat larger percentage of gross national product than the ratio of gross investment to gross national product is perhaps apt. Furthermore the greater the responsiveness of taxes and expenditures to the shortfall or excess of unemployment rates from a close approximation to a stable price level full employment, the smaller the relative size that government could be.

The government budget can be divided into three parts. One part consists of those expenditures which are not deemed to be responsive to variations in income. This includes not only the costs of general government administration, defense and the basic income transfer system but also the investment expenditure of government enterprises (one should not step up or cut back on nuclear power expenditure or the maintenance and improvement of the road network just because overall unemployment rates are too high or too low).

The second part consists of those government expenditures which will increase whenever income and employment fall short of the targetted level and fall whenever the level of income and employment rises above the targetted level. Unemployment insurance does react in this way - and so do the other means or status tested transfer payments schemes. However aside

---



from unemployment insurance and the means tested welfare type schemes the other transfer payment schemes should not - although they do - react in an appropriate way to unemployment. There is no reason why the decision to "retire" should be related to the aggregate unemployment rate.

However an in being permanent structure of public employment schemes at the minimum wage would react promptly and appropriately to the changes in private employment. If such a scheme<sup>are</sup> is in being then the various income maintenance ~~schemes~~<sup>devices</sup> that are "means tested" can be reduced in size and significance. If such a permanent employment thrust is combined with a universal childrens allowance then the welfare system which fosters dependency relation can be reconsidered.

The third part of the government consists of tax and other revenue measures. A government budget that is some 15% to 20% of Gross National Product need not require an oppressive set of taxes. The tax system should be responsive to variations in income and employment.

Unfortunately the tax requirements due to the balance of payments implications of the United States dependence upon energy in general and offshore energy in particular impose both constraints upon spending and taxing. Harrisburg made it clear that if nuclear energy is to be part of the total energy system, the ownership of the nuclear power plants cannot be left to private utilities. There is an important administration and organizational question as to how the nuclear plants are to be managed by a public authority, but Harrisburg made it amply clear that the system of private ownership and operation just won't do.

If nuclear power plants are shifted to the 'public' domain, then there will be substantial investment programs by that government that, because of long time taken by the production of the investment goods, cannot be used as a vehicle for government cyclical policy. Furthermore because of the nature of nuclear power plants, the nuclear plants are "base producers" of electricity; the revenues received by the government authority will not be cyclically variable. If as seems desirable, the United States moves to a broad array of fully nationalized industries (nuclear power production, a "national" oil company, most, but not necessarily all, railroad and a system of Public Broadcasting) <sup>as a minimum</sup> the expenditures and receipts of these sectors should be removed from the government budget aside from the provision of equity funds to finance investment and operating subsidies that reflect clearly defined social and economic purposes.

The "oil crisis" argues for a serious excise tax on either all of oil or gasoline. Such a tax should be set so that in the middle 70's it would have yielded from \$80 to \$100 billions. This would have been about 1/3 or 1/4 of the total government budget. The receipts from taxes on oil, in general, or on gasoline in particular, would be a bit, but not too, sensitive to variations in income and employment.

The need for an "oil crisis tax" of course opens the way for serious tax reform. In particular given that the government size is prescribed it would require a cut in other taxes. Unfortunately from the point of view of the responsiveness of

government revenues to private employment, the best candidates for a tax to be eliminated is the payroll tax used to finance social security. This tax is regressive and by raising the cost of labor acts to constrain employment. Furthermore it is a cost of doing business and therefore shows up in product prices. A non-inflationary solution to the need to amplify OPEC prices to restrain demand by taxes is a reduction in those taxes that directly show up in product prices. Inasmuch as the other excise taxes such as tobacco and liquor are minor revenue yielders - they could well be abandoned by the Federal Government - the major tax that can offset the excise tax on oil and reduce prices is the payroll tax.

The core of the revenue system should become a modernized and updated income tax, which quite clearly <sup>taxes</sup> the incomes of persons and families regardless of the source, <sup>and a value added tax.</sup> ~~Thus~~ Transfer payment receipts, the per share earnings of corporations regardless of whether they are paid in dividends, and the value of "owner occupied housing" should all be included in taxable income. Once the per share earnings of corporations are imputed to households the rationale for the corporation income tax disappears.

A simple but thorough income tax system, which is fairly progressive in the range of incomes that includes profit receivers and well paid workers, should be quite responsive to variations in employment and income. Inasmuch as the ~~elimination~~ of the employers tax for social security has been eliminated because of its impact upon employment and prices, the employe~~e~~'s contribution should be integrated into the income tax. It is not administratively difficult to take a part of the tax - say some 5% <sup>of taxable income</sup> ~~on wages and salaries~~ - and credit it to individual social security accounts. However as all forms of household

income should be in the tax base, including social security and other transfer payments, the tax schedule could very well be that the "exempt income" is set at the normal social security or employment program income. A large tax exempt income means that the rates will have to be a bit higher and bite a bit more deeply on the margin on incomes above the exempt base than would be true with a lower exemption. But such a higher average and marginal rate on incomes that would vary with the trade cycle increases the efficiency of the government as a stabilizing device.

One aspect of an income tax that is integrated with the taxation of per share profits in lieu of a separate corporate income tax is that the maximum tax rate on personal income effectively determines the ratio of retained earnings to corporate income and incidentally the maximum rate of growth of "equity" by means of retained earnings. Thus in 1975 the gross profits before taxes of corporations\* was \$203.9 billions of which some 89.4 was counted as "capital consumption allowances" leaving \$114.5 billions as the net profits before taxes. Corporations paid \$49.2 billions in taxes which left a \$65.3 billions after tax profits. A net dividend of \$32.1 billions was paid so that the growth of corporate equity by means of retained earnings was \$33.2 billions.

If the maximum income tax were set at a 70% ratio then

---

\*Source: Statistical Abstract of the United States 1977  
Table 927, page 567.

all corporations with very rich stockholders would be <sup>"forced"</sup> "freed" to pay 70% of their earnings in dividends if they were to supply the cash by which these very rich stockholders would pay their tax liability. Thus using the above figures some 70% of the after tax profits or \$81.15 billions would have been paid in dividends, leaving \$33.35 billions in retained earnings. The end result is pretty much the same in terms of the retained earnings of corporations.

A tax system that taxes income from ownership of corporation stock by imputing per share earnings to the share holder regardless of dividends paid will likely lead to some loss of revenue. Apparently the top 1/2 of all wealth owners own about 50% the total corporate stock held by persons in the United States. If we assume that this means that one half of the impute stock income will be taxed at the 70% rate and one half at a 40% average rate the total tax take from the ~~\$~~114.5 billions of corporate profits would be \$63.0 billions. In 1975 the corporate profit tax was 49.2 and the personal income tax on 32.1 at the 70%/40% split was 17.8 for a total of 67.0 billions. A four billion dollar loss in revenue from clearing up the ambiguities of the profits tax is a small price to pay for reform.

If the rate of return on "equity" (the inverse of the price/earnings ratio) is between 10% and 15%, then the 70% pay out requirement virtually imposed by the tax system would lead to a maximum growth of retained earnings by large and giant corporation of some 3% to 4.5%. On the other hand small corporations whose shareholders tend not to be <sup>as</sup> rich, earning the same rate of return on equity, might very well be required by the

tax situation of their shareholders to pay out some 50% of their earnings. Thus a tax bias favoring the growth through retained earnings of smaller corporations might well be a beneficial side effect of such an integrated tax system.

The question as to how big a government is needed has lead to the tentative conclusion that government must be big enough so that its potential deficit or surplus when income and employment falls short or exceeds that which is consistent with full employment at stable prices should be a sizeable proportion of full employment investment. This seems to imply that a government whose taxes and revenues are some fifteen to twenty percent of gross national product is sufficient; furthermore the more responsive the tax and expenditure system is to variations in employment and profits the smaller the "full employment" government need be.

The what kind side of the dual question about big government is that the government need not be big by way of nationalized industries or by means of extensive administrative interventions into economic life. There are ample grounds in efficiency and due regard for the public safety and well being to nationalize all or part of various industries such as nuclear electricity generating, railroads and oil, but if such industries are nationalized they should be treated not as "government" but as "public enterprizes" in which the government involvement, aside from chartering, is the furnishing of equity capital and well defined subsidies so that the "fee for services" induce desired behavior *by users of the public enterprise.*

Government should be big by means of some base transfer payment schemes such as a childrens allowance<sup>\*</sup> and a base social security scheme, which as a percentage of GNP could be smaller than the 6% that ruled in 1976. However, both Social Security and a childrens allowance are base schemes that should not vary appreciably with ~~GNP~~ cyclical changes in G.W.P..

Presumably defense is another 5% to 6% of GNP and general government net of defense could well be cut back to 1% or 2% of GNP. This leaves us with some 2 1/2% of GNP or 40 billions of dollars in 1976 figures that are available, some half for general subsidies to modify the workings of the price system and some half for a permanent employment strategy effort.

Given a wage cost of some \$5,000 per year per person a W.P.A. effort that employs 1 million or so in times of full employment and which subvents the employment of some 4 million young, old, and part time workers at some \$2,500 a year will cost about \$15 billions. For each million of unemployed who join the program when income declines there will be a \$5 billion increase in costs. Thus a rise from a 4% full employment, unemployment rate to a 7% - 8% depression rate will lead to about a \$15 to \$20 billion rise in spending.

---

\* A childrens allowance of \$600 per month in 1976 would have amount to some \$40 billions of which \$8 billions would have been recaptured in increased income taxes. This \$40 billion dollar gross cost would have been some 2 1/2% of gross national product.

This flexible expenditure program need be combined with a tax system heavily weighed by income and value added taxes so that a <sup>rise</sup> use in the unemployment rate from 4% to 9% would lead to a 10% decline in tax revenues.

Thus the Federal Government need not be oppressively big if it is to act as a fiscal steering wheel. The tax system and the public employment projects act as a "steering wheel" which tend to guarantee that a catastrophic fall in profits will not take place.

#### D. Financial Reform

##### 1. Introduction

The legislation and regulations that affect the financial institutions and usages of an economy that mainly relies upon decentralized markets to determine the details of output and which allows the private ownership and profit seeking management of means of production must be based upon an awareness that capitalist financial practices are disruptive in that their <sup>evolution</sup> ~~production~~ ~~tion~~, when the system is functioning well, leads to conditions conducive to booms and depressions. As long as an economy is capitalist it will be unstable. Once the decision is made to be capitalist the policy problem is how to make the best of a flawed system.

External finance and specialized financial institutions tend to amplify the unavoidable, within-capitalism, cycles in investment. Even though a capitalist economy with sophisticated financial institutions is inevitably unstable, the consequences of this instability are affected by the institutional structure; thus instability means a deep depression after 1929/33 and stagflation in the years after 1966. The task of legislative and administrative intervention is to develop institutions and practices which tend to attenuate the tendency of the economy to



generate business cycles or stagflation. Standard manipulative monetary and fiscal policy can be interpreted as attempts to ameliorate the cyclical tendencies of the economy without overtly modifying or controlling the structure of financial practices and institutions. Various programs of reform of finance that were proposed during the 1960's and early 1970's looked to efficiency and perhaps equity considerations in the design of institutions - they were not mainly concerned with the impact of institutional structure upon the stability of the economy.

Economic policy - when its scope is extended so as to include the adjustment of institutions and practices - must be based upon an awareness that perfection - in the form of an absence of even a <sup>decreased</sup> tendency towards business cycles - cannot be achieved. The economic behavior which tends to generate business cycles cannot be eliminated as long as an economy is capitalist. The best that can be achieved is an attenuation of the thrust towards serious instability and an amelioration of the pain due to the instability which remains in spite of best efforts. Because financial practices are linked to capital-asset ownership and the financing of investment to the structure and practices of financial institutions, the industrial institutions and usages of an economy must be consistent one with the other. What is needed is a 'system of reform' rather than isolated adaptations.

The history of the American economy is punctuated by the occurrence of deep depressions. The deep depressions of history were associated with the rupturing of financial relations and the destruction of institutions as the prices of financial assets and real capital-assets fluctuated relative to the prices of current output. Each big depression therefore 'reformed' the institutional structure. Furthermore big depressions were often followed by eras of reform designed to "correct" the struc-

ture. The history of legislation with respect to money, banking and finance of the United States can be interpreted as a "search" for a structure of financial institutions and practices that would not exhibit destructive instability. Although no deep depression business cycle has occurred since the Great Depression of the 1930's, three near misses and partial financial crises have occurred in recent years. The events of 1966, 1969/70, and 1974/75 show that the fundamental financial processes that lead to financial crises and deep depression cycles are still going on. Federal Reserve action, as lender of last resort, was important in aborting these thrusts towards major instability, but in doing this the Federal Reserve protected the institutional structure that facilitated the instability. Because "markets" are not permitted to go through a debt deflation process, the economic and financial structure becomes laden with weakened institutions that were supported by special financial intervention. In an economy in which debt deflations and deep depressions do not occur because the Central Bank (perhaps in the form of the government or even 'private' business playing a Central Banker's role) refinances and gives concessionary treatment to threatened organizations, the Central Bank and the legislature need control, guide and "prune" the institutional structure so as to constrain and eliminate institutions and practices that are conducive to financial instability.

A program of financial reform designed to attenuate the tendency towards financial crises has to begin by considering if any changes are necessary in the way in which investment and positions in the stock of privately owned capital-assets are financed. The questions that need be addressed are how the techniques by which producing units finance investment and control over capital-assets leads to instability and what changes in

financing techniques are needed if instability is to be decreased. In our economy business corporations are the dominant private organizations that control capital-assets and order investment output. Thus the financial rights, privileges, and practices of the business corporation is a starting point for any consideration of how the cyclical flaw in capitalism can be attenuated.

The Federal Reserve System has its origins in the view that the lack of a flexible currency under the National Banking Act was mainly responsible for what went wrong in the various financial crises of the late 19th and early 20th century. The felt need for a money supply that responded to the needs of business together with the recognition that banks and money market institutions need a guaranteed refinancing source gave rise to the Federal Reserve System. The current doctrine, associated most directly with monetarism but also embodied in the views of less doctrinaire economists, which holds that the Federal Reserve primary function is to control the path of income by controlling the money supply was not of great import at the time the Federal Reserve was organized: ~~The~~ Federal Reserve was organized to control instability. Given that instability continues to be a serious problem for our economy, a program of reform of financial institutions and financial practices should aim at reducing both the thrust towards and the amplification of instability that comes from financial practices. Inasmuch as the Federal Reserve system <sup>has to intervene whenever the financial system</sup> threatens to enter a serious debt-deflation, the powers of the Federal Reserve and other competent authorities should be extended to enable them to intervene to prevent conditions and practices conducive to financial instability from developing. The Federal Reserve or other appropriate authority has to be concerned with the ever changing structure of financial relations. This stands in sharp contrast to the basic hands off policy with respect to financial usages and

institutions that now characterizes Federal Reserve behavior. The Federal Reserve should not be constrained to a limited set of operations within a financial structure but should be concerned about the evolution of financial institutions, and whether particular innovations in financial markets should be encouraged or discouraged.

Financial reform cannot be successful if it is undertaken in isolation - it has to be considered as a part of a system of reform. As long as main objective of policy and of the design of economic institutions is to facilitate investment, in the hope that growth of measured GNP will lead to improvement in living standards, then the growth and development of ways of doing business that facilitate the financing of investment and capital asset ownership will take priority over usages that foster stability. But debt financing of investment and capital asset ownership is a major destabilizing influence in the economy and instability is the major cause of economic retrogression. The substitution of an employment for an investment strategy for economic policy is a precondition for any reform of financial institution that aims at decreasing instability.

We need to look at both the corporate and the Federal Reserve end of the network of financial interrelations as well as the financial institutions and intermediaries in order to develop an integrated perspective on financial reform. Our objective is to develop, in the light of our theory, our reading of history, and our observations upon the behavior of existing institutions the outlines of a good financial society for a capitalist economy.

An examination of data and history, as well as the theory we have developed, indicates that free markets in finance as now organized are strongly unstable, this instability is endogenous to the workings of markets that deal with time and asset-valuation, and the instability of financial markets is

critical to the instability of the economy. The policy problem is to design a financial system which dampens instability within an economy which allows decentralized and private ownership of capital-assets and investment decisions. Even as the above<sup>2</sup> stated, the possibility arises that the world imposes a trade-off. A financial system which may tend to amplify instability may simultaneously be conducive to a high level of investment and thus accumulation and what passes for rapid growth, whereas a financial system which ~~may tend to dampen fluctuations~~ may tend to dampen fluctuations may also dampen investment and lead to an apparently slower growth rate.

Therefore a program of financial reform will need to be consistent with the view of growth and investment that is advanced. A basic result of this study is that "the better use of what is" is now not only relatively more important than the "seeking of ever more", but that this is really the only route to betterment that is available. A reform of finance that develops an institutional structure that is less conducive to the accumulation of capital assets even as it is less hospitable to destabilizing financial practices than our current set up is consistent with the basic view of capitalism which guides this study.

The central financial institutions of a capitalist economy are its banks: commercial, merchant (or investment), and savings. Although laws and regulations may at any time draw legal lines separating various banking activities, commercial banks, by their very nature, tend to engage in practices that fall within all three spheres of banking.

Banking is a line of business encased in myth: it is almost a "mystery wrapped in an enigma". In conventional economic theory, with its rudimentary treatment of capital-assets,

the emphasis in the analysis of banking is upon the particular liabilities of banks--demand and time deposits--that function as money and the impact of changes in the money supply upon household demand and thus system behaviour. Our emphasis is different, for in a capitalist economy the assets of banks reflect the way the nominal owners of the stock of capital-assets and the nominal investors in embryonic capital-assets use debts to finance their activities. Bankers are professionals in "arranging" the liability structures of business organizations that own capital-assets and invest. They arrange the liability structure of business by either acquiring debts on their own account or by finding others who will acquire debts or equity interests.

Like medical doctors, bankers are fiduciaries who presumably give advice and act in the interests of clients, even as their own income depends upon the services they sell to the clients they advise. Some of the lines that the law draws among commercial, investment, and savings banks reflect attempts to moderate the conflict between the fiduciary and the private profit making activities of banking organizations. However the line now drawn between commercial banking, which lends on short-term, and investment banking, which arranges for longer-term financing, cannot and should not be sustained in practice. In particular, restrictions upon the investment banking activity of smaller banks, which of necessity have to service smaller business clients, works to the advantage of the giant banks and the larger corporations which in turn are conducive to both instability and inept intervention. Furthermore giant banks succeed in evading restrictions which the smaller banks perforce must obey, and in truth the principals of smaller banks often engage in investment banking, but off the books of their banks.

It is important to note that policy decisions about banking structure are simultaneously decisions about industrial structure. A highly decentralized banking structure with a large number of small and medium sized banks and no "giant" banks is conducive to an industrial structure that consists of a multitude of small and medium size firms.

We will proceed by starting with an analysis of corporate financing, and then examine the structuring of banks and financial institutions before taking up central banking. A major theme, which is carried over from our prior theoretical and historical/empirical argument, is that decentralized capitalist finance is destabilizing, so that the successful functioning of a market economy requires that an apt set of restrictions and ~~de~~control upon financial practices so as to attenuate the thrust towards instability as well as the existence of institutions which prevent disastrous systemic shortfalls in business cash flows and which can refinance positions. Once such attenuating and supporting institutions are in place the policy problem shifts to the prevention of what is now called "stagflation" - a combination of unemployment, inflation and inefficiency which is ~~the~~ chronic debilitating rather than <sup>an</sup> acute disease of capitalism.

## II. Corporations and their Financing

### a. Introduction

Title to most of the capital-assets that are used in production is vested in corporations. However corporations as they now exist are a relatively recent development. During the Great Depression of the 1930's, following the interruption of the recovery by the recession of 1937, a major investigation of the structure of the American Economy was undertaken by the Temporary National Economic Committee, a joint Congressional and Administration Committee. In the course of that investigation the legitimacy of the corporation as the appropriate major

form of organization for business was questioned. Before the issue could be fully resolved, the second World War was on the horizon and national attention was diverted from the issues of the impact of the corporate form of organizing business on the stability, efficiency and equity of the economy. It is necessary to reintroduce the question of the appropriate place of corporations and the apt structure of corporations into the national agenda. Instead of the corporate form being constrained, and controlled so as to aid stability efficiency and equity as was envisaged by some of the TNEC reformers, the constraints on the corporate form have been relaxed to the point of vanishing in the years since World War II. As a result the dominance of the corporate form of doing business has increased.

Corporations are usually treated in economic analysis as devices for collecting equity funds from a large number of separate units in order to finance some undertaking. Corporate stock, by limiting the liability of the presumed owners of the corporation, makes a divorce between ownership and responsibility possible that is not true with other ways of organizing business such as proprietorships and partnerships in which the liability of owners is not limited. Thus corporations facilitate the use of large scale capital assets and as a result the use of the corporate form tends to promote investment. The corporation is an apt form of organization for policy to promote if the object is to have a high investment economy: corporations are social devices that facilitate accumulation and their "desirability" is directly related to the desirability of a high investment economy.

An economy which finances a great deal of investment will also have a high proportion of its total income in the form of profits. Thus, in an economy that aims at and achieves a



high rate of investment, corporations will be profitable. Corporate success and dominance as a way of organizing economic life are correlatives of a policy that emphasizes investment as the way to sustain income and facilitate income.

If a capitalist economy shifts towards a lower investment - lower growth mode of operation then the rights and powers of corporations need to be reconsidered.

However corporations are not only a means of gathering equity funds from a large number of units, corporations also facilitate debt financing. As a result if a low-investment low profit way of operating capitalism follows a high-investment - high profit way of working capitalism, the debts of corporations become a handmaiden of instability. In a cyclical environment an inept use of the corporate form of doing business may amplify the cycle: the investment booms are stronger and the depressions are deeper than in the absence of this form.

Thus there are basic policy questions about the extent to which law should favor or erect barriers to the use of the corporate form. Basic policy questions about the permissible liability structure of corporations, the ability of corporations to own stock in other corporations, and whether corporations should be chartered for general or for specific functions need to be addressed.

#### b. Constitutional Weakness

An incompatibility can exist between the expected life of a representative capital-asset and the desired holding period of a particular household decision maker of a particular capital-asset. As Keynes has pointed out (General Theory, Chap. XII) ". . . The Stock Exchange revalues many investments every day and the

revaluations give a frequent opportunity to the individual (but not to the community as a whole) to revise his commitments. It is as though a farmer . . . , would decide to remove his capital between 10 and 11 in the morning and reconsider whether he should return it later in the week" (G.T. p. 151). Once business ownership and management are separated, once public rather than private companies dominate in holding capital assets and once stock exchanges exist the holding period can conform to the prejudices, wishes, life cycles and changing perceptions of households, even though the commitment by the public company to the ownership of capital-assets can be for the expected productive life of the assets.

If capital-assets are relatively cheap so that a household of modest means can acquire those needed for a business enterprise and if businesses and families are essentially "patriarchal", then a simple proprietorship or partnership form of organization will do. Whenever workers can own their own tools, private companies will be the dominant form of organization. Once capital assets become so expensive that households of modest means are barred from ownership and when - as a correlative of being expensive - the expected profitable life of capital assets exceeds the life expectancy of any mature individual, then because of these biological and technological imperatives, holding periods become shorter than capital-asset lives.

Commitments on liabilities issued to finance positions in capital assets will be validated if cash flows that the capital-asset earns as it is used in production are large enough. Even the ability to refinance Speculative or Ponzi liability structures depends upon expected earnings being large enough.

In principal capital-assets can be divided into two classes. One class of capital-assets are like agricultural land in that the asset can be used by many different producing organizations and can be used in a wide variety of outputs. In each of these varied uses and with any of these alternative users the land can be expected to yield a value of output that exceeds the current out of pocket costs. Thus in a quite impersonal way, independent of the particular operator and the particular final product, this land can generate a cash flow that is available to validate debt. Land, and capital-assets like land, such as residential and commercial property, are suitable for mortgage financing: i.e., for financing which is tied to the asset, rather than to any owner.

For those capital-assets which are flowing through the channels of commerce and being processed, whether it be basic materials, such as wheat or standard copper bars, specialized parts, like electric motors that are assembled into washing machines, or consumer goods, on the racks of mercantile establishment, the expected sale of the asset or the finished goods in the near future at a price larger than the processed costs of the good makes these assets and activities eligible for financing that is tied to the asset. This explains bill of exchange, warehouse receipt, and floor plan financing, all of which involve the pledging of receipts from the sale of a specific commodity bundle for the repayment of a specific debt. The funds to meet the debt will be obtained as the items are sold.

Both long life - general purpose assets and short-lived commercial assets are fit to the asset financing. The payment commitments on the debts used to finance ownership of such assets can be closely related to the cash flows that these assets are expected to yield as they are used in production

activities. It therefore is possible to use "to this asset financing" as a basis for hedge financing of the ownership of such assets. However when inventories become "unsaleable" at the initially expected prices during a recession/depression an initial hedge financing relation becomes a speculative relation. Similarly prior to the 1930's, the peculiar restriction on bank financing which limited bank financing to instruments with a maximum initial life of five years meant that "to the asset" financing was often speculative.

The other class of capital-assets consists of plants and equipments which essentially have no alternative uses but in a specific production process at a particular place. These assets have no significant value outside of a particular application. They are not capable of generating cash flows except as they are used in a particular production process. One mile of a pipeline, a portion of a petro-chemical complex, and a stamping machine in an automotive body plant are examples of capital-assets which have but a limited set of uses and few alternative outputs in which they can be used. These assets are not suitable for mortgages or other "to the asset" debts. They have little value independent of their use by a particular organization in its production process. These special purpose capital-assets are not suitable for financing that is tied to the asset, for a creditor has nothing of value if the asset is taken over.

If positions in special purpose capital-assets are to be debt-financed then the debts must be of the organization for which the capital-assets will yield profits rather than to the capital-asset. If the gestation period of the capital-asset and the period over which cash flows are expected as the capital-asset is used exceeds the life expectancy of a representative proprietorship or partnership, then a proprietorship or a partnership cannot hedge finance the ownership of such capital-assets.

If production processes that require such capital-assets are undertaken by private firms then either the principals personal funds must finance the entire investment in specialized durable plant and equipment or the unit must engage in speculative finance. For the hedge financing of such organizations to take place it is necessary to devise an organization whose holding period for the capital asset can be as long or longer than the period over which the asset is expected to yield cash flows that can be used to validate the debts that were used to finance control the capital-asset. A debt issuing capital-asset owning organization is needed, whose expected life is not restricted by human mortality.

The corporation therefore is a social artifact created to "hold" and "operate", ~~from~~ expensive special purpose capital-assets whose life as earners of quasi-rents exceeds the ~~normal life as earners of quasi-rents exceeds~~ the normal life expectancy of mature adults. The debts a corporation issues to finance its position in special purpose capital-assets are not tied to the cash-flows that any specific capital-asset will generate, but rather are tied to the future of the organization as a whole: they are the equivalent of a "to the person" loan. Given that the continued provision of some services and output by an organization will require the use of capital-assets with overlapping life expectancies, a corporation operating special purpose capital-assets is required to have an open ended life expectancy.

In the absence of a corporate alternative, if special purpose capital-assets had to be owned by proprietorships or partnerships, there would have been an inherent constitutional weakness in that speculative finance would have been the only possible mode of financing of high technology production techniques. Given that the "state" or community is in principle a perpetual organization it is natural that an extension of the

state be developed to overcome this constitutional weakness so that services can be provided whose provision is deemed to serve some communal purpose. It therefore is not surprising that the corporation as we now know it is not more than a century old, and that the first burst of capital-asset owning corporations came with the development of the railroad. Furthermore as is amply shown by the history of railroads, the "corporations" were often mixed public and private or wholly public enterprises. Similarly the development of municipal water, gas and electricity services were often either by public corporations or by "public service" corporations. The early corporations had to prove that they were serving a "public function" in order to get a charter. That the owners and promoters of these corporations did well by doing good was often true, but the application for a charter usually evaded this aspect.

However the modern corporation is not restricted to the ownership and operation of big ticket, highly specified capital assets where partnerships and proprietorships cannot readily function. The modern corporation has become the dominant form of organization even to the point where organizations that only have personal services to sell and which are tied to the particular performance of individuals are incorporated. Among the reasons for this development are the tax advantages that accrue to corporations - tax advantages that only became significant when income tax rates became "high" - , the ability of the corporation to organize a large hierarchy<sup>ical</sup> and bureaucratic organization to take advantage of marketing possibilities, and advantages in financing.

Corporations make possible the issuance of long term debt to finance capital asset acquisition that is not linked to any particular capital asset. As such corporations make the

hedge-financing of special purpose capital assets possible. As a result the volume of such capital assets that is used may very well increase, which may or may not be a good thing. However to the extent that corporations make <sup>possible</sup> ~~the~~ long term debt financing in areas where it would not otherwise rule, corporations are stabilizing.

However the corporate form of organization facilitates the divorce of financing from the ownership and acquisition of particular assets - both long run and short run assets. Thus if the overall financial markets show a favorable cost differential in favor of short term debt, corporations which borrow from the market and from banks on the basis of their overall "profitability" and their overall balance sheet will be tempted to intrude short term debt into their liability structure in excess of the amount required by their ownership of short term assets. Thus while the corporation's origin may very well lay in the need to develop a vehicle for the hedge financing of special purpose long lived capital assets, the success ~~over the years~~ of the corporate form in fulfilling debt commitments in a high profit economy with sophisticated financial institutions has led over the years to the corporation becoming a vehicle for the speculative finance of many positions. Whereas the corporation was initially a device that <sup>extended the scope of</sup> ~~made~~ hedge financing, <sup>possible</sup> the corporation, in the relaxed financial environments that developed ~~ed~~ when capitalism works well, has become in many instances, a vehicle for speculative financing.

---

Thus the initial stabilizing effect of the corporate form has been undermined, and the corporation has become a destabilizing influence both because it facilitates investment into capital intensive modes of production and because it facilitates speculative financing.

Thus there are two "constitutional weaknesses" inherent in financial structures. One is that the use of expensive capital assets with a long life is economically feasible only if the capital-assets price is "amortized" over a large output, which means over a long life. If the capital costs of a nuclear power plant were "loaded" into the first kilowatt or even the first year's "kilowatts" the plant would not be viable, for the output could not be sold at that price. Thus an economic body with a long life has to be invented to handle this problem. This economic institution is the corporation. But because the corporation's life is long relative to the life of the "owners", a market need arises in which the individual interests in the corporation can be transferred: a stock market is a necessary adjunct to the use of the corporation as a device to facilitate the private ownership of the means of production. But such a market in which stocks are traded leads to the possibility of the financing of ownership of perpetual liabilities by short term debt as well as to the various forms in which speculation on the future price of stock exchange securities can take place.

The corporation can eliminate the constitutional weakness inherent in the incongruence of the life expectancy of adults and the life expectancy of much of plant and equipment. But the corporation cannot take care of the preference of wealth owning households for short assets by which the ownership of wealth can be transformed without much trouble and time into funds for the purchase of current output. Thus there remains the constitutional weakness that supply and demand conditions of short and long term financing are such that the terms on short term financing are normally more favorable to the units that need financing than the terms on long term financing. This is parti-



cularly so whenever the demand for financing is high and rising rapidly because the short term markets have a flexibility of supply that results from the ability to devise new instruments and institutions. Thus there is always a residual thrust towards speculative finance and to the development of market institutions that facilitate the rolling over and refinancing of positions.

c. Entrepreneurial Involvement and the Bureaucratic Corporation

Corporations are financial organizations which have advantages in raising funds by equities because of their special privileges of limited liability and in raising funds by debts because of their extended life. Furthermore because they do allow for dispersed ownership corporations can grow to a size which if private ownership or partnerships were the only permissible forms of organization would lead to a ~~sub~~ huge concentration of wealth. Instead of huge overt private fortunes we have a large number of bureaucratic corporations which often manage great bodies of capital assets. This managing is presumably in the interests of the stock holders, but as Watergate made evident, the fiduciary responsibility of corporate management has often been compromised. By its very nature, the perpetual life bureaucratic corporation in which there is no large overlap between owners and managers contains a strong potential for a conflict between the fiduciary and the private interests of the managing group.

To be highly efficient, organizations require a strong entrepreneurial input. The difference between a well managed business and the presumable sloth of a bureaucratic office reflects the control exercised and the commitment of an "entre-

preneur". In the hey-day of the Roosevelt reform era, when government was growing rapidly, there may have been confusion and conflict within the administration but there was no question of the commitment, integrity, and energy of the government personnel. In all cases, whether it be business, government, military or a University efficiency in operations depends upon a commitment by leadership. Time serving leadership will not lead to efficient operations.

A perpetual lived corporation is no different than the government bureaucracy except in the source and assuredness of its revenues. Regular dissolution of corporations and a periodic reform of government bureaucracies are requisites for effective performance. In competitive business the inefficiency of bureaucratic management can eventually lead to bankruptcy - as happened to railroads when their monopoly disintegrated. However if as is true of electric companies and other monopoly enterprizes that use expensive capital-assets the ability to raise the taxes they levy (in the form of fees for services) makes it likely that poor service at high prices rather than outright bankruptcy will result. Thus the ability of electric utilities that have non-functioning or poorly performing nuclear power plants to put these plants in their rate base illustrates how bureaucratic corporations with market power can breed inefficiency.

The virtues of decentralized market organizations with decentralized finance are mainly due to the entrepreneurial energies that can be released and the way in which competitive market processes work to eliminate high cost units. Thus any economic order which intends to take full advantage of decentralized market processes needs provide for new entry; for the facilitation of the growth of new and smaller organizations. One way

to facilitate such growth is to assure that organizations which have encrusted market positions are dissolved.

One aspect of a policy towards corporate structure and industrial organization which has been much neglected is the facilitation of divestures. Instead of making corporate agglomeration into ever larger units - the growth of conglomerates which penetrate many different markets - profitable policies with regard to taxation should facilitate the divesture of corporate parts. One way of facilitating divesture is to make some of the rights and privileges of corporations vary inversely with size. A progressive corporate income tax on the gross of corporate profits is an obvious way in which size could be penalized. but a corporate income tax is in itself a poor tax unless, it can be avoided by actions which in themselves are not inefficiency, inducing.

Perhaps the best divesture inducing scheme is a franchising tax which increases with size of assets or sales. The corporate charter is a privilege and an annual franchise tax is a rational charge. The franchise tax could be a minor item for corporations under particular ceilings in sales and assets controlled and would increase progressively with size.

Basic to any program of corporate reform is the national chartering of corporations. Corporations need be restricted in their ability to own other corporations and to own stock in other corporations. Corporations should be chartered for well defined and specified lines of business. A corporation would be allowed to follow its techniques into new lines of business, but with the expectation that divesture would occur when new lines became large.

#### d. Prices, Monopoly Prices and Debt Validation

In a modern capitalist economy the cash flows that validate private business debts and determine the market value

of private financial liabilities are mainly the current and expected difference between corporate total/revenues and the cost of labor and purchased materials. That is the proximate organizations around which financial flows revolve are ordinary business and financial corporations. Because of their sizes and market powers, many of the larger corporations are tax farmers, in the sense that the selling prices of their services or outputs are determined by cash flows that are needed to validate debt, just as taxes are set by the revenue needs of the state. The determination of price - or its equivalent the mark up or out-of-pocket costs - by cash flow needs requires that the market constraints, imposed by demand conditions, should have some slack. Monopoly or near monopoly positions which follow from giant size loosens the constraints imposed by market conditions.

It is necessary to stop thinking about corporations as if they were tiny organizations which are faced by market pressures which force the unit to accept prices as determined in markets. Those operations which really require the corporate form of organizations invest heavily in special purpose capital-assets - capital-assets which have few if any valuable uses aside from producing the outputs for which they were designed. To finance the acquisition of these capital-assets the owning firm - or the using firm - made cash payment commitments to banks, bond holders, and equity share holders. These cash payments commitments are a large portion of the total receipts that the unit expects to receive over a calendar year. In order for such pledges to pay to be creditable, the liability emitting unit must have some control over its unit mark up: this control comes from either size or market power. Such a corporation is really

a tax farmer which has implicit or explicit guarantees from the state, now that government is "big" so that the mass of profits are guaranteed.

Any sharp dichotomy between government bodies and giant private corporations is false. Giant private corporations, such as Penn-Central Railway, A.T. & T., and the local utility have public functions - they are required to produce particular outputs - and to a considerable extent the value of their liabilities are covertly guaranteed by public authorities.

The covert guarantee of liabilities is clear in the case of those firms whose output prices are set by negotiations with a regulatory authority. For these companies the major function of the excess of revenue over out-of-pocket costs is to validate debt and to permit additional deficit financing to construct new facilities. Much of the juggling of prices to generate revenues takes the form of "playing" with a rate base and a target rate of returns on the rate base. That the price is like a tax is evident from the practice in many jurisdictions which permits expenditures upon plant under construction and not yet producing to enter into the rate base. If a utility builds a power plant which does not "work", the rules of the game do not impose a loss upon the stock holders - the rules of the game impose a higher set of rates upon the users of the service.

A utility rate tariff is a tax schedule determined by "negotiations" between a commission and a management. The revenue in excess of costs collected by A. T. & T. and its subsidiaries are not different in any meaningful economic sense from gaso-

lene taxes collected by state governments which must be used to finance road construction. Telephone tolls are taxes that collect revenues that are used to validate past debt and to furnish parts of the equity basis for debt financed spending on telephone facilities. (Incidentally if A.T. & T. were government owned and its spending, taxes, and "dividends" were exactly as they are it would add a substantial amount to the government deficit each year).

If at any time the expected cash flows of a regulated utility are insufficient to validate debt and serve as a basis for financing capacity expansion, the utility enters into negotiations as to the regulatory authorities to raise the rates to raise taxes. Because the authorities typically try setting the rates below the profit maximizing rates, the expectation is that there is some "unused" monopoly power so that a rise in rates towards the monopoly level will lead to an increase in cash flows. However just like New York City and taxes which are based upon demand for a service, there is a possibility that price goes above the "monopoly" rate so that net revenues do not rise or even fall when the rates are decreased. When this happens for a giant firm or utility government intervention in the form of subsidies, special tax credits, or even purchase of some assets takes place. It is obvious that either by adjusting rates to generate sufficient cash, overt endorsement of debt, subsidies and purchase of assets government is an ~~validating~~ organization that <sup>validates</sup> ~~for~~ private debts.

It is worth noting that the rates are set so as to achieve a target "bundle of gross profits". But gross profits are the difference between revenues and out-of-pocket costs. Costs include not only purchased materials and labor that is absolutely essential to operate and maintain the physical facilities, costs also include the managerial and professional stuffs. As

long as there is a margin of "unused" monopoly profits in the rate structure there is no reason for management to be "cheap" either in the wages it pays labor, the salaries it pays for "executives", or in the fees it pays to lawyers, advertising agencies, insurance companies, and utility regulators. In a sense the "costs" of a constrained monopoly, such as an investor owned utility, are determined by the revenues that can be obtained. Only after monopoly power is used up, so that the market price is the monopoly price, is there any pressure on a utility to be "efficient" in terms of costs.

It is also important to note that the taxes administered by utilities constitute a complex of rates for different types of output: the time of day/day of week differentials in the A.T. & T. long distance rate schedule <sup>are</sup> ~~is an~~ example. In such a complex of rates cross subsidization is not only possible ~~but~~ <sup>but</sup> inevitable. Rates on service A may be raised to pay for services to user B. Utility rates in the central cities, whose population has been decreasing, have had to pay for facilities that provide services to the suburbs. Instead of telephone and utility rates being cheaper in the central city, because of rate schedule problems they are often higher.

Whereas one set of uses will subsidize another set within a firm, as shown by telephone rates, there is a general objection to cross subsidization across firms or product lines. Bridge tolls into New York City are not used to subsidize bus and tram traffic <sup>and in</sup> to the city, etc. Furthermore it is quite evident that taxes in the form of commodity or service prices are much more acceptable in our economy than taxes that are not so hidden.

The prices of Wheaties, gasoline, and under-arm deodorants generate the revenues which are used to pay the

"talent" on T.V. shows. The guiding principal for the financing of television in the United States is from each according to his spending on under-arm deodorant, to each according to his ability to sit in front of the tube. ~~Perhaps~~ if studies in ~~depth~~ were made of the distribution of financing and "benefits" derived from television ~~(-)~~ it may turn out that television tax and services are the most income "equalizing" tax in our economy. Our ~~co~~vert system of taxing through commodity prices for television raises much more funds for television than an overt tax would. The principal beneficiaries of this system are the <sup>license holders,</sup> managers and professional entertainers in television.

Because the capital-asset production decisions of many giant firms will be validated by revenues generated by "private taxes", it is legitimate for these investment decisions to be public decisions. Each brain scanner at a hospital shows up in Blue Cross and Blue Shield rates, which in turn show up as a cost of labor to employers, which in turn show up in prices of products. We have a tax supported medical system in the United States - however the tax rate is largely determined by the medical profession as the provider of the services. The issue in national health is not whether taxes which show up in other product prices will pay for medical care, the issue is whether tax payers will have a voice in determining the costs of the service.

If raising the mark up on out-of-pocket costs carries price above the profit maximizing price, then the funds required to validate <sup>support the business steps</sup> debt and finance expansion ~~cannot be raised by~~ <sup>may not be forthcoming from</sup> taxes that work within the market process. In such a case it becomes necessary for the authorities to intervene by using their financing ability to bail out the distressed financial instruments. Thus in 1974 ~~(E)~~ New York State bailed out Consolidated Edison by buying plants. The subsidy through endorsement of



Lockheed and the <sup>Federal</sup> Reserve operation mounted for Chrysler in 1970<sup>0</sup> are examples of public intervention to validate existing debt.

We therefore have a type of contingency socialism in the United States in which the liabilities of particular organizations are protected either by overt government intervention or by the subterfuge of allowing taxes in the form of service related prices to rise. One aspect of this contingency socialism is that a contingency<sup>t</sup> liability affects choices even if the contingency never occurs. Thus capital-asset construction in the protected dimension will go to a lower cost of money margin than capital-asset construction in other dimensions.

Financial reform needs to confront the "public nature" of much that is private and assume<sup>s</sup> that the implicitly tax backed dimensions of the economy are not carried too far.

One aspect of the public contingency involved in so called private debt is that "big" or "giant" organizations carry at least an implied public liability on their debts. Although Franklin National was allowed to fail, the full consequences of the failure were short circuited by the intervention of the authorities. Thus there is a financing bias favoring giant corporations and giant banks, for the implicit public liability leads to preferred market treatment. Financing relations may force government intervention to validate the cash flow expectations of lenders even if investment is inept. One way the government intervenes is by generating a "massive deficit". But these massive deficits are the basis for inflation even as the threat of private default is a basis for unemployment.

## e. Corporations and their financing - conclusion

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

As a result of our understanding of how a large government implies that a profit sustaining deficit will take place whenever income and employment fall it is clear that a great contraction such as took place in 1929/33 cannot occur as long as government remains big. Thus there is no need for policy to support and sustain corporations with market power as "price sustaining" devices. In fact such corporations can be expected to use any decline in volume of sales as an "excuse" to increase mark ups therefore tending to raise prices as employment falls.

In a world with big government individual bankruptcies can be tolerated because individual bankruptcies cannot lead to a wholesale default on obligations. Thus the barriers to bankruptcy should be eliminated, the legal procedures simplified and the costs and time involved sharply reduced. A quick writing down of the equity owners "interests" <sup>and</sup> of a quick transformation of debts along a prior established scale of "entitlement" should be possible. Once this is done the inflation constraining forces of competition are free to operate. In moving to a more competitive economy that is more open to bankruptcy, it is necessary that no organization be so large that even the temporary disruption of bankruptcy cannot be tolerated. Thus

the limitation of the size of individual firms, so desirable from the point of view of promoting entrepreneurial dominance, becomes desirable from the point of view of constraining inflation within the context of a big government that prevents debt deflation.

### III. Banks and Banking

Banks are the central financial organization of a capitalist economy. Once the institutional characteristics of the system of banks and the assets and liabilities of banks are set the financial framework within which business, other financial institutions and households will develop is largely determined. Of course, as bankers pursue profits within any legislated structure the institutional characteristics and the financing transactions of the system of banks evolve. As a result of the evolution of banking it becomes necessary to reform the banking system from time to time mainly so that the weight of instability inducing speculative and Ponzi finance is decreased. Thus when financial markets exhibit instability as the markets have since the middle 1960's, it becomes necessary to reform the banking and financial system so as to diminish the evident fragility.

However because there is a symbiotic relation between the structure and operating technique of banks and the structure and operating techniques of business, such reform has to be carried out in the light of the expected effect of the changes on the structure of industry.

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

is made up of a few nation-wide branch banking systems is conducive to an industrial structure that is mainly made up of large and giant firms.

The United States is fortunate that it has over 15,000 banks, and that the banking system has many independent and entrepreneurially aggressive banks. This is a fortunate consequence of an accident of history. The current fundamental banking law of the United States, the Federal Reserve Act, is a product of the "progressive era" in which a deeply felt though largely intuitive suspicion of a highly centralized financial system, giant banks and business monopoly guided economic policy. Thus the national laws and regulations guiding the structure of banking allowed the various states to determine the structure of banks within their boundaries. Each state determined whether unit or branch banking was to be allowed within its boundaries, and if branch banking was allowed, the extent of branching is determined by state law.

Because no bank - with a few exceptions - was allowed to have branches in more than one state, states rights resulted in a highly decentralized banking system, with many banks having monopoly positions in a local market, but with no bank having monopolistic control over a large market. Furthermore the United States maintained a dual chartering system - banks can either be chartered by the National government or by the various states. This system of dual chartering has meant that entry into banking has never been "closed off", although getting a bank chartered is never as simple as getting an ordinary corporation chartered.

Thus in principal state lines constitute boundaries in the areas any bank can service. In recent years in various forms the integrity of state lines as boundaries to a bank's activities has broken down. First of all there is a correlation

between business size and the size of the bank which can handle its business. Obviously a bank with a lending line of even \$10 million dollars cannot handle the short term financing needs of a giant corporation that may be headquartered in its "home town". Giant firms naturally gravitate to the largest New York and Chicago banks. The financing needs of any corporation in the "billion dollar" or even multiple "hundred million dollar" sales class cannot be handled by any single bank. Giant and even moderate size firms have multiple bank connections and multiple lines of credit. Thus no matter where a very large firm may have its headquarters, it will need have financing relations with the giant banks.

In addition to the migration of the banking business of giant firms to the biggest New York, Chicago and California banks, the geographical division of banking has been eroded by the giant banks setting up regional "loan development offices" which solicit, service and supervise customers throughout the country. The growth of holding companies has enabled some banks to acquire sales finance companies, which in principle could have nation-wide offices financing business as well as households. A further erosion of the geographical divisions of American banking occurs when foreign banks have branches in various parts of the country and then "take over" a domestic bank.

However in spite of these erosions of the geographical division of banking, the United States has not as yet travelled very far along the road to a banking system dominated by a very small number of giant banks. As long as chartering and therefore entry into banking remains quite easy, then the existence of either a monopoly power over borrowers that yields a "high"

return to giant banks or a fringe of bankable customers who feel exploited or poorly serviced will lead to entry - or to an existing independent bank moving into the "business space" that exists.

Even though the erosion of the highly competitive banking system has not gone very far, it is desirable that the national banking laws and the regulation of the Federal Reserve, Comptroller of the Currency and the Federal Deposit Insurance Company be reexamined and revised so that they foster and encourage the growth and prosperity of independent, smaller banks. Symmetrically the laws, regulations and practices that favor giant banks should be changed.

The reason is simple: Banks when they finance a business become in effect a "partner" in the business in that the success of the bank as a lender depends upon the success of whatever the borrower undertakes. The bank lending process has three steps: solicitation, structuring and supervising. Soliciting is obvious, bank representatives visit business and other potential borrowers to solicit business - bankers sell their services just as any other business "sells". However getting a potential customer - a potential borrower - interested in borrowing from a bank is only the first step. The second step is to structure the borrowers financing so that the transaction is "profitable" to both the banker and business man; this means that the cash flows that the business man will receive as a result of activities financed by the loan exceeds by a margin of safety the principal amount and the interest the borrower is committed to repay. The "margin of safety" not only dulls the disquietude of the banker but provides the "profits" of the business man. A well structured bank loan is supposed to be a

good thing for both the bank and the borrower and the "negotiations" and the "exchange of information" that enters into the structuring of a loan are designed to demonstrate that the expected cash receipts are consistent with the contractual commitments to make payments that are being undertaken.

However any particular bank loan is but one item in the financial structure of a borrower. Thus the structuring of any loan is in the context of the other financing relations the borrower has. By its very nature the banker - bank customer relation examines the entire financing perspective of the borrower as it fits any particular loan into the total liability structure. The structuring of a particular loan becomes one step in the structuring of the finances of the business.

The smaller the business the more important the banking connection is in the finances of the business. The banker not only is the source of short term funds but is also the advisor and the connection to other financing sources.

The third step in the bank lending process is supervision, which is thereafter the loan relation between a "banker" and a "customer" <sup>has been set up.</sup> To both the banker and the borrower each particular loan is envisaged as a single step in a continuing relation. Thus even as one loan is "working" its way through a business, other loans are implicitly or explicitly under consideration. Furthermore each loan has "codicles" - conditions which the borrower must fulfill for the bank to extend further "tranches" of the loan or for the loan not to be fully due immediately. Thus bankers oversee the business of their borrowing customers by a "post-loan" exchange of information. The correspondent balance convention, by which a borrower agrees to keep a particular proportion of an outstanding loan on deposit

is one way of conveying information to the lender about the progress of the borrowers affairs.

As a result of the continuing relation between a business man and his bankers, the <sup>2</sup>b<sub>1</sub>aker becomes a source of continuing advise and guidance to the business man. The banker is not guided in his advice and guidance by altruism but by the "partnership" in which the borrowing customer's prosperity determines the profitability of the relation to the banker. It follows that the banker should have a wide array of "financing" forms to offer the customer, either in the form of "loans" or in the form of being a placement agent. Restrictions ~~on~~ bank assets and liabilities are unwarranted insofar as the bank can meet the cash flow commitments, in particular restrictions on banks acting as dealers, underwriters and financial advisors are unwarranted.

One determinant of the businesses that any particular bank can service is the size of the "line limit" of the bank - the limit that is set by law, convention or the internal decisions of the bank on the maximum credit that can be extended to any particular borrower. As a general rule the laws and regulations that guide and control banks set a maximum line limit at 10% of the bank's book value - the value on the balance sheet of the paid in capital, surplus and undivided profits. Thus if a bank with \$60 billions of total assets has a \$2 billion book value the legal and regulatory determined maximum to any one borrowing firm will be \$200 million; often the bank's board of directors will set a limit to the maximum loan that is lower than this formal limit. Similarly a bank with \$60 million in total assets might have \$4.0 million as its book value, which would lead to a line limit of \$400,000. Obviously the \$60 million bank could not be a serious and major source of financing for any firm where sales run into billions or even into multi millions; such a bank can finance only smaller businesses.



Equally obviously a giant bank can and does have many small business borrowers. However it takes many a half million dollar loan to generate the profits of a single \$100 million dollar loan. The best talents of a giant bank will be assigned to the large customers.

Giant banks have an advantage over small firms in that they can have loan officers who are specialists in a particular industry: they can have "departments" that study particular industries and that therefore can "aid and abet" firms in that industry. However giant banks, like all giant organizations, suffer from the bureaucratic disease so that the departments often become victims of standards and routines that are obsolete. Although in principle the specialist loan officer can better supervise a loan, the dismal performance of the giant banks in financing the R.E.I.T. industry indicate that supervision can be almost non-existent when bankers lose their prudence as they drive for performance.

Even though giant banks in principle can service smaller businesses, smaller banks can only survive as they service smaller businesses. Thus to the extent that an economy has a set of entrepreneurial smaller banks it has institutions whose success depends upon the success of the smaller businesses and which will seek out, foster and support smaller business. In truth if properly channeled, the multitude of smaller banks in the community become a "small business" development agency.

The proper channeling of the energies of the smaller banks require that they be allowed to function as investment and merchant bankers as well as commercial bankers. This does not mean that the "German" pattern in which the banks take equity positions in firms should be followed, but rather that the smaller commercial banks be allowed to function as investment bankers -

underwriting and placing the equity issues of corporations - equity issues which may not be "large enough" to warrant a public placement and which will appeal to a relatively small number of sophisticated investors in a community.

In fact smaller commercial bankers who are "entrepreneurial" minded do act as an investment banker - but it is off the books of the bank. In the course of the ordinary business of a bank there will be successful (profitable) expanding customers who run up against a credit availability limit because the ratio of borrowed to equity funds becomes too high from the bankers point of view. Additional equity funds are needed but the amount is often too small, ~~and~~ the firm is too dependent upon a few individuals, and too unknown for it to be able to use the investment banking network. In such cases the banker often acts as the "coordinator" to a private placement in which the "banker" and a few other investors put together a "package" to finance expansion. In every active business community there are such "investor" circles. If small banks are allowed to function formally and officially as investment bankers then the vitality and expansive power of the smaller business enterprises will be enhanced.

There may be merit in preventing the giant commercial banks from acting as investment and merchant bankers. The investment and merchant banking needs of the giant and very large firms are so big that specialized organizations are available to serve them. However Wall Street is not the entire economy. For many businesses the major locally available financially sophisticated advisor and guide - as well as the only practicable underwriter for equity issues or middleman for long term debt placements - is the local commercial banker. Thus if smaller business is to

be supported by economic policy then the smaller banks - their natural financing source - should be free to act as investment and merchant bankers: Commercial banks of modest size should be free to be underwriters, place debts with third parties and give financial advice for a fee; they should also be able to collect fees for arranging mergers, divestitures and takeovers.

What is the "practical boundary" in the United States between smaller banks and larger banks. In the United States today a billion dollar bank is a "big" small bank - a \$5 billion bank is a "small" but not minute "giant" bank. The billion dollar bank will have some \$50 millions as the book value of its equity funds and will have a \$5 million dollar limit to its lines of credit. Such a bank will not often participate in the multiple bank syndicates that are used to finance giant firms. On the other hand a \$5 billion bank will be in such syndicates; its business will be predominately with firms whose business runs into multiple millions per year. With inflation a million dollars is not what it used to be - and neither is a billion dollars. Although it might have adverse consequences in some cases by allowing a "big" local bank to dominate a market, a ceiling of a billion dollars in total footings for banks that are allowed to function as merchant and investment banks seems reasonable in the light of the current needs of business. There might also be a ceiling to the size of the individual underwriting and public placements in which such a bank can engage; one or two million dollars seems reasonable.

The attempt to control the aggregate ability of banks to finance activity and positions in capital assets by means of requirements about the relation between the cash holdings of

banks relative to a particular few bank liabilities is the centerpiece of the Federal Reserve's operations ever since the Federal Reserve accepted monetarist doctrine. If banks were simply deposit creating automation<sup>ons</sup> and if banks only affected economic activity by way of household "excess" or "deficit~~s~~" cash in portfolios, then the attempt to control the economy by means of controlling bank reserve might have some change<sup>ce</sup> of succeeding. In fact banks are complex profit making organizations which have a multitude of actual and an infinity of potential types of liabilities and who can devise many ways of financing activity if such financing is profitable.

Banking cannot be trusted to manage itself; that banks can finance an inflationary boom and create fragile and debt-deflation prone financial structures has been demonstrated many times in history. It is necessary to control banking by controlling the amount of assets banks can acquire and the rate at which the assets of banks can increase. The major control device for banks and banking should be the capital-asset ratio and the rate of growth of bank capital.

As things now stand the adequacy of bank capital is a subject matter for the bank examination and supervision procedure. However the bank examination and supervision procedure is effective only on small banks; not only are the smaller "country" banks more impressed by examiners but the operations of country banks are more readily understood. Furthermore the large branch and overseas structures of the giant commercial banks makes it virtually impossible for the authorities to properly examine such banks. As a result the control over the capital adequacy of banks has been an effective device to constrain the assets per unit of capital of the small banks and is not effective with the large banks.

In order to constain the inflationary potential of a runaway ~~of~~ bank financing of operations and asset holdings, to set a net worth barrier against a debt deflation process and to remove the bias in favor of gaint business which exists in the preferential asset/equity ratios of giant banks, the Federal Reserve and the Federal Deposit Insurance Corporation should be authorized to set a fair and equal asset equity ratio <sup>to</sup> banks - that is for all institutions which have deposits subject to transfer by check or on demand withdrawal:

In the United States given the cyclical nature of the economy and the present financial situation, a capital/equity ratio of 5% seems reasonable. However banks differ in the relative size of their "off the books buisness", in particular in their trust business. I would suggest that an appropriate capital/asset ratio would be 5% on all assets as listed on the official bank statement (including assets such as customers liabilities on acceptances) after assiging equity equal to ~~10%~~ <sup>17%</sup> of assets managed to an "in home" trust department guarantee fund.

If these ratios are accepted then many of the very largest banks would have to acquire additional equity funds. A bank with \$60 billions in total assets with \$2 billion in equity funds (after allowing for trust fund activities) would be shy \$1 billion in its equity account. Given that a bank of this size has a "public" purpose" component, one solution to the capital deficiency could be an infusion from the Treasury of \$1 billion of equity funds. Alternatively the banks with a net worth deficiency could raise new equity funds through new issues of common or preference shares. A third option might very well be to freeze the total assets of <sup>such</sup> ~~the~~ banks while as returned earnings increases their equity base. Inasmuch as banks which

engage in liability management banking can decrease their assets and liabilities by not ~~se~~ling their liabilities as aggressively, ~~and~~ <sup>and</sup> allowing loans to run off and by selling off parts of their "investment" assets, there is another option, cutting back the size of the institution to fit the book value of the bank. There is no obstacle to the implementation of a uniform asset/book value ratio which requires a decline in this ratio for some banks.

The ability of many of the smaller banks to lend and invest will be increased by the uniform capital/asset ratio. Many of these banks the possibility of raising their assets/equity relation from 12 to 15 to 1 to 20 to 1 will be open. The problem of these banks will be to find adequate assets and also to place their liabilities. There will be a transition problem but the end result will be a more favorable financing environment for the smaller enterprizes.

The more favorable financing conditions for the smaller enterprizes will be the result of the on the whole higher asset capital ratio that will apply to the smaller banks after the reform. Let us assume that the "representation" rate of return on equity capital through the economy is 15%. An investor in a bank will therefore expect to earn about 15% on funds invested in banks; because banks are considered safer than other enterprizes the return might well be lower. If a bank has \$15 of assets for every dollar on equity, it will have to make 1% on assets to earn 15% on equity. If a bank has \$30 of assets for every dollar of equity, then to earn 15% on equity it will only have to make one half of 1% on assets. Under the present regime of differential asset/equity ratios the big banks can achieve any target rate of return on equity with a smaller mark up on the

costs of money than is true for smaller banks.

As the system will evolve after reform the mark up on money costs that the small banks will apply will decrease even as the mark up of the big banks will need rise. An even handed asset equity ratio among banks will go some way but not all the way towards equalizing the conditions for the bank financing of large and small businesses.

Given that an aggressive, well managed bank makes 15% on its book value, the requirement, consistent with the integration of the corporate and personal income tax that a firm "pay out" 70% of its profits in dividends will lead to a retained earnings that is 4.5% of the existing book value of equity. This implies that the growth of bank assets consistent with the growth of equity will be at 4.5% per year. If the average return on bank is in the neighborhood of 10% to 12% because of the security of bank earnings then a 70% pay out relation will lead to a 3% - 3.6% internal rate of growth of the equity base of banks. Thus a reformed tax law and the representative rate of return on book value will lead to an internal rate of growth of bank equity which is consistent with the rate of growth of the money supply that is advocated by the "monetarists".

Control over the required capital/asset ratio and the required pay out ratio for banks are powerful weapons that can be used to guide the development of banking. Once set the uniform capital/asset ratio should not be routinely changed. However there is no reason why the authorities regulating banking should not be granted the power to raise the pay out ratio if bank profitability is too high and the growth of bank equity is too fast. A rise in the required pay out ratio will not raise tax revenues, but it will make it necessary for banks to go to

the equity market if they want to raise funds to promote more rapid expansion. Thus if a 15% overall return on bank equity is associated with a 4.5% rate of growth internal funds, then a rise to an 80% pay out ratio will lead to a 3% rate of growth of funds from internal sources.

Of course a cut in the allowable asset equity ratio will lead to a sharp reduction in bank asset holdings. A cut in the ratio to 19 (5.26%) from 20 (5%) will force a 5% fall in assets. If the required ratio is changed in an effort to control banking the changes will have to be by minor increments.

One corollary of free entry into banking is that both new banks and existing banks are free to raise equity funds by issuing stock. Thus if the Federal Reserve forces a high payment ratio on banks, banks can gather funds by new issues of equity shares.

During a transition period the currently highly levered giant banks might very well have a restricted ability to expand, because they need to make up the deficiency in their equity account. In these circumstances the Federal Reserve might be granted a temporary right to lower the payout ratio that is symmetric with its ability to raise the payout ratio to prevent too great an expansion of bank credit.

Banking is not so profitable that "free entry" would lead to an explosion of banking capital by means of new entrants. Thus the control of the rate of growth of banking by means of controlling the internal rate of growth of book value is a more promising path than that which obviously does not work - the control of bank asset acquisition by means of a control of bank reserves.



The corporate form makes possible the hedge financing of special purpose capital assets by providing for "to the organization" financing. Once "to the organization" financing becomes prevalent the mingling of liabilities by corporations means that the short term financing of longer term positions becomes possible. Given that in a regime of robust finance a supply of short term finance is likely to exist at advantageous interest rates and that markets in which short term debts are negotiated are such that refinancing of positions seems always feasible, a thrust towards speculative finance is facilitated by the corporate form.

Banks provide a large portion of the in being and stand by credit that is used by both business and non-bank financial institutions. If banks are restricted to "to the asset" financing of business, then the debts of borrowers from the banks will embody payment commitments that are consistent with the cash flow receipts due to the assets. That is, if banks are somehow constrained to making "to the asset" loans then at least the bank loan part of the liability structure of firms would be a "hedge-financing" relation.

The idea that it is a good thing if banks are constrained to "to the asset" financing of business is a tenet of the real bills doctrine. This doctrine holds that if banks only financed "goods in the process of production", then the right amount of money would be created. Within the framework of the standard economic theory "the right amount of money" ~~that~~ would lead to stable prices. It was shown that the restriction of the assets of banks to "real bills" could not prevent a growth of the money supply (and an expansion of the volume of activity financed by banks) so that a rise in prices results.

However our concern is not with the correct quantity of money. The volume of total bank assets will be controlled by the ceiling set to the assets/equity or the commitment/equity ratio. The rate of growth of bank assets is to be affected by the power over growth through "retained earnings" that the banking authorities will have. The control over the quality of bank assets is aimed at affecting the stability of the financial structure.

The initial Federal Reserve Act and Federal Reserve operation during the early days of the Federal Reserve System were affected by views derived from the real bills doctrine. The Federal Reserve Act initially provided that only bank loans that reflected to the asset short term financing was eligible for rediscounting. Furthermore in the aggregate rediscounting was a major source of bank reserves. Similarly the Federal Reserve encouraged the rise of bankers acceptances and the development of markets in which acceptances were traded. Both the dominance of rediscounting as the source of bank reserves and the encouragement of the acceptance market gave way to the use of open market operations in treasury securities as the way to affect reserves quite early in the history of the Federal Reserve System.

There are pervasive influences that reflect fundamental characteristics of a capitalist economy which lead to instability. Finance's contribution to this instability is the thrust to <sup>use</sup> ~~some~~ speculative financing relation to finance positions in capital assets. Policy on bank asset and liability structures can attenuate this thrust and perhaps lengthen the intervals between threatened financial crises. The policies designed to foster to the asset hedge financing of business by tilting bank financing in this direction is a worthwhile effort but it cannot eliminate the cycle.

An apt way to encourage to the thing financing by banks is to once again have rediscounted bank debt be the major source of bank reserves. Although the primary control over the size and growth of bank assets remains the maximum allowable asset/equity ratio a secondary control over banking in the form of a cash reserve requirement against<sup>s</sup> different liabilities is desirable in order to make sure that banks hold assets that will give them access to the discount window. Thus a system of cash reserves against all liabilities is desirable in order to assure that banks will have assets that are eligible for discount in their portfolios.

Biasing banks in favor of short term to the asset financing of activity is a way of introducing a factor tending to attenuate the thrust towards instability. In a similar way other financial institutions such as sales finance companies, life insurance companies, even ordinary business corporations can have access to the discount window by means of holdings of paper eligible for discount. The "eligibility" requirement would be such as to assure that the borrowing unit has engaged in "to the asset" financing.

#### IV. Central Banking

Financial relations affect the behavior of any economy that is capitalist: the path in time of the economy affects and is affected by the financial structure. The business cycles of history especially those that exhibit deep depressions  $\ominus$  are largely the perverse results of the normal functioning of an economy with the financial institutions of a capitalist economy. For capitalist economies to do better than they have in history

in preventing deep depressions, inflation and the current peculiar "stagflation", it is necessary to manage and control the evolution of financial relations so as to constrain the development of situations conducive to financial instability and to constrain and offset the effects of such instability when it occurs. The institutions that attempt to manage and control the evolutions of financial relations and to contain and offset the effects of instability are the Central Banks.

Central Banks exist because financial markets cannot manage themselves the way necktie and handbag markets manage themselves. History forced the conclusion that government needs a flexible intervenor in financial markets on practical men even as economic theorists could not explain the observed instability. Inasmuch as our theory explains instability as the result of the interactions of profit maximizing business and profit seeking financial organizations, it should enable us to understand why central banking is necessary and what can be done to constrain and control instability.

Central banks are the primary instrument of government intervention in financial markets. The proper domain of central banks is the financial structure as it is, not some subset of financial institutions or some particular financial instrument used to finance a bank's position. Thus it is wrong to emphasize that the Central Bank is the regulator of some special subset of financial institutions-called "Member Commercial Banks"-or that the central bank is the controller of the amount of some special bank liability outstanding - called money. Perhaps at some stage in the evolution of financial relations controlling commercial banks or money may have been a "good enough" goal for central banks but it is not an apt definition of the central

bank's domain of responsibility once a complex financial system is in place.

One particular objective of the central bank is to assure<sup>R</sup> that the supply of funds in key position-making markets is not disrupted by any flight from the market. The lender of last resort function, which is a key central bank function, requires that the Central Bank clearly defines the financial markets which it will protect and the markets~~which~~ which will not be protected. Furthermore the key relation is between the central bank and a market, not the particular institution with which the central bank transacts business. Thus the lenders of last resort intervention is a delicate operation which allows<sup>the</sup> refinancing ~~process~~ ~~markets~~ to reject particular units, types of paper and branches of industry even as it assures that the total amount of refinancing does not collapse.

The importance of Central Banking therefore increases the more business practices includes positions which need to be refinanced: central banking is the corollary of the use of speculative finance by organizations. Thus the relation between central banking and commercial banks<sup>is clear: Commercial banks</sup> are organizations which by their nature engage in a speculative financing of positions. However as the capitalist economics evolve other major organizations also emerge which engage in speculative finance. As long as the organizations that are called commercial banks are involved in the financing, refinancing and contingency financing of these other speculative financing organizations, then it may - as a practical matter - be sufficient for the Central Bank to be concerned mainly with commercial banks. However even if the Central Bank deals mainly with commercial banks it need recognize that it is truly responsible to assure "normal" behavior of finance.

During the great depression in the United States the Federal Reserve System took a narrow view of its responsibilities, so narrow that it even did not succeed in keeping its narrow domain - the member banks of the Federal Reserve System - functioning "normally". As a result of this failure a number of specialized organizations with what are partial "Central Bank" characteristics emerged. These organizations are the Federal Deposit Insurance Corporation, the Homeowners Loan Corporation, the Federal Housing Administration etc; these organizations were added onto the pre-existing Comptroller of the Currency and the individual state licensing and regulating bodies. As a result the actual Central Bank in the United States is a decentralized operation with the Federal Reserve as the "pre-eminent" body. A minor but not insignificant reform of United States institutions would have the specialized partial central banks in the United States structure become branches or departments within the Federal Reserve.

In a modern capitalist economy - which means that the "initial condition" is a complex financial structure - ~~a new financial structure~~ - new financial usages, markets and types of financial institutions emerge as responses to profit opportunities. Commercial and investment bankers are always structuring deals for both "borrowers" and "lenders". In a sense each unit that needs financing and every owner of a "portfolio" is unique; the financial officers of companies, loan officers of banks, position makers for a variety of organizations and money managers whether amateur or professional, are always working in an environment which is receptive to innovation. The loan officers problem - to structure a financing deal so that it is advantageous for both the borrower and the lender - in a competitive market environment

means that financial markets are always undergoing change.

In such an environment Central banking is a learning game in which the Central Bank is always trying to affect the current and future performance of a system even as the system is changing. The Central Bank learns about the emergence of an institution, market, or usage with a lag, and reacts to this development in a manner that either encourages or discourages the new development. Central Banking is successful in this type of environment to the extent that it knows the way the institutional structure it has to deal with really behaves and correctly assesses how the changing institutional structure affects the level of operations and the stability of the economy.

Central Banks therefore have to try to steer the evolution of the financial structure. The weapons it has can affect the profitability of a usage or its "risk" characteristics. The reserve requirement on a liability affects the cost of issuing that liability whereas the eligibility of an asset for discounting or the protection of a market in which an asset may be sold affects the riskiness or the liquidity of an asset.

The Central Bank is the master of its own portfolio excepting where law lays down a provision - such as the Gold Standard~~s~~ dictates - that a Central Bank buy all of some asset offered, although usually the Central Bank in these conditions has some control over the terms on which it buys. Thus the Central Bank has an ability to influence, though not to determine the financing relations that develop by its ~~power~~ to define the assets it will protect. Furthermore the Central Bank supplies reserves to member banks by acquiring assets. The Central Bank can affect the structure of financing by its selection of assets that it will use to furnish reserves to the banking system.

Whatever the activity or the way of doing business that the asset acquired by the Central Bank in <sup>or</sup>crediting reserves finances may be, it becomes, in the Reserve creating process, an activity or way of doing business that is cofinanced by the Central Bank. Thus favorable terms because of both cofinancing and its protected market ability will characterize this asset.

Thus as long as banks need Central Bank deposits as reserves, the Central Bank can affect bank portfolios. Therefore it is important that both the normal and the emergency creation of central bank liabilities occur on the basis of assets that reflect actual banking practices.

If finance is robust **then** speculative and Ponzi finance, provide a relatively small portion of the financing of positions in real assets and in investment in process. Furthermore when finance is robust business is likely to hold substantial stocks of money and other liquid assets. Robust finance therefore means that bank assets will largely consist of instruments other than short term business paper, bank assets will be heavily weighted by government debt. In these circumstances it is proper for the Central Bank's operations that affect the reserve position of banks and thus affects the financing available from banks ~~to~~ to consist mainly of transactions in which the Central Bank buys sells or accepts as collateral Treasury debt.

In a robust financial structure open market operations to constrain bank financing can constrain the financing available without inducing significant present value reversals. The cash needed to fulfill payment commitments of investing units does not increase substantially when interest rates rise, <sup>in</sup> when investment process is largely financed by investor's own rather than borrowed funds. Similarly in a robust financial structure long



term financing terms will not react strongly to transitory changes in short term interest rates. Thus in a regime in which the bank financing of activity is not very important, variations in the financing made available from banks will have a slight effect on the level of activity, without having any substantial effect on the viability of financial relations.

In a robust financial structure the attempt by the Central Bank to restrict bank lending by decreasing bank reserves or bank reserve growth will not lead to a decline in the financing available from banks, for banks will be able to substitute business debt for government debt in portfolios. The effect will be on interest rates as treasury debt is sold to obtain funds for private debts. Similarly if the Federal Reserve accelerates the growth of reserves beyond that which current financing requires, the banks will buy Treasury Debt from the market. In a robust financial structure the effect of monetary policy that operates on the quantity of reserves upon bank financing of business is always by way of the interest rates, there never are any serious quantity constraints.

It follows that open market operations to vary the reserve base and the financing available from banks can have a limited but appropriate effect on bank financing of private spending in a robust financial environment. But a robust financial environment is a transitory state. The very robustness of the financial environment means that credit to private organizations can expand more rapidly during periods of expansion than the credit base and can contract less rapidly than the credit base when the base contracts. However these differential rates of expansion of bank aggregate holdings relative to the monetary base decreases the robustness of the financial system: the propor-

tion of private debt relative to public debt in the portfolios of banks increases. In the shift towards fragility the ratio of Treasury debt in bank portfolios and the use of Treasury debt as the position making instrument decreases.

If banks - and other financial institutions - do not use Treasury debt as the position making instrument even as the assets and operations of the Central Bank are mainly in Treasury debt there is no direct business contact between the commercial banks and the Central Bank. Furthermore if a banking system is fragile ~~and~~ constraint on the expansion of or <sup>or</sup> decrease in bank reserves has to be well nigh fully reflected in the rate of growth of <sup>of</sup> the volume of bank loans. There is no "Treasury Debt" safety valve or shock absorber. A given expansion or contraction by the Central Bank has a larger proportionate effect on the quantity of available financing and on interest rates in a fragile than in a robust financial structure.

When organizations are "carying" longer term assets with short term debt, then the demand for finance to "roll over" the maturing debt is highly inelastic with respect to interest rates. The greater the volume of such speculative if not Ponzi finance in the structure of financial relations the more susceptible the financial structure is to variations in the level and flow of reserves to banks.

In a fragile financial environment Central Banking cannot blindly conform to the rules and techniques that were successful when the financial system was robust. In particular when Treasury securities are of diminished importance in bank portfolios and are no longer the position making instrument open market operations in Treasury securities are an inept instrument to use in guiding the evolution of financial relations. Variations in the level and rate of growth of bank reserves need to be related

to the assets owned by banks, and the need for banks to cofinance their holdings of assets with the Central Bank in order to acquire reserves is a relation that can be used to guide the assets used by banks and thus affect the way business finances its activity.

The trend of bank reserve must be more responsive to the demand for credit in a system that is fragile than in one that is robust. In particular the supply of reserves must be linked to assets owned by banks and to assets that banks use in order to make position. In a financial structure that is fragile the Central Bank has a responsibility to ameliorate the fragility by inducing banks to hold assets which reflect "hedge finance" by the borrowers. There is a need for the authorities to look through the veil of the banks balance sheet to the balance sheet of the organization that is being financed.

The fundamental question a banker asks a potential borrower is "how are you going to get the money to repay me". The same principal should guide the oversight through eligibility requirements of bank portfolios by the Central Bank. Banks should have access to central bank cofinancing of part of their position only through assets that reflect "hedge financing" by the banks customers. The Central Bank shall use its powers to provide bank reserves to act as a brake on the emergence of ever more levered speculative finance.

This means that the Central Bank should move away from the open market operation technique of controlling the banking system. In the open market technique of controlling the banking system the Federal Reserve determines the volume of reserves and the rate of change of reserves by operations in Treasury securities: buying securities when the Federal Reserve desires to augment bank credit and selling securities when it desires <sup>res</sup> ~~erves~~ to lower bank

credit. This technique implies that the Federal Reserve is cofinancing credit in general - not any particular type of credit.

The alternative to open market operations as the source of bank reserves and the technique by which the Central Bank cofinances banks is Central Bank discounting of bank assets and open market paper that are tied to the short run financing of business activity. In the discount window technique, reserves are furnished to commercial banks by the Central bank buying or lending on specified types of bank assets. The classical British discount market, in which banks "made position" by calling previous loans or lending to money market financial intermediaries which hold portfolios of business loans which originated in the financing of commerce combined with a Central Bank portfolio in which the reserve base of banks was largely the result of the central bank's ownership of loans that were initiated by banks as they financed business, is an apt structure for central bank control over the supply of credit and its evolution once the financial system is fragile.

If the reserve base of the commercial banks largely results from the discounting of short term loans tied to the ownership of goods in process, then each day, as borrowing banks "pay" the central bank the principal of the discounted loans which mature, even as the originating debtor - the commercial bank's customer - pays the commercial bank, the commercial banks find their reserve balance falling. In order to bring its reserve balance up to its desired or legal level banks will have to acquire reserves. This means it will discount paper. A reserve base that is generated by banks discounting paper at a Central Bank leads to a continuing business and discounting relation between each commercial bank and the source of its reserve funds,

the Central Bank. If the full British "discount intermediary" technique is adopted then each commercial bank will have to find market intermediaries willing to acquire its paper even as the market intermediaries find it necessary to acquire funds from the Central Bank.

The major reform of Central Banking in the United States that is indicated by the above argument is that the Federal Reserve should shift from the present Treasury debt/open market operations base for the creation of the reserve base and for monetary policy operations to a private debt/discount rate base. The treasury debt/open market operations technique is an apt technique for a robust financial structure where there are ample shock absorbers between the Federal Reserve actions on the quantity of reserves and the banks ability to finance business. In a robust financial structure the Federal Reserve need have no "policy" with respect to the assets that banks should acquire. In a fragile financial structure the Federal Reserve needs to use its powers to tilt financing towards hedge financing. This means that the Federal Reserve should encourage the use of short term bank financing for the carrying of business assets which turn over quickly. By using paper tied to goods in the process of production and distribution for both the creation of the reserve base and the monetary policy operation designed to affect activity, the Federal Reserve would be acting to induce favorable terms for financing that tends to sustain the robustness of the financial structures.

It really makes little difference whether the Federal Reserve discounts paper directly from banks or whether the paper need go through a market intermediary - there is no need to copy the details of the British 19th century practice. What is

important is that the Federal Reserve use paper that arises in those business financing practices it wishes to encourage as the basis of its reserve creations. Not only is the Federal Reserve creating a market for this paper in its own purchases but it is also assuring that this type of paper in the portfolios of business will have a protected status in the financial markets and therefore such paper will be in a preferred risk class. The guidance will run from the Federal Reserves portfolios to a favored interest rate state in the market for the "eligible" paper - the short run business originated paper that is used to finance short run ownership of commodities.

The discount window technique means that each day a portion of the reserve base is extinguished and banks or the market need to come to the Federal Reserve with eligible paper as they try to make position. Presumably in a complex financial structure with many varieties of bank liabilities and asset sales/hypothecation possibilities each bank will have alternative sources of funds with which to make position. These position making sources will develop a pattern of terms - and the terms on discounting will find their place in this structure of terms, depending upon the relative other costs and advantages of acquiring reserves from alternative sources.

The Federal Reserve instrument to control the amount and rate of change of bank reserves is its control over the terms on which banks can acquire reserves at the discount window. The principal is that the supply of reserves is infinitely elastic at a price to all who hold the appropriate instruments but the terms at which reserves are available is fixed by the Federal Reserve.

It is difficult to discover or invent a serious reason for being for eleven of the twelve Federal Reserve Banks in the present system where treasury debt is both the main asset owned by the Federal Reserve and monetary policy is carried out by means of open market operations. (The New York Federal Reserve bank is the operating agency for Federal Reserve Operations) and therefore has a reason for being. However if the key Federal Reserve activity is the discounting of paper that originates in the various banks then a highly decentralized banking system will require money markets and regional Reserve Banks. A shift to a discount window central bank leads to meaningful responsibilities for the various Federal Reserve Banks.

Instead of having a unified centralized market for commercial paper, banker acceptances, and discounted bank loans each Federal Reserve District would have one or more markets at which the Federal Reserve stood ready to purchase paper in the amounts deemed necessary to keep the financial capacity of banks and discount market houses at a target level. The major technique of the District Banks would be to offer to purchase paper of a specified qualitative characteristic from banks or the market at an interest or discount rate set by the Reserve Banks.

This discounting technique means that for any bank in the economy reserves would always be available at a term set by the Federal Reserve, as long as the bank had a specified type of asset. Furthermore a not insignificant amount of this type of asset would be in the portfolio of the Central Bank. In the aggregate the Central Bank would be financing activity of a particular type.

The type of paper that the Central Bank should acquire in the creation of reserves is that which results from the hedge financing of short term positions in goods in the process of

production. It is obvious that this argument has resurrected the commercial loan theory of banking - but only as a way of operating the banking system so as to encourage the use of banking system funds for hedge financing. The view is not that unrestricted supply of bank funds created by these asset yields the correct money supply but that the encouragement of this type of financing is a practical way of sustaining a degree of robustness to the financial structure.

Obviously the technique being suggested sets up a "financing" relation between the central bank, the commercial banks and the various money market institutions. The bankers well recognize that the "lender" or "potential lender" has the right to look over the shoulders of the borrower or potential borrower to assure the lender of the continued probity and credit worthiness of the borrower. In this way the Federal Reserve as the potential and actual lender to commercial banks has the right to "look over" the shoulder of the bank and comment on the adequacy of the ratio of eligible paper to total paper. The growth of the ratio of ineligible paper to eligible paper would be the occasion for a review of the line of credit available for the borrowing bank; the amount of paper the borrowing bank can originate which the district bank will assuredly acquire.

The virtue of the discount window technique of generating bank reserves is that the credit available to any bank is infinitely elastic at the posted terms, as long as the bank has the appropriate paper. Thus a bank will always work with two constraints, a cash reserve constraint and an asset/capital constraint. It will always keep a "reserve" of ability to borrow at its district Federal Reserve Bank in the form of eligible paper.



There are situations in which the volume of bank holdings of eligible paper may decrease because of a decline in the borrowing needs of business. This is what occurred in the great contraction of 1929-33 - when bank holdings and therefor Federal Reserve holdings of paper eligible for discount decreasing. However the fundamental fact is that a great contraction such as occurred in 1929-33 cannot take place in a world with big government. This is so because a sharp decline in investment and therefore income will trigger a veritable explosion of the government deficit - thus maintaining profits. The large government deficit means that the financial markets have to absorb treasury securities. <sup>us & a</sup> This <sub>A</sub> business and bankers, in response to perhaps a financial crunch unto an incipient crisis, ~~restrain their issuance and purchases of business paper,~~ the banks will keep fully invested by acquiring treasury bills and other government issues.

Once banks acquire <sup>the</sup> such Treasury bills for their portfolios then the Federal Reserve can assume that the Treasury Bill market becomes an effective position making market. If banks are acquiring Treasury debt at a time when the Federal Reserve wishes the reserve base to grow more rapidly than it is, the Federal Reserve can augment the reserve base that is created by the discount mechanism by purchasing Treasury bills from the open market.

Thus the mechanism by which the Federal Reserve generates the reserve base need be flexible: it need change as the operations and the instruments used by the banking system change. The Federal Reserve - and the other central banks of the capitalist world - have an obligation to oversee and guide, even as they cannot mandate, the evolution of the financial structure of business

and households insofar as this can be done by clearly defining the instruments that will be protected in the sense that there is a 'residual' market <sup>m</sup>aker - the central bank - that will halt downward pressure on the prices of these assets. The protected instruments should include the instruments used for the normal functioning generation of a large portion of the reserve base. The discount window/discount market technique of reserve creation seems to be the appropriate technique for a central bank that recognizes the likelihood of financial crises and accepts a modicum of responsibility to try to prevent the development of liability structures that are conducive to financial instability. The use of paper tied to the physical assets that flow through the production process seems to be an apt way of encouraging hedge finance - even as we recognize that in a capitalist world a thrust to speculative financing exists because bank and other short term assets can be used to acquire physical assets, companies and financial instruments.

In a capitalist economy with a big government a thorough going debt deflation that leads to a deep depression cannot occur as long as the government deficit that automatically accompanies a decline in income can be financed. This proposition changes the significance of the Central Banks lender of last resort function. The Central Bank has a responsibility to assure that those government deficits which results from a decline in income is financed in a way that does not lead to interest rate and term pressures on private debt. Thus the central bank needs to facilitate deficit financing under lender of last resort circumstances by making bank reserves available outside of the

"normal" discounting channel. The Federal Reserve need engage in vigorous "open market operations" in the recession/depression that follows a financial trauma.

However because the debt-deflation processes can be readily constrained, there is no urgent need for the Federal Reserve to intervene quickly and forcefully whenever a financial crisis occurs: the Federal Reserve has the option to stand back a bit and allow losses to accumulate and firms and financial institutions to go bankrupt before it steps in to refinance banks and other financial institutions. The principal to guide Federal Reserve intervention is perhaps easier to state than to use as a guide for action. The principal is that organizations which are fully viable at normal incomes with restructured debt at normal financing terms but which are not "solvent or liquid" with their current debt structure at crisis financing terms and recession incomes are eligible for refinancing under "protected" market conditions.

The longer the Federal Reserve delays its intervention the larger the decline in income and employment that will follow a crisis. The quicker the intervention by the Federal Reserve the sharper the subsequent rise in prices and the more fragile the financial structure with which the subsequent expansion begins. Thus how quickly the Federal Reserve intervenes to halt a financial crisis determines some aspects of the subsequent recovery.

When a Central Bank steps in to prevent a debt deflation by providing funds to refinance some positions, the Central Bank is protecting organizations that engaged in this type of financing and thus in a sense, spreading the protection against losses to this technique. Thus in a subsequent expansion units will feel that the Central Bank will again step in and

protect this type of financing. But it is an untoward extent of speculative and Ponzi finance that causes the fragility that leads to a crisis prone system. Thus if the Central Bank quickly steps in and validates the financing practices that led to a crisis it is virtually assuring that there will be another crisis in the near future unless by law or administrative decree it outlaws the practice. (This was done after 1933 with regard to thin margin financing of stock exchange equities and short term non amortized mortgage). Thus Central Bank intervention as a lender of last resort must be but one step in a restructuring of the financial practices of the economy in which the Central Bank's pressure is always favoring hedge financing and always leaning against speculative and Ponzi finance.

If a financing regime with a significant mix of speculation and Ponzi finance exists then a Central Bank can deliberately set out to trigger a financial crisis by adopting a sufficiently restrictive posture with respect to the volume of bank reserves or its rate of change. In a strongly expansive economy with big government and a sophisticated and innovative financial structure Central Bank restrictive activity is only effective as it brings about a financial crunch, squeeze, or debacle. Ever since the financial system became sufficiently fragile in the mid-1960's Federal Reserve constraint has only "worked" by means of first producing an incipient financial crisis. However in the years since 1966 it has also been demonstrated that the combination of a large increase in the government's deficit and a quick lender of last resort intervention limits the decline in income and employment (it also limits the decline in prices). Thus the question arises as to whether the Federal Reserve action to deliberately bring about a credit crunch is a useful tool of monetary management.

The argument is that "monetary policy" that will regularly lead to near financial crises introduces uncertainty into the outcome of portfolios, even as the big government/quick and effective lender of last resort interventions reduces uncertainty. Thus the use of Federal Reserve policy instruments to force crunches and squeezes is a way of constraining the growth of portfolios that lead to fragile financial structures.

However, in a paradoxical way, the knowledge that the Central Bank will attempt to force losses upon financial institutions, once it feels that the financing techniques being used are inept with respect to the stability of the system introduces certainty into the system. Organizations will need to pay a high premium in interest rates to banks and other financial institutions to get them to engage in these types of financing activity once it is clear that any untoward growth of speculative and hedge financing will lead to a "crunch" induced by the Central Bank. An announced policy of the Central Bank with respect to protected financial practices has <sup>as</sup> a corollary an announced policy of using ~~to force losses on organizations that engage in financial restrictive Central Bank practices~~ that the Central Bank feels are inducive to the emergence of serious endogenous instability.

Thus the Central Bank policy of constraining the development of speculative financial structure may, as a corollary, involve the continuous dampening of those economic activities that lead to speculative and Ponzi finance. But Ponzi finance is the "usual way" of financing investment activity in excess of the investment that is financed by internal funds. Thus ~~on Ponzi finance puts a damper~~ putting a strong damper on new firms/new industries and other dimensions of innovation. Capitalism without the financial practices that lead to instability tends to become a dull, institutionalized, and bureaucratic capitalism. To take the possibility of the disastrous cycle out of capitalism might very well take the spark out of the system.

However the central bank leaning against Ponzi and speculative finance does not mean that such finance does not

exist. The need to structure deals for business organizations means that bank loan officers and loan committees will always be faced with situations when the short term investment they are financing is really a Ponzi deal in that the "next stage" in a process of producing investment goods will provide the funds to meet the loan.

However if the Central Bank is "leaning against" speculative and Ponzi finance even as commercial banks are authorized to engage in underwriting then the "loan officers" in structuring the financing of a customer will have the "funding" of the bank loans into either intermediate term bonds or into equities in mind. We can visualize a financial structure in which commercial banks have access as "middle men" to life insurance, companies, pension funds and other money managers for the placement of the debts and equities of their "customers".

Once banks are allowed to be investment and merchant bankers for their customers, which leads to them becoming middle men in the placement of bonds and equities, a conflict of interest with banks as managers of funds for others arises. Can the commercial/investment bank also function as a "money manager". A local bank's trust department has obvious advantages as a source of funds for local companies. If the aim of banking reform is to promote a vigorous decentralized capitalism then local "investment" trusts should be fostered. It is evident that the local banks have advantages in organizing and managing such local investment trusts. Thus the "clear statement" of functions of different branches of a commercial bank combined with the expectation that the owners of funds made available to such local investment trusts are sophisticated means that the gains

from flexibility might outweigh the losses from conflicts of interest.

The above discussion has been largely phased in terms of "a" or "the" Central Bank, rather than in terms of the Federal Reserve System". This is so because in truth the Central Bank function of controlling and guiding the evolution of the Commercial banking system and the financial system of the United States has been "parcelled out" in portions among a variety of organizations. The Comptroller of the currency, the Federal Deposit Insurance Corporation, the Home Loan Bank Board and the bank regulatory agencies of the fifty states and the District of Columbia all have some Central Bank functions. As a minimum the Comptroller of the Currency and the Federal Deposit Insurance Corporation should be integrated as departments within the Federal Reserve.

It is evident that from the point of view of the economic theory, the interpretation of history and the analysis of institutions of this book doctrines to the effect that if we get money right, whatever that may mean, a close approximation to bliss (however defined) will result are pernicious. Banking as Henry Simons <sup>wrote</sup> is a pervasive phenomena and with banking's pervasiveness money takes many forms. Thus the economy's effective money supply is an ever adjusting concept and the supply of effective money is not determined by the setting of any "parameter" to the banking system by the "authorities". This is one reason why Central Bank operations through the discount rate (the terms on which Central Bank cofinancing and refinancing is available for eligible instruments) is superior to the Central

Bank operating through open market operations.

In a world of big government, the massive downward instability of a big depression is impossible as long as a downward movement of the economy leads to a large deficit. In principle big government also would prevent a large scale long lasting inflation. If the money value of government spending is set and an inflation leads to a large increase in money tax revenues then the resulting surplus will decrease profit flows and lead to asset valuation and debt validation problems. Thus it is the indexing of government spending ~~and~~ tax relief with inflation and the lender of last resort/ government reflation intervention that either singly or in some combination lead to chronic inflationary pressures.

Thus whereas the lender of last resort intervention can very well be delayed until after a debt deflation process has progressed quite a bit, which makes the lender of last resort function less important, the actual implementation of the lender of last resort function in the recent crises has been of critical importance in sustaining the overall inflationary thrust. In part it has been because the lender of last resort interventions have been prompt and forceful. In part because the Federal Reserve never followed up the intervention with a "censuring" of practices that forced the intervention: dependence on odd position making instruments, open market paper based upon imperfect refinancing commitments and overseas branching on the basis of "high cost" and "volatile" funds.

Thus the true significance of the Central Bank is not that it determines the money supply or that it is a lender of last resort but that by the assets it favors and protects it



can sustain a strong <sup>Core</sup>~~case~~ of hedge financing by business based upon borrowing from banks. The more the Central Bank can tilt the banking business towards using its financing for "trade and production" inventories with <sup>CR</sup>~~short~~ times to expected cash flows, the more stable the financial system and the smaller the special refinancing that the Central Bank will have to make available in the aftermath of a crisis.

## E. THE INVESTMENT BIAS IN POLICY

## I. Introduction

The relative importance and the financing techniques of private investment are critical determinants of the instability so evident in our economy. The greater the proportion of private investment in Gross National Product (GNP) and the greater the weight of speculative and Ponzi finance in the totality of financial relations the more unstable the economy. In particular the economic processes which tend to increase the weight of investment in output and of speculative and Ponzi finance in total finance lead to inflation and investment booms; the greater the weight of investment and of speculative and Ponzi finance the greater the likelihood of a financial crisis and a debt-deflation with an associated deep depression.

The instability of our economy leads to inefficiency and inequality. There are three root causes of the inefficiency of our economy: the investment boom and associated speculative/Ponzi finance leads to unwarranted and uneconomic projects, the debt-deflation and deep-depressions cause not only an enormous loss of output but also destroy people, and the existence of instability in a world where at least some outputs are carried on by capital-intensive techniques leads to a tolerance of monopoly and monopolistic organizations. Thus a first, necessary but not a fully sufficient, element in a program of reform is to recognize that we have a quite unwarranted investment bias in our policy and then, once we recognize that policy (and policy

includes legislated institutions) carries a pro-investment bias, we need to eliminate this bias. The elimination of the pro-investment bias takes the form of tax-reform, reform of corporate law, and reform of financial institutions and usages. Inasmuch as the other side of the coin that deemphasizes investment is an emphasis upon employment, a necessary dimension of reform is to eliminate the anti-employment bias in policy.

The contention therefore is that policy and this means our <sup>1</sup> institutional structure has a pro-investment and an anti-employment bias.

Inasmuch as both the importance of investment in GNP and the financing techniques available for both investment and positions in the stock of capital-assets are reflections of policy, public policy towards investment and its financing largely determines the instability, inefficiency, and inequality of our economy. Because of the need for the external finance of investment and positions in capital-assets and because of the significantly greater inequality of the distribution of wealth than of income, a capitalist economy will always exhibit some instability and inequality. However the extent depends upon the weight of investment in the economy and the behavior of financial institutions. For a capitalist economy to do better, policy has to be directed towards restricting the domain of private investment and reorganizing our financial system and usages so as to reduce the potential scope of speculative and Ponzi finance.

An investment oriented economy which permits speculative finance is also inefficient. During boom periods the possibility of

"floating off" projects makes the short term position taking of speculators a dominant influence on investment. In these circumstances, investments are made which are unwarranted and inept. The condominium complexes of Florida, Colorado, and California, the spate of oil

tankers, and the fleets of 747s, 1011s, and D.C. 10s are investments in the recent past which were unwarranted and inept until they were floated off by inflation. The idle capacity of the recessions and incomplete recoveries of the mid 1960s - mid 1970s is further evidenced that a cyclical economy is inefficient. The inefficiencies so beloved of the micro-economists, which are due to static monopolies of various kinds and inept government regulation, are small compared to the dynamic inefficiencies so evident in the ineptness of boom time investments and the unemployment of depressions and partial recoveries. Furthermore "static monopolies" often reflect the need to try to assure cash flows sufficient to sustain asset values of capital intensive projects.

Even though destabilizing effects of investment are inherent in any economy with a capitalist financial structure, the instability that investment can induce increases as the capital intensity of private investment increases. The greater the reliance upon private investment in capital-intensive techniques as the main force in sustaining income at full employment levels and in inducing "growth", the greater the potential and incentives for speculative and Ponzi finance. Although speculative and Ponzi finance are the proximate villains in capitalist instability, the deeper seated villain is the existence of a investment bias and in particular a bias towards capital intensity in the policy mix.

The investment bias in part reflects a policy strategy which emphasizes an indirect approach towards achieving a reasonable approximation to full employment instead of a direct job creating approach. The economic policy strategy that has been dominant since World War II is to create conditions conducive to private spending on investment and consumption that will in turn create a demand for labor. One side of this strategy is the proliferation of transfer payments, by means of which money is given to some designated group or the government pays for some designated service, such as medical care, for a target population. Another side of this strategy is the contract system by which government buys goods and services from private contractors. Instead of having arsenals and navy yards produce weapons and ships and government research facilities develop new weapons - as was the usual case prior to World War II - we now have for profit enterprises whose primary if not sole function is to produce for government contract. A third part of the indirect strategy is the development of inducements to invest.

To argue that the emphasis upon investment as the route to salvation is bad policy ~~because it is based upon an economic theory that misses the point as how our economy works~~, is to fly in the face of the conventional wisdom of both liberals and conservative "policy" economists. Investment is like the remedies sold by flim-flam men in the early days of our country - whatever ailed you, the medicine man's tincture would cure. In truth investment is not a universal cure-all. An emphasis upon investment leads to inflation, unemployment, and income equality.

Investment is inflationary, for those employed in producing investment goods 'demand' current output. Investment can generate unemployment as the produced capital-asset, when assimilated into production, leads to a substitution against labor in production. Investment leads to income inequality for profits, which are much more unequally distributed than labor income, rise as a share of output whenever investment rises as a share of output. The investment route for policy promises "pie in the sky", for investment, especially capital-intensive investment, takes a long time to work its presumably wonderful ways. Stalin 's economics, as well as the current investment oriented economic policies, promise "jam tomorrow, never jam today". The better use of our current capabilities rather than an emphasis upon more tomorrow for less today is what is needed.

Presumed benefits from investment follow from two aspects of standard economic theory. One is the special "Hansonian" depression oriented reading of Keynesian Theory. This Hansonian model of income determination, developed during the Great Depression, emphasized the passive nature of consumption and the active role of investment in the generation of income. In this model the way to have full employment is to have enough investment or government spending. Although transfer payments might affect the consumption income ratio, the policy thrust that dominated ~~in thinking~~ was to get investment or its proxy, government spending, high enough so that sufficient employment results.

The second theoretical strand that entered into the emphasis upon investment was the development after World War II of a model of economic growth that was based upon the simple consumption function.

This model derived the rate of growth of the economy by dividing the percentage of income saved and invested by a presumably fixed coefficient that related increases in capacity output to increases in the capital stock. Thus for example if 12 percent of income is saved and invested and the capital coefficient is 4 then the rate of growth of income would be 3 percent per year. Thus theory holds that investment is presumably beneficial in sustaining current income and generating productive capacity. In arguing that policy efforts to increase the pace of investment in order to sustain income and accelerate growth are disruptive and more than likely futile does not mean that policies to halt investment are desirable. Whereas an economy that emphasizes growth is not likely to achieve full employment, an economy that emphasizes employment will grow -- although the nature of the growth will differ in the two economies.

Whereas the emphasis in policy upon investment in general leads to the inflation/chronic unemployment situation we now have, an emphasis upon capital intensive investment is particularly disruptive. Not only does capital intensive investment give rise to more opportunities for speculative <sup>finance</sup> but the investors and financeers of large scale capital intensive projects require protection against market forces that can lead to prices in the neighborhood of unit out-of-pocket costs. Thus monopoly by regulation or oligopoly by institutional evolution are a "natural" outgrowth of the need for protection against the uncertainty that is inherent <sup>in</sup> the commitments involved in long-lived capital-intensive investment. Private capital-intensive investment imposes a requirement that markets be non-competitive. Price determination of

outputs that use capital intensive modes of production cannot be left to the unconstrained decision of profit maximizing management.

One policy problem is to design an economy that achieves full employment even as the emphasis upon investment, and in particular capital intensive investments, is decreased. Policy therefore must remove both the subsidies to investment and the barriers to employment of labor and the use of labor intensive techniques. It will become clear in what follows that policy aimed at diminishing the emphasis upon investment cannot be aimed solely at investment. Tax, employment and wage policies are all related to investment policy. Once reform impinges upon investment, employment, wage, and financial dimensions of our economy, the ramifications spread over the entire economy: piecemeal reform will not do.

### II. The Theoretical Roots of the Investment Bias

The dependence upon long-lived capital-asset production in order to sustain income and provide for growth in capacity is at least in part the result of policy decisions that are based upon inferences drawn from the standard interpretation of Keynes - inferences which are quite at variance from those that Keynes drew. Maynard Keynes, both in The General Theory and in other essays, saw a limit to accumulation. Keynes in 1936, envisaged a time, in the not too distant future, when, if the scourages of war, excessive population growth, and depression were eliminated, the productive capacity was such that it really was not worth very much to society to sacrifice substantial amounts of current income in order to provide for a greater income in the future. We now have a productive capacity that is far greater than those that Keynes envisaged when he foresaw the end of



growth. A question that must be faced is how much is enough: What is it worth in current sacrifices to foster growth? Is there an alternative policy to fostering growth in the policies that encourage the better use of existing capabilities?

In the United States in 1975 total personal consumption expenditures, as reported in the National Income Statistics, were \$963.2 billions. The reported population was 213.6 millions. This implies a consumption per capita of \$4,510.00 (\$4,180.00 in 1974). The median family income in 1974 was \$12,936.00. The difference between the \$16,720 that a presumed average four person family spend on consumption in 1974 and the median family income of \$12,836 is a measure of the inequality of incomes in the United States.

If as some data indicates the top 5% of the population consumes 17.7% to 20% of the total entered into the consumption data for national income, then in 1975, some 10.7 million people consumed some \$163.7 billion to \$192.6 billion; \$15,000 to \$18,000 per person. At this point one has to introduce a personal normative judgement. What is it worth in national effort, sacrifice, inequality and cyclical instability to assure that the representative family of four in the top 5% of the income distribution will be able to increase its consumption levels from an average of \$60,000 to \$72,000 per four person family at a 4% annual rate rather than at a 2% annual rate.

The "humane" rationale for economic growth in the United States is that it is worth a national effort to improve the lot of the poor by increasing per capita income through growth. If for example per capita income rises by 3% per year per person then, in some 23 years, the

consumption per capita in the lowest <sup>5%</sup> ~~group~~ would be \$2,260. However <sup>rather than the 1975 1130,</sup> this doubling would be accompanied by a rise in the average consumption of a one in the top 5% to a level of \$30,000 to \$36,000 per person. A growth orientation seems an awfully inefficient way to go about trying to improve the lot of the poor.

The theory of growth that permeated the programs and ideology of the 1960s with which we still live and which still are embodied in programs is an investment theory of growth. Output per worker in this theory as related to capital-assets per worker. It follows that if a higher GNP per worker is the goal, then output per worker has to increase and this can be achieved only by increasing capital-assets per worker through investment. Doctrines were advanced that private investment was good in two ways: private investment helps generate income and furthermore investment is the prime mover in increasing productive capacity. These virtues of private investment were good and sufficient reasons to induce various administrations and successive Congresses to give overt tax and subtle endorsing subsidies to investment.

Investment generates chronic unemployment, inflation and instability. Investment induced by fiscal and financial manipulations tends to be labor saving; the aim of the investment is to achieve a process of production which uses fewer workers per unit of output. If there is an expectation that money wages will be rising, then it pays to buy machinery and equipment at today's price level on the assumption that it will be used with higher wage labor and its output will be sold at a higher price level. The anti-employment - pro-capital-asset bias of expected money wage inflation is quite marked and an economy that

uses investment as its proximate income determining tool is "comfortable" with inflation. The faster the anticipated rise in money wages the greater the relative present worth of the more labor saving of alternative techniques. Where one chooses in the book of technical options for investment projects depends upon views as to how total revenues and out-of-pocket costs will develop over the expected useful life of the "contract" that runs for the anticipated economic life of a capital-asset. Thus the greater the expected rise in money wages the more it pays to substitute current capital-asset costs for future out-of-pocket, i.e., labor, costs. To the extent that there is a choice of technique or choice of timing of investment the greater the anticipated inflation in money wages the more the current choice of technique will substitute against labor and the earlier an investment project will be undertaken.

Investment is inflationary in that the income generated in the production of investment goods will be spent upon consumption goods: The workers who produce investment goods spend. The greater the emphasis upon investment, the greater the demand for consumption goods per unit of employment in consumption goods production. Thus the solutions to problems of income and employment generation that involve investment goods production introduce an inflationary bias to the economy.

### III. Socialization of Investment

Through regulation, government licensure, tolerance of non-competitive markets, overt government endorsements of various kinds, as well as aggregate demand management we have socialized much of the potential for losses from investing in capital-intensive techniques.

In doing this we have changed the relative advantage among various techniques, biasing private choices towards capital-intensive techniques. The changes in techniques that have taken place since World War II have not been the result of some "natural laws" working their inexorable ways. They have been side effects of policy decisions which have absorbed or eased the uncertainty that would rule under competitive market circumstances in an economy as cyclical as ours was prior to World War II. Such absorption of uncertainty by policy affects both borrowers and lenders. By affecting lenders the absorption of uncertainty by government intervention facilitates the growth of speculative financial relations. In truth the devices intruded into the economy in order to facilitate and stabilize investment with the objective in mind of stabilizing the economy have the longer term effect of expanding capital-intensive investment and increasing speculation, so that over time a ever greater <sup>potential</sup> / for instability is established. Any improvements in the performance of the economy that are achieved through reforms that absorb uncertainty while leaving unchecked the <sup>potential</sup> / <sup>financing of</sup> for private gain through successful speculative / investment are transitory. In time the tendency towards instability that prompted the reforms will be reestablished and if policy is to continue along the path that was broken earlier, government will have to absorb even more of the uncertainty.

Basically every time government intervention absorbs some potential for losses, it increases <sup>some</sup> / expected gains. Such an improvement in expected <sup>gains</sup> // <sup>set</sup> off a thrust of activity in particular directions which thrust will continue until the incremental gain is

offset by lower net returns and through increased leverage, by increased potential losses. Because aggregate policies sustain and increase investments' relative share, the lower net returns will not occur. Thus the process of expanding investment through speculative finance continues until market feedbacks break the speculative boom.

The impacts of government policies upon investment and choice of techniques can be illustrated by developments in agriculture. One of the distinctive attributes of American agriculture is the large amount of land and the large stock of capital-assets used per agricultural worker. But this dominance of capital-intensive techniques in American agriculture is a recent phenomena; it followed upon the introduction of various government protections against price and income declines in agriculture in the 1930s. The dependence of our "free" agriculture upon government intervention is well illustrated by the apparent fee for service arrangements between the political leadership and various dairy organizations that surfaced in the "Watergate" revelations. From the point of view of the dairy industry our government in the late 1960s - early 1970s was the "best that money could buy." The importance of non-market forces in determining the profitability of the "free enterprise" of the dairy industry made it important to "buy" the government.

The serious content of the agricultural price support programs is the socialization of downside uncertainty through a complex system of government programs. With downside uncertainty constrained, there is a floor to the cash flow that a farmer will receive each crop year. Such a guaranteed minimum cash flow makes the farmers signature on paper

to finance the purchase of equipment better than it would otherwise be. In terms of financing costs government intervention means that both lender and borrower uncertainty are diminished: the effective ability to lever capita-asset purchases on cash flows increases. That which would have been financially unattainable becomes easily arranged. However the end result of this process is not the creation of independent yeomen. Rather we now have an agriculture which is fully borrowed and mortgaged. The price of land and equipment, are now so high -- and the need for purchased inputs are so great -- that the cash flows required to service debt require that constant pressures be applied on government agencies for ever higher price supports. The system of ever improving price supports has even been built into land prices: in most of the mid-west agricultural land prices can only be rationalized on the basis of expectations that prices will rise higher in response to ever higher price supports. These ever higher price supports are needed so that revenues validate farmers' debts and to enable successful farmers to increase their borrowings to finance land acquisition. Commercial agriculture is as unstable and insecure as the more self-sufficient agriculture of the 1920s and earlier. The big difference is the political nature of the insecurity that now rules and the greater dependence upon the debt financing of capital-assets.

In agriculture, machinery has been a substitute for labor. The "push" out of agriculture and to the cities was facilitated by the availability of credit, not just for the purchase of simple implements but also for the purchase of machines that dramatically increase the capital stock for farmers,

Similar absorption of downside risk occurs in the various housing programs.

The entire thrust of the financing arrangements for energy put forth under the aegis of "Project Independence" is the absorption of downside risk. Losses that are expected to occur will be absorbed by the governments; profits, if any, as well as fees for managing, will accrue to the "private" contractor.

There are other "socializations of risk" of investment beyond those involved in agriculture, home mortgage guarantees, and various loan endorsement programs. Various regulatory authorities allow "banks" to carry assets at values that exceed their market prices during periods of near crisis. Monetary and fiscal policies have become powerful instruments for validating inherited debt and sustaining if not increasing the nominal value of capital-assets. These devices introduce a powerful inflationary bias into the economy; The repercussions of enabling banks to carry businesses that in truth are insolvent and of high government deficits, such as ruled in 1975, are felt in strong inflationary pressures during subsequent recoveries.

By socializing the potential for losses we have increased the upward instability of capitalism. We now have booms and inflations without the debt deflations, depressions, and deflations of earlier times. As things stand there really is no "issue" about the socialization of much of the investment and positions in capital-intensive capital-assets. The issue that we have to face is the nature of the socialism we will have and the effects of the socialism we choose, or have thrust upon us, upon the stability, efficiency and equity of our economy.

#### IV. Alternatives to an Investment Orientation

The alternative to a policy strategy that emphasizes investment is a policy strategy that focuses on the better use of what exists - the better use of labor and capital assets. Instead of a full employment policy that operates by means of inducements to invest we need to design a full employment policy that directly focuses on employment: a government employing agency reminiscent of the W.P.A. of the 1930's is necessary.

However the W.P.A. thrust is not enough; it is necessary to foster and promote more labor intensive, more capital saving modes of production. The financial reforms discussed in section D which argued for a shift in bank financing to the financing of goods in the production "pipe line, which argued for the preservation of a multi-bank banking system with a mass of smaller, local banks, and which argued for the ability of these smaller local banks to function as investment banks so that smaller and new business will have better access to equity and long term debt financing than at present are steps in the direction of eliminating the investment bias in policy.

Other steps to remove this bias will be taken up in the following sections. A pervasive reform of the tax system is necessary - as well as the development of institutional forms that constrain the corporation and provide alternatives to the corporation. The corporate form of organizing business is well suited to accumulation and to the use of capital intensive modes of production. Thus institutional changes that look to the promotion of alternative forms of business enterprise are needed.

Finally, the alternative institutional structure needs to emphasize employment. The constraints on labor market participation that are a legacy of the 1930s need to be undone even as



institutions that guarantee employment needs to be introduced.

The major institutional changes that are needed in order to implement an alternative to the existing policy strategy are those that assure that income from jobs are available for all.

## F. Taxation: The Pro-Investment Bias

### I. Introduction

Once government becomes big, whether as a purchaser of goods and services or as a device for transferring income, the tax take must grow along with government if large scale inflation is not to result. However once the tax take is a substantial portion of total output the structure of taxes becomes a powerful determinant of what happens. Taxes at high rates affect relative prices and decisions in a much more powerful way than do taxes at low rates. Qualitative changes do occur with quantitative changes.

It is worth recalling how tax rates have changed. In 1929, for the personal income tax, a married couple with two children had a \$3,500 personal exemption and the first tax bracket (up to \$4,000) of taxable income was at 3.8%: a family with \$7,500 of income would pay \$15 in taxes. The maximum tax rate of 24% applied to taxable incomes over \$100,000. In 1973 and later a similar married couple had a personal exemption of \$3,000 and the first bracket rate was 14% on \$500.00. The top bracket began at \$100,000 and was 70% on unearned, income. The rates for the

corporation income tax were 11% in 1929 and 48% in 1971 and after. All in all the enormous changes in rates have increased the power of income taxes to influence decisions. However these are ostensible rates: the true rate depends upon how individuals and business' react to the rate patterns. This is of especial importance with respect to corporations.

Both the effective tax rate on corporate capital income and the weight of the direct tax on corporate capital income in the Federal tax take have decreased over the years since the 1950's. Even as Federal Government tax receipts and expenditures have increased significantly faster than gross national product the taxes on corporate capital income have grown at a slower rate than gross national product.

The Federal Government tax take can be divided into four parts: personal income taxes, Social Insurance "contributions", Corporate profit taxes, and miscellaneous indirect business taxes. Personal Income Taxes and Social Insurance "contributions" have grown as a proportion of the tax take. The reduction of the effective rate of taxation on corporate profits over the past twenty-five years has been favorable to investment and the use of relatively capital-intensive techniques in production. Symmetrically the rise in social security tax rates

make labor more expensive. Social security taxation biases choices of technique against the use of labor intensive techniques. The post-war changes in the tax structure has a dual bias in favor of investment and against the use of labor. If we combine these biases with a low tolerance of unemployment, then the unemployment generation aspects of the tax structure leads to an expansionary thrust to aggregate fiscal policy and an inflationary thrust to monetary policy. On the one hand tax policy operates to increase unemployment and on the other hand monetary policy and government spending operate to decrease unemployment.

The reduction in the effective tax rate on corporate income has been achieved even as the ostensible or book rate on corporate income has remained high. This feat was accomplished by exempting much of

corporate capital income from the tax base and by special tax credits for particular types of corporate spending. The exemption of capital income from the tax base takes two major forms: the definition of a part of capital income as depreciation or capital-consumption allowances and by exempting capital-income that is paid as interest from the corporate income tax. Of the special tax credits, the most pernicious from the point of view of inflation, employment, and stability is the investment tax credit.

As a result of the present crisis in policy it may be possible to start a serious discussion of tax reform which does not look at modifying the "gimmicks" in the tax laws but rather looks at how the structure of taxes "rig" the game that is the economy. Once again it may very well be that it is not "big government" which is at fault but the structure of what government does and how the government extracts the revenue needed to constrain if not halt inflation.

## II. Investment, Government Spending, Profits, and Taxes

In a closed economy, spending on investment and by the government are largely independent of the short run operations of government. Investment is determined by the present value of expected future capital-asset incomes and current supply price of capital-assets. Government spending is determined by programs and "entitlements" - the entitlements do yield a feedback relation between government spending and the current state of the economy.

Even as Investment and Government spending are largely independent of current short run performance of the economy, consumption is mainly

determined by how the economy is currently running. In the not too distant past a typical worker had no financial resources independent of current receipts from employment and no programs of entitlement, such as social insurance, food-stamps and social insurance, existed. In these circumstances workers incomes and thus workers expenditures depended quite closely upon their pay packets.

During World War II workers accumulated financial assets. Various home ownership programs have led to workers having an equity interest in houses. These developments, along with the plethora of transfer payments and the expansion of consumer credit have attenuated the close connection between workers wage income and consumption. This has had the effect of maintaining consumption as unemployment increases and even allowing consumption spending to lead the way in business cycle recoveries.

One striking aspect of the business cycles of the post-World War II era is the way in which consumption spending led recoveries. Once the 'sky does not fall' in the recessions - even in the progressively more severe recessions of the 1965-75 decade -

a relatively short period of moderate consumption and high savings ratios by households is followed by a burst of consumer spending - including a rise in household debt-financed spending.

Given that the sum of the surpluses and deficits over the various sectors must add up to zero and that every debt issued by some unit has to show up as an asset of another unit, the household receiving and spending relations affect the behavior of the economy. However it nevertheless remains desirable, in the first cut at an examination of the effects of government spending and

taxation, to assume a "passive" behavior of the household sector. In fact relations are clarified if we assume that households do not save, so that we can work in a simple set up in which profits plus taxes equals investment plus government spending. That is profits minus investment is the corporate sectors surplus or deficit and taxes minus government spending is the government surplus or deficit. The sum over all sectors of deficits and surpluses must always equal zero. (This is nothing more than the statement that for every borrower (deficit) there must be a lender (surplus).)

Government spending plus investment demands are the total "exogenous" spending in our economy. Given that households are assumed not to save and that all of profits are saved then Profits plus Taxes equals Government Spending plus Investment. We assume that government spending can be broken down into a demand for consumption goods and a demand for investment goods ~~output~~ (more about this in a bit). We assume that for each output of investment goods we can know the corporate profits taxes, the social security contribution, the various excise taxes, and, by looking through the businesses to the households, the personal income taxes that will be collected. That is although we are looking at it a bit differently we are assuming that it is possible to estimate the budget tax receipts associated with different levels of income. We also presumably know the corporate profits that will be generated at each level of investment and consumption output.

The demand for investment goods and the investment demand component of government spending generate an output of investment goods. This output of investment goods yields three variables: employment in investment goods, profits in investment goods production, and taxes that result

from this level of investment goods production. The difference between the Government spending plus investment spending minus the profits and taxes that are generated by investment goods production and sales yields the sum of profits and taxes that will be earned in consumption goods production.

For every level of profits plus taxes in consumption goods production there is a particular level of consumption goods output. Thus consumption goods employment is determined.

The requirement that profits plus taxes equals government spending plus investment determines the level of income and employment. However the way in which taxes are generated will affect the distribution of income, the incentives to invest, and the weight of investment in the economy.

### III. Corporate Capital Income Taxation

Corporate capital income is the quasi-rents that capital-assets earn as they are used in production. In terms of the available data these quasi-rents consist of the sum of corporate profits before taxes, capital consumption allowances, and net interest paid by corporations. That part of corporate capital income that is conveyed to the private purposes of management by means of expenses or salaries is missing from our measure of corporate capital income. Such "conveyance" has become a public relations problem for the managements of publically held corporations during the post-Watergate revelations of corporate behavior. "Conveyance" of various kinds is an endemic phenomena of smaller, closely held corporations.

Quasi-rents for purposes of determining the values of capital-assets <sup>are</sup> the quasi-rents minus the profit tax liability of corporations. Some of this capital income minus profit tax liabilities is distributed as interest payments, some as dividends, and the remainder is the retained earnings of corporations

Savings equals investment but savings are not investment. The way in which the equality is brought about is by adjustments in the level and distribution of income, so that realized savings equal investment. Investment calls the tune; income, employment, and the distribution of income between labor and capital income change in response to changes in investment; and after all the changes take place the result is an equality of saving and investment.

A major source of savings is the quasi-rents of corporations. First of all a part of the quasi-rents, the corporate gross profits after taxes, are held as gross retained earnings in corporations. A second part is paid as interest and dividends. Some of these interest and dividend payments go to pension funds and life insurance companies. The pension funds and life insurance companies pay no taxes and they mainly save their investment income. Taxes are paid on that part of interest payments and dividends that accrues to individuals.

We therefore expect the savings ratio out of profit income to be large and savings out of capital income, as we define it, to be a major portion of the total saved. If the world were as simple as the naive Kalecki model, in which workers income was all spent on consumption and all of capital income net of taxes was saved, then capital income net of taxes would equal investment. Capital income gross of taxes would adjust



so that the investment that actually takes place would be offset by saving. In this view any profit taxes will show up in the mark up on wage costs in the production of consumer and capital goods and not in a reduction of the after tax income of capital-assets: profit taxes are not really different in their distributional aspects than excise or sales taxes.

It is obvious that profit taxes will show up in the margin over out-of-pocket costs in the production of consumer goods if we assume that these tax receipts are spent to employ workers who then proceed to spend their entire income on consumer goods. Government spending that employs workers who spend their disposable income on consumers goods generates profits in consumer goods production equal to such government spending. Profits before taxes rise if there is a simultaneous increase in spending on consumer goods by government employees and in taxes levied on corporate capital income.

If profits taxes are carried forward to product prices as the anticipated receipts are spent to hire state employees then a profits tax will not affect the after tax profitability of capital-assets. What will be affected by profits taxes and government spending is the mark up on labor costs that rule in the production of consumption goods. By the rule that capital asset prices and investment in capital-assets that specialize in the production of capital-assets depends upon the after tax quasi-rents, a rise in profit taxes will lead to an increase in the mark up on out-of-pocket costs in the production of investment goods.

If profit taxes do not affect the after tax profitability of business, why are capitalists, legislators dependent upon capitalists, and administrations that are interested in the well being of capitalists so adamantly interested in reducing taxes on corporate capital-asset income?

The reason is that while corporate capital-asset income generates a major share of the savings that offsets investment, it is not the only source of such savings. If the volume of spending by government is invariant with respect to the profit tax receipts, then a reduction in profits taxes will either lead to a government deficit or a rise in taxes in some other sector which decreases the savings in the other sector. Thus a decline in corporate income taxes and a rise in household income taxes with no change in the government budget posture would lead to a decrease in saving by the household sector and a rise in the quasi-rents in the corporate sector. That is with less household saving, more of the investment will have to be offset by a rise in capital-asset income.

The tax structure therefore is important in determining whether saving to offset investment (and incidently any government deficit) will occur as household saving or as corporate saving. If taxes are household biased, then a larger portion of the saving will take place in the corporate sector. This means that the gross capital income after taxes will be larger for any given investment and any given federal deficit than it would be if the tax structure were more heavily weighted on corporate-capital asset income. Inasmuch as the size and surety of corporate capital-asset income is a determinant of capital-asset values, the smaller the corporate taxes the higher capital-asset prices and thus investment.

In a world with big government the tax structure is a major determinant of the profitability of capital-asset. Big government per-se contributes to profitability - and big government with a decreasing share of corporate taxes in total taxes is an especially powerful contributor to corporate profitability.

## IV. The Course of Corporate Capital-Asset Taxes in the Post-War Period

In 1950 G.N.P. was \$286.2 billions and Federal government tax receipts were \$50.0 billions: tax receipts were 17.5% of G.N.P. Over the twenty-five years since 1950 G.N.P. grew at a compound rate of 6.62% and Federal Government tax receipts at 6.97% (Federal Government expenditures grew at 8.68%) so that receipts were 19.0% of G.N.P. in 1975. (Because the Federal Budget was in substantial surplus in 1950 and in massive deficit in 1975 the ratio of expenditures rose from 14.2% in 1950 to 23.8% in 1975 (of G.N.P.).)

G.N.P., Federal Government Receipts and Expenditures  
1950-1975

	G.N.P.	Federal Government		Expenditures + G.N.P.
		Receipts	Expenditures	
1950	286.2	50.0	40.8	14.3%
1955	399.3	72.6	68.1	17.1
1960	506.0	96.1	93.1	18.4
1965	688.1	124.3	123.8	18.0
1970	982.4	192.1	204.2	20.8
1975	1499.0	285.3	356.9	23.8
Growth Rates (%)				
1975/1950	6.62	6.97	8.68	
1965/1950	5.84	6.07	7.40	
1975/1965	7.79	8.31	10.64	

Even as the size of the Federal Government grew both absolutely and as a percentage of G.N.P., the significance of the Corporate profits tax decreased. In 1950 and in 1951 corporate profits taxes accounted for about 34% of Federal Tax receipts. In 1975 the corporate profit tax accounted for 14.2% of Federal Government receipts. At the same time as the Corporate income tax was declining as a percentage of total tax

receipts, indirect business taxes were falling from 17.8% of tax receipts to 8.5%. The Federal Tax System now is to an overwhelming extent dependent upon two taxes: Personal income taxes account for some 45% of tax receipts in recent years and social insurance taxes account for about 33%. The taxes on personal income and on labor services together accounted for 77.3% of Federal Tax receipts in 1975.

In the years since 1950 the marginal tax rate on corporate profits as given by the law has varied from a low of 42% in 1950 to a high of 52.8% in 1968-69. The rate since 1971 has been 48%. Throughout the period the marginal rate has been applicable to all taxable corporate income in excess of \$25,000 per year. Because of both income growth and inflation we should expect the proportion of total corporate income in the lower tax brackets - under \$25,000 per year to be a smaller percentage of the total corporate income. These inflation plus growth phenomena should have resulted in a higher effective average tax rate on corporate capital income.

However in fact the effective tax rate on corporate capital income has fallen from 39% in 1950 to 18% in 1975. As a result of the reaction of business to the tax laws and the writing of the tax laws so as to exempt some cash flows from taxation the capital income exempt from taxes has grown much more rapidly than taxable profits. Thus over the entire period corporate profits before taxes grew at a rate of 4.01% per year whereas capital consumption allowances grew at 7.84% and net interest grew at 14.6%. Profit taxes grew at a rate of 3.17% over these 25 years. As a result corporate capital income after taxes grew at 7.41% over this period whereas nominal GNP grew at 6.62%! The ratio of 25 years of growth at 7.41% to 25 years of growth at 6.62% is 1.22 - corporate after tax capital

Receipts of Federal Government Sector of  
National Income and Product Accounts

Types of Receipts as % of Total Receipts  
1950-1975

	Personal Income Tax	Corporation Profit Taxes	Indirect Business Tax	Social Insurance
1950	36.2	34.4	17.8	11.8
1951	40.6	33.7	14.6	11.0
1952	46.1	27.6	15.3	11.0
1953	46.0	27.9	15.6	10.6
1954	45.5	26.5	15.2	12.9
1955	43.3	29.1	14.7	12.9
1956	45.1	26.8	14.4	13.6
1957	45.7	24.9	14.4	15.0
1958	46.8	22.9	14.6	15.8
1959	44.4	25.1	13.9	16.6
1960	45.4	22.3	13.9	18.3
1961	45.6	21.9	13.9	18.7
1962	45.8	21.2	13.7	19.3
1963	45.0	21.5	13.4	20.2
1964	42.3	22.7	14.1	20.9
1965	43.4	23.2	13.3	20.1
1966	43.5	22.1	11.0	23.3
1967	44.9	19.9	10.8	24.4
1968	45.6	20.8	10.3	23.4
1969	48.1	18.4	9.6	23.9
1970	48.0	15.6	9.8	25.2
1971	45.3	16.9	10.3	27.6
1972	47.6	16.1	8.8	27.6
1973	44.5	16.5	8.2	30.8
1974	45.5	15.9	7.5	31.0
1975	44.3	14.2	8.5	33.0

Source: Table B-67, Economic Report of the President, 1976.

	Profits Before Taxes	Capital Consumption Allowances	Net Interest	Profit Taxes	Capital Income minus Profit Taxes
	(Billions of Dollars)				
1950	29.6	12.6	.9	16.9	26.2
1955	38.2	19.2	1.6	20.2	38.8
1960	37.4	27.0	3.5	19.2	48.2
1965	66.1	32.8	6.1	27.2	77.8
1970	51.6	53.1	17.0	27.3	94.4
1975	80.7	89.5	34.3	37.3	167.2
	<u>Growth Rates %</u>				
75/50	4.01	7.84	14.6	3.17	7.41
65/50	5.36	6.38	12.8	3.17	7.26
75/65	2.00	10.04	17.27	3.16	7.65

income grew 22% more than G.N.P. over this 25 year period.

Over the last decade nominal G.N.P. grew at a 8.45% rate; over this period capital income after tax liability, grew at 11.43%. The claim that capital income has been starved is patently wrong. What has happened is that the tax exempt portions of capital income have grown relative to the taxable portion. The rapid growth of capital consumption allowances is a function of tax laws and not of technological fact; the rapid growth of net interest payments is indicative of how liability structures have responded to tax law provisions as well as being a repercussion of the boom in investment

The boom in investment in turn has been facilitated by the introduction of investment tax credits. Investment tax credits not only lower the effective price of capital assets, they also increase the relevant quasi-rents that determine asset values.

## Effective and Ostensible Corporate Profit Taxes

1950-1975

Year	Profits Before Taxes	Capital Consumption Allowances	Net Interest	Total Capital Income	Profit Tax Liability	Tax Liability + Capital Income	Ostensible Marginal Rate	Capital Income Minus Profit Tax Liability
Billions of \$								
1950	29.6	12.6	.9	43.1	16.9	.39	.42	26.2
1951	33.4	14.6	1.1	49.1	21.2	.43	.50	27.9
1952	30.3	15.7	1.2	47.2	17.8	.38	.52	29.4
1953	29.9	17.0	1.3	48.2	18.5	.38	.52	29.7
1954	28.6	17.9	1.6	48.1	15.6	.32	.52	32.5
1955	38.2	19.2	1.6	59.0	20.2	.34	.52	38.8
1956	36.1	21.5	1.7	59.3	20.1	.34	.52	39.2
1957	35.0	23.7	2.2	60.9	19.1	.31	.52	41.8
1958	30.1	24.9	2.7	57.7	16.2	.28	.52	41.5
1959	39.7	26.0	3.1	68.8	20.7	.30	.52	48.1
1960	37.4	27.0	3.5	67.9	19.2	.28	.52	48.7
1961	37.4	27.8	3.9	69.1	19.5	.28	.52	48.6
1962	44.9	28.7	4.5	78.1	20.6	.26	.52	57.5
1963	50.0	29.8	4.8	84.6	22.8	.27	.52	61.8
1964	56.7	31.0	5.3	93.0	24.0	.26	.50	69.0
1965	66.1	32.8	6.1	105.0	27.2	.26	.48	77.8
1966	71.2	35.7	7.4	114.3	29.5	.26	.48	84.8
1967	67.2	39.3	8.7	115.2	27.7	.24	.48	87.5
1968	72.1	43.0	10.1	125.2	33.6	.27	.53	91.6
1969	66.4	47.8	13.1	127.3	33.3	.26	.53	94.0
1970	51.6	53.1	17.0	121.7	27.3	.22	.49	94.40
1971	58.7	58.2	17.9	134.8	29.9	.22	.48	104.90
1972	72.0	62.6	19.1	153.7	33.5	.22	.48	120.20
1973	75.9	68.7	24.7	169.3	39.1	.23	.48	130.10
1974	63.2	78.3	31.7	173.2	42.7	.25	.48	130.50
1975	80.7	89.5	34.3	204.5	37.3	.18	.48	167.20

Source: Table B-8, Economic Report of the President and J. Peckman, Federal Tax Policy.



Gross Domestic Product  
Non-Financial Corporate Business  
1950-1975

	Gross Domestic Product	Gross Capital Income	GCI After Profit Taxes	GCI + GDP	<u>GCI - PFTXS</u> GDP
1950	151.9	43.1	26.2	24.9	17.2
1951	174.5	49.1	27.9	28.2	16.0
1952	182.3	47.2	29.4	25.9	16.1
1953	195.0	48.2	29.7	24.7	15.2
1954	191.9	48.1	32.5	25.1	16.9
1955	216.7	59.0	38.8	27.2	17.9
1956	231.6	59.3	39.2	25.6	16.9
1957	242.3	60.9	41.8	25.1	17.3
1958	236.3	57.7	41.5	24.3	17.6
1959	265.7	68.8	48.1	25.9	18.1
1960	277.3	67.9	48.2	24.8	17.4
1961	284.5	69.1	48.6	24.3	17.1
1962	311.0	78.1	57.5	25.1	18.4
1963	330.9	84.6	61.8	25.6	18.7
1964	357.6	93.0	69.0	26.0	19.3
1965	392.1	105.5	77.8	26.8	19.8
1966	430.7	114.3	84.8	25.4	19.7
1967	452.9	115.2	87.5	25.4	19.3
1968	498.4	125.2	91.6	25.1	18.4
1969	541.8	127.3	94.0	23.5	17.3
1970	560.6	121.7	94.4	21.6	16.8
1971	602.5	134.8	104.9	22.4	17.4
1972	671.0	153.7	120.2	22.9	17.9
1973	751.9	169.3	130.1	22.5	17.3
1974	808.7	173.1	130.5	21.4	16.1
1975	866.1	204.5	167.2	23.6	19.3

Source: Table B-8, Economic Report of the President.

## V. Corporate Tax Reform

Because the corporate profits tax is now such a relatively small part of the total tax take the time might well be ripe for a rather thorough reconsideration of the taxation of corporations. The virtue of a corporation income tax is that it is relatively easy to collect - once income is defined. A simple definition of income is value added - which is simply total revenues minus out-of-pocket costs. The only question here is the definition of out-of-pocket costs.

One way of looking at income is to realize that, after all the purchased inputs are "cancelled out," income is labor income plus gross capital income. Present usage divides the gross capital income into five components: capital consumption allowances, indirect business taxes, profit tax liability, profits after tax, and net interest. In 1975 gross domestic product of non-financial corporations amounted to \$866.1 billions, and their indirect business taxes and profits tax liability totaled \$130.4 billions (this is both state and local taxation). In calendar 1975, Federal Government collected \$40.2 billion in profits taxes and \$24.2 billions in indirect business taxes. In addition \$93.5 billions were contributions for social security of which about half were from business. In 1975 the Federal Government collected some \$110 billions in taxes from business and \$170 billions in personal income taxes and social security from individuals.

The \$110 billions collected in corporate taxes would be some 12.7% of the gross domestic product of non-financial corporate business. If we allow for value added in non-corporate business and in finance, a simple 10% straight value added tax would seem to yield the same gross revenue as the

present set of taxes. (Alcohol, tobacco, gasoline and tariff revenues would in fact make the required receipts from the value added tax needed to offset the end of corporate taxes lower than 12.7%.)

One virtue of the value added tax is that it is neutral as between capital income and labor income. However labor income is distributed to households and then enters into the personal income tax. Capital asset income, through retained earnings, can evade such taxes. It is necessary to devise some means of taxing corporate profit income in order to close this potential for avoiding taxes.

An obvious way to tax capital income is to tax the full net income of corporations at the stockowner level by imputing the per share earnings to the stockholders regardless of whether or not dividends are paid. Inasmuch as the value added tax could be set at a level that "makes up for" the abandoned corporate profits tax and inasmuch as the ownership of property is much more unequally distributed than labor income, the combination of a value added tax and an imputation of corporate profits to households can yield more than the present direct and indirect taxes on corporations. Such a reconstruction of taxes holds out a promise of a substantial decline in tax rates on personal income. In 1975 non-financial corporate income was about twice as great as dividends. These would be taxed at the household rates.

Inasmuch as profits are taxed regardless of whether or not dividends are paid the rationale for capital-gain taxation is reduced. Capital gains take place either because of accumulation of profits within the corporation, because capitalization rates on future profits have increased, or because of entrepreneurial skill. With full imputation of profits to stockholders ~~the~~ the accumulation through retained earnings are already taxed and there is no

need to tax capital gains on that score. Capital gains that accrue through rise in capitalization rates on future income reflect an overall lowering of expected gross profits flows relative to the cost of capital-assets and will accompany a low-investment strategy. There is some virtue in attempting to recover these gains by means of taxes but such capital gains are I suspect difficult to differentiate from capital gains that accrue due to entrepreneurial skill.

Capital gains due to entrepreneurial skill are the result of successful innovations. It should be a major aim of policy to encourage entrepreneurial drive and commitment. In the light of these concerns the taxing of capital gains due to entrepreneurial skill and drive should be avoided. Because of these reasons the capital gains taxes we now have should be eliminated - once full taxation of per share earnings at the individual level are initiated.

One further point: inheritance taxation is desirable mainly because great inherited wealth is a barrier towards entrepreneurial organizations and generates power bases that are incompatible with democracy. The treatment of inheritance as income with some five years averaging of the inheritance in computing the tax would be an equitable way to treat this problem. Extraordinarily high tax rates for extraordinarily high incomes needs be built into the income tax schedule if this is the route taken.

## VI. A Federal Tax Package

A strict definition of corporate profits combined with the elimination of the corporate income tax and the full imputation of per share profits to the taxable income of stock owners is a first item in tax reform. It not only removes a tax incentive to debt finance but it also eliminates the tax induced advantage of the corporate form of organizing business over the proprietorship and partnership form.

Another item is to move towards a comprehensive definition of personal income. Not only should the fair rental value of owner occupied housing be imputed to the income of the owner but the costs of owning and maintaining the property should be fully costed against this income. Expenses of modernizing, upgrading or gentrifying housing should also at least in part be offset against the income due to the owner occupied house. In addition the cost to the employer of fringe benefits should be imputed to the taxable income of the employee.

Much has been made of the explosive run up of the costs of medical services. It is odd that the public discussion has not related this to the way the tax system allows the employer to deduct the premium as a cost even as the beneficiary does not have an offsetting taxable income. Thus for a tax paying corporation, the fringe benefit is a labor cost to be reflected in price whereas the employee receives non taxable benefit. This system is inflationary in two ways. One the premium has to be recovered in the price of the employers products even as the employee is "delivered" a package of services with a zero or negligible incremental cost (which of course leads to use of the system). The strong demand for medical

services that results leads to even higher prices. These prices show up in the price index as a higher cost of medical services and a higher price, reflecting the higher costs, of the employers product.

Similarly employers contributions to employees pensions should be fully taxed as employee income. Because they are fully taxed as income they should by law be fully and completely vested.

A critical step in tax reform is the complete elimination of social security taxes as they now exist. A straight five percent tax on income from all sources without any personal exemptions should be the individuals contribution to social security; an equal contribution from general revenues should go into the "fund". The social security benefit should be open ended, although the benefit might well take the form of a minimum plus an earned income which does not increase in ~~proportion~~ <sup>proportion</sup> to the individual "kitty". Thus social security should have a slight but significant progressive bias.

In lieu of the Social security tax on employers, a moderate, say 10% to 12%, added tax should be introduced. Some 5% of the wage bill portion of value added can be considered as an employers contribution to Social Security and every wage earner can, if it is deemed desirable, receive a credit of this amount towards his social security.

Note that the way in which social security is treated it "pays" for an employee to have the employer pay the value added tax. Furthermore to the extent that the Social Security benefit will be related to the amount credited over the years to an individuals account and there is no cut off to the annual income that leads to Social Security benefits it is always in the interest of the employee to have the value added tax paid.

Once a comprehensive income tax and a value added tax are made the foundation of the tax system, then a series of excise taxes and subsidies designed to steer consumption and production techniques are a valid part of the tax package. Two principles indicate the desirability of such taxes. All taxes except perhaps the personal income tax, show up in product prices: the employers contribution to social security taxes, value added taxes and corporate income taxes will be recouped in prices. Thus aside from the progressivity that can be introduced into a tax structure by way of the income tax, the distinction between progressive and regressive taxes is not on any firm foundation. The second principal is that all taxes modify behavior in the direction of tax avoidance or evasion, but taxes that are at a low rate have minor impact and the impact increases sharply as the rate of taxation increase.

The tax avoidance and evasion impact of taxation implies that when tax rates are set the authorities have to consider what form evasion and avoidance will take. In many situations it is clear that tax avoidance takes the form of the development of a parallel or gray economy in which labor services and outputs are offered for currency rather than for check. (Similarly regulation will lead to acts to evade or avoid. Regulation should tread warily into areas where avoidance and evasion profoundly affects society: the United States experiment with prohibition is an example of regulation gone awry).

Because a big government requires expenditures that are 20% of gross national product a tax system must be that large. In order to keep the income and value added taxes within bounds it is desirable that they be supplemented by some excise and for revenue import duties. It should be recognized that excise taxes can be powerful devices to affect relative prices and that whatever net revenue they yield can be used to moderate income tax and value added tax rates.

In the United States ever since the shift toward a serious dependence on offshore oil it has been clear that these are serious external diseconomies, or costs in terms of national well being, from the balance of payments deficits that results from unconstrained oil imports. Because of such public and not private costs, serious excise taxes on oil products or on "oil" as an input to the refining process are in order and have been in order since the early 1970s. Given the volume of oil used in the United States an excise tax of \$10 a barrel on all oil would profoundly affect the relative price of oil products.

Such a tax would easily be set at a rate that would more than offset the present employers contribution to social security or would lead to a sharply lower value added tax than would otherwise be necessary. The tax, which will prompt action to avoid and evade, will use this trait for social ends, tax avoidance will be "patriotic" although if successful it will force an increase in the value added tax.



## G. Alternatives to Corporate Dominance

### I. Introduction

In a historical perspective, the institutionalized, bureaucratic and non-specialized corporation which is today's dominant business form is a young creature of the law, of the state. The corporation has become the dominant economic institution only over the past century. The corporation, as we know it did not exist in 1776 or 1876. The corporation emerged as the dominant form of economic organization after the law was altered to give corporations additional financial powers. The corporate form won over the proprietorship and partnership forms in the market place because, together with the financial system that evolved in a symbiotic relation with the corporate form, corporations are a powerful tool for accumulation; especially of long lived specialized capital-assets. Corporations are more powerful than a proprietorship or partnership as vehicles for accumulation.

The corporation is primarily a financial organization. Its major strength is that it can issue long lived debts and equity shares that are not tied to the "fortunes" of specific persons or the value of specific assets. Thus the corporate form facilitates the external financing of long lived, specialized, and expensive capital-assets; the full costs (which includes financing charges) of such capital-assets are relatively cheaper for corporations than they would be for proprietorships or partnerships. The corporation is a vehicle that fosters the dominance in the economy of capital-intensive production techniques that utilize specialized capital-assets. The corporation is a social device that tilts the economy towards the use of labor-saving techniques.

In the United States over the past several decades the dominance of capital-intensive, specialized capital-asset production techniques has grown to such an extent that a chronic labor surplus has emerged. In order for the economy to work better it is now necessary to invent and promulgate productive enterprises that put this surplus labor to work; we need to develop enterprises that use more labor intensive modes of production than are now being used. The decrease in the labor-force participation rates <sup>of</sup> young and older males as well as our chronically high unemployment rates are indicative of the unbalanced nature of our economic development over the past half century. New institutions and modifications of existing institutions are needed so that labor intensive modes of production can coexist in a full employment economy with capital-intensive modes.

Because of their ability to issue debt and the way in which depreciation accounting leads to cash flow accumulations, financial resources accrue to corporations at a rapid rate when the economy is functioning normally or when the government, in response to income declines, runs a large deficit. The corporation, under existing law, is free to deploy these resources from one business sector to another. Corporate imperialism and corporate conglomeration are built into our economy through our tax laws and the provisions in corporate law which enables one organization to function in many markets and which enable one corporation to own shares in other corporations. Conglomerate and imperial corporations are not necessarily more efficient in a production and distribution sense than smaller firms, their success is oft due to their financial strength which lowers the cost of borrowed funds. In fact financial strength can obscure underlying production and distributional inefficiencies. From time to time an apparently prime firm will collapse because its strength in financial markets derived from earlier profitable days overcame, for a time, its deteriorating production and sales performance.

The growing dominance of the economy by giant, institutionalized, and non-specialized corporations has affected the way in which the economy functions. Financial crises and deep depressions are endemic to capitalism. They existed prior to the development of the current corporate and banking structure and the evidence from the past decade is that financial instability still exists with giant corporations and banks dominating the economy. The basic processes that lead to financial crises and deep-depressions seem to be unchanged, the resolution of the processes, in terms of the time path of the economy, is now different. The big government sector plus the government, central bank, and giant bank interventions to prevent overt bankruptcies by giant firms has meant that an institutionalization of both inefficiency and chronic inflationary pressures has occurred.

One way in which the inefficiency of an economy dominated by giant corporations, banks, and government is manifest <sup>is</sup> in the fostering of unwarranted capital intensive production techniques. The giant corporations and the apparatus of finance are set-up to accumulate and invest. The price system is heavily weighted by controlled markets. As a result of these controlled markets and the massive deficits that big government assures whenever income falls away from prosperity levels, it is virtually certain that in the aggregate, the cash flows needed to validate even inept investments and debts issued to finance such investments will be forthcoming, albeit at the price of inefficiency and chronic and potentially accelerating inflation. Thus even over the 1974-75 episode when serious bank and corporate failures occurred, a debt deflation threatened, and the economy fell into its worst slump since the 1930s corporate gross profits increased at an impressive rate. The cash flows that in the aggregate validate debt and the capital-asset structure occur not

because the capital-assets are in any meaningful sense productive but because massive deficits by government will lead to large increases in the cash flows to the corporate sector.

Because the corporation is a creature of legislation, the determination of the role that the corporate form of organization should play in our economy is a policy matter. In making policy with respect to the corporation, a distinction should be made between bureaucratic and institutionalized corporations on the one hand and entrepreneurial corporations on the other. A bureaucratic and institutionalized corporation draws its strength from its financial position and the control it commands over markets. In many cases the bureaucratic and institutionalized corporation is a tax farmer: A.T.&T. is an example of a technologically successful bureaucratic and institutionalized corporation that is essentially a tax farmer. The management of a bureaucratic corporation is professional. Its leading officers either progressed through the ranks or were hired from outside as executives, often because of some performance shortcomings under the internally developed management. The current management of a bureaucratic corporation had little if anything to do with the founding and the growth of the corporation to its present preeminent position.

On the other hand an entrepreneurial corporation is largely the extension of the personality of a founder or a founding group. It initially drew its main strength from the creative drive of its leading officers. The present leadership of such a corporation was mainly responsible for the growth and development of the corporation. Even though it may now be strong financially, initially the main strength of an entrepreneurial corporation did not rest upon its financial resources.

In the history and evolution of a corporation, a bureaucratic corporation may come under the direction of a strong creative executive, so that a burst of "entrepreneurial" activity occurs. Furthermore some of the "bureaucratic corporations" have strong internal research and development capabilities which leads to product and process innovation. However, in spite of these complexities, it is clear that the two types of corporations are quite different. A policy public towards business organization will distinguish between the two.

In principal a bureaucratic and institutionalized corporations is no different from an industrial unit in a socialist economy which is run under some profit-maximizing rule and which receives but limited subsidies from the state. In many cases such socialist organizations and bureaucratic corporations are sustained by their ability to collect revenues from markets even as they become inefficient in a technical sense. A capitalist economy which emphasizes investment and which is dominated by giant bureaucratic corporations is characterized by strong cyclical instability. However the bankruptcies of the depression, which at least changed the managerial control and liability structures used to finance capital assets, are replaced by government or Central Bank arranged bailouts and debt restructuring of the giant corporations and their banks. The fear of major repercussions from the bankruptcy of giant corporations leads to a peculiar institutionalization of inefficiency. Giant corporations, under capitalism, can become as inefficient as socialist industries. One rule that should guide policy with regard to the financial and corporate structure of the economy is that no financial unit and no non-financial corporation can be so large that its bankruptcy cannot be contemplated.

Some of the similarities and differences between bureaucratic corporations and nationalized or publicly owned industries should be noted. First of all, it should be noted that the Stalinist economic order that calls itself socialist

is an engine of accumulation - just as the bureaucratic corporation. The dominant economic rule of a Stalinist socialist economy is, to paraphrase the Red Queen in Through the Looking Glass, "Consumption tomorrow, never consumption today." Because the profits of bureaucratic corporations accrue to individuals and because of capitalist trade unions are able to force a sharing of income gains, the capitalist corporate society does provide a bit of jam today, even though in the doctrines of growth it, like a Stalinist economy, does hold out a promise of more jam tomorrow.

The basic constraint upon the bureaucratic corporation is that the sum of the revenues received from various markets must pay for the flow through inputs, validate commitments on bonds, and lead to market prices of capital-assets that make it possible to finance the purchase of additional capital-assets.

The nationalized industries of economies that are primarily capitalist often lack this discipline by which operating revenues must meet costs and validate debts: that is publically owned firms often receive cash from the general revenues of the national state or local government that owns it. In the context of political management and trade union organization, the possibility of subsidizing operating income from general tax revenues leads to the possibility of the management and the workers exploiting their favored position.

It is important that any publicly owned operation be disciplined by the need either for operating revenues to at least meet out of pocket costs or than an overt political decision determines that cross-subsidization is desirable. Ideally "political cross subsidization" should have an associated excise or general purpose tax which leads to a decision as to who shall subsidize whom.

Even if we accept the point that the price system contains a great deal of what, from the point of view of simple pricing models, could be considered as cross subsidization, the revenues expenses relation of corporations does lead to a discipline on workers and management that tends to constrain costs.

Inasmuch as aggregate policy needs to validate costs if a semblance to full

employment is to be maintained, price stability is possible in a capitalist economy with trade unions only if the discipline in maintained that expected revenues, at the current price/wage levels, are to pay specified costs. Thus in publicly owner operations - such as rail or mass transit operations - the objective should be to have revenues meet at least out of pocket costs. Capital-asset acquisition might be a public responsibility because it is viewed that a particular structure of the economy is needed - it is the capital-assets that determine external costs or benefits - but the limit to subsidization should in general be restricted to some or all of the capital asset costs.

In contrast to the bureaucratic corporation, the entrepreneurial corporation is almost always a vehicle for economic and technical progress. The building of a firm and incidently of a fortune is a "good game" to absorb the energies of the imaginative and perhaps the unscrupulous. Because of the nature of the game, a successful entrepreneur will acquire a fortune and power: quite likely a larger fortune and more power than is needed, strictly speaking, to draw forth the effort. The major problem that economic policy needs to face up to is not the building of fortunes and corporations but rather the existence of institutionalized, inherited fortunes and the existence of giant corporations that survive the initial entrepreneurial fortune builder.

The essential attribute of a policy towards corporate structure that is aimed at promoting the use of decentralized markets as a control device is to intrude effective incentives that limit the size of corporations by making the divesture of parts of the corporation profitable. The incentives to diversture could take the form of penal corporate income taxes, related to the size of assets managed, once the original entrepreneur no longer is the effective manager. The tax treatment of stock acquired as the result of a divesture and of a cash distributed as the result of the sale of a subsidiary should be such

as to facilitate divestiture. For example there should be no capital gain at the point of divestiture of the stock acquired by holders of the divesting company as the result of a divestiture. Cash distributions that result from divestitures should not be taxed as capital gains if invested in equities within some reasonable period.

In addition to cash distributions due to divestitures corporations should be encouraged to distribute excess cash to shareholders in order to "cut back" their capital/equity liability account. Inasmuch as shareholders have already paid their full income tax on the earnings of corporations such "capital divestiture" cash payment should be tax free.

If the tax system includes meaningful limits to inheritance, then there need be little concern about the tax treatment of "capital gains due to divestitures or of the tax treatment of "capital disbursements."

In addition to voluntary divestiture in response to the stimuli in the tax laws, we need to develop institutional arrangements in which divestiture can be readily ordered by a "cartel commission" without extensive complex litigation. When a corporation exceeds some limit set by the commission in assets controlled or in employees then the corporation should be required to "show cause" why certain operations should not be "pruned" into independent organizations. Corporation strategy would under these institutional arrangements include programs for building businesses to the point of divestiture and then allowing independent companies to flourish.



The attainment of an economy in which a multitude of corporations which are both "small", compared with the current giant corporations, and "young", in the sense that they are extensions of a dominant personality

dominate will make the market a more powerful control device than it is today. Because of the ever present possibility of divestiture, the liability structure of corporations will need to be simpler than they now are. A more firmly equity based economic structure will be less susceptible to financial crises and debt deflations than our present economy.

One implication of an employment strategy for income maintenance and economic stability is that the government or the banking authorities will not intervene to protect any particular corporate organization when an epidemic of bankruptcy takes place and a subsequent debt-deflation threatens. The jobs strategy involves a commitment to assure that there are jobs for all who want to work at the designated minimum, it is not a commitment to any particular set of jobs. Similarly the employment strategy does not require intervention to abort whatever deflationary movement financial instability triggers, for the employment strategy maintains the total number of jobs and the automatic increase in the deficit that occurs as the employment strategy works its way

virtually assures that a rise in corporate gross profits will take place. Such increases in profits makes it certain that even though a debt deflation may be triggered, it will be quickly constrained.

It is not enough to have tax and anti-trust laws that induces divesture and sets limits on the absolute size of assets any one organization can overtly control. Positive steps to foster alternative organizational forms such as sole proprietorships and partnerships should be taken. The inheritance laws should be changed so that ownership and control of a simple proprietorship and partnership could be transmitted to heirs with a smaller tax liability than an equal value inheritance in marketable financial assets.

Other measures are needed in addition to constraining giant institution-alized corporations and encouraging partnerships, sole proprietorships, and entrepreneurial corporations. The existence of chronic unemployment, in spite of a labor force whose size is constrained by policy, means that we need to develop business organizations which emphasize labor intensive techniques of production. Labor intensive modes of production can be either labor intensive manufacturing or artisan and craftsmen production. Given the deterioration of artisan and craftsmen production in the United States, the rebirth of such production will require the development of specialized training and distribution systems. The development of smaller scale but labor intensive manufacturing will most likely require initial subsidization; if only to expedite a process that will be set off when the barriers to such production are removed.

## II. Limitations on Corporations

The limitation on corporations should be designed to eliminate or constrain the private power over markets that giant corporations now exercise. Market power in part comes from monopoly or monopsony (oligopoly or oligopsony) and in part from the sheer size of assets controlled. Thus the current view that more bigness is not bad has to be offset by reforms that directly and indirectly attack bigness.

The first step in a serious reform of the industrial structure is the institution of the national chartering of corporations that engage in interstate commerce. This was one of the thrusts of the reform movement that centered around T.N.E.C. It fell by the wayside as World War II pre-empted the stage from concerns about the nature of the economy.

Interstate commerce shall be precisely defined in the legislation. If employment, virtually all sales, and the places of doing business are in one state then the firm shall have the option of being chartered by the state in which it operates. The aim of this provision is to facilitate the development of local firms, market power within one of the states is not the same as market power in the nation.

Although corporations that are chartered by a state shall not be able to engage in interstate commerce, partnerships and sole proprietorships shall be allowed to do so. By allowing proprietorships and partnerships to engage in interstate commerce even as state chartered corporations are not allowed to do so a bias in favor or organizing small and new firms as partnerships and proprietorships is introduced.

The narrow definition of interstate commerce will not attenuate the protections that labor now enjoys because of the broad definition inasmuch as the open ended employment offered by the W.P.A. scheme will set effective minimums to the wages, hours and conditons at which workers will accept jobs. Workers will

be protected not by regulation but by the tight labor markets that W.P.A. type devices will create. Substandard employment and the need for "regulation" to protect workers are creatures of slack labor markets.

Incidentally the existence of perpetually tight labor markets at a floor wage and at tolerable working conditions as set by the government means that trade unions in private employment are both strengthened and weakened. The W.P.A. structure means that workers either on strike or otherwise disaffected can have income from work; this strengthens trade unions. On the other hand private employers will know that they have to offer better wages and conditions than are available on W.P.A.: this weakens unions

The coexistence of partnerships and proprietorships which can engage in interstate commerce and corporations which cannot leads to obvious possibilities for collusion and evasion. The law would have to deal with such evasions.

Obviously the reason for national chartering is not only to bring uniformity into corporate law, especially in the law on rights and privilege of stockholders etc., but also to tighten and restrict what corporations are allowed to do. The national chartering law should view corporations as instruments of the state which are granted certain powers (perpetual life, limited liability) in exchange for performing particular useful functions.

The national chartering law should prohibit corporations from owing shares in other corporations. The wholly or partially owned subsidiary should disappear. Mergers and takeovers - as well as sales of assets should be permitted but the dealings will have to be at arms length; partial purchases prior to merger or takeover will not be allowed.

Ideally corporate charters should be for rather precise lines of business, but this limitation seems hard to define and administer. However a clear demarkation should be made between financial and non-financial business. In particular businesses whose assets are normally mainly financial shall not be carried on by

assets.

A second, perhaps more important reform measure is to change the anti-trust laws so that "market power" rather than monopoly is the villain and "market power" is associated with size. Once bigness is identified with the existence of power then it is necessary that either this power be exercised "for the public good" or that the power be constrained or controlled.

Inasmuch as capitalism implies inequality of private wealth and private wealth bestows power on the rich, capitalism cannot attain the equality of power that is the democratic ideal. However the virtues of the market system of coordinating decisions and the private capital markets power as the relocater of investment funds means that this limitation of capitalism is tolerated. It is the function of inheritance taxation to limit the intra-generational transfer of power that goes with the inheritance of great fortunes; inheritance taxation as presently constituted does this poorly.

The market power of giant and monopolistic corporations rather than the personal power that great wealth bestows is at issue in the policy decisions on the size and power of corporations. One obvious way which has been discussed is to intrude incentives to divestiture into the tax system. Another is to limit the asset size of banks - which will make the financing of giant corporations a bit more difficult. Both of these measures can have but a slight effect if the exercise of power is in fact profitable. Positive features are needed.

The European examples of Cartel Commissions should be examined. The thrust of a cartel commission should be the active promotion of competition. The virtue of competition is that it greatly reduces the power of individual economic units. However in many cases the best that can be attained is competition among a few.

A corporation however is a creature of the state. If effective competition cannot be achieved then the corporation must be treated as if it were a public entity and behavior must be subject to rules that are designed to diminish if not eliminate the power it has: the marginal cost pricing rule so beloved of the market socialists is an example of such a rule. Another example would be the "public utility" rule of a maximum rate of return on assets that are managed. Whatever the rule that is adopted a monopolistic firm or a firm that controls too much in the way of assets will from time to time have to show why it should not be dissolved.

Dissolution - the breaking of giant firms into component parts - should be a remedy recommended in the legislation for firms that are too big in terms of employment, sales or assets managed. The anti-trust and trade commission approach to market organization should be replaced by a structure of industry approach in which pressure is put on firms to split rather than ~~firms~~ to grow.

### III. Alternative Organizational Forms

Economic policy should encourage experimentation with forms of organizing business other than the corporation, proprietorships, and partnerships. One form is the cooperative, another is the publicly owned entity. Both the various public and cooperative electrical distribution system of some western states and the Tennessee Valley Authority demonstrate that forms of doing business, that are not privately owned, can be successful. Government is not always incompetent. Until recent years the United States postal service was a tolerably effective organization. The question is not why is government inefficient but rather why have government operations become so much less efficient in recent years.

It is necessary to experiment with forms of doing business which lead to more labor intensive modes of production than are now commonly used. Artisan, craft, small proprietor workshops and various producer cooperative forms that exist and function well in other capitalist economies come to mind.

The main thrust to the strategy of economic policy being advocated here is to replace the transfer payment/contract/ investment strategy with an employment strategy. The key to an employment strategy is a well defined government open ended employment scheme at the minimum wage; this idea is discussed in the next section.

One aspect of the government employment strategy is that the government employment may well be a "no questions asked" scheme in which questions about other income and even other jobs are not raised. Thus there could well be significant number of workers who have a base income from the government employment who supplement their income with other jobs. This should be encouraged - provided the project oriented government employment schemes are effectively executed.

But given that government employment scheme employment is not means tested the question arises as to whether the government employment schemes could be used as a basis for wage supplements for the production of marketed goods and services. Wage supplement schemes are difficult to administer unless the targeted population is clearly defined. However the possibility of wage supplements by location or type of organization (cooperative, production, manufacturing in central cities, in high employment areas, or low wage areas etc.) should be explored.

However such supplements might not be necessary. The change in tax laws (including social security) and the removal of barriers to labor market participation might well do the job of triggering a move towards small proprietorships and artisan forms of doing business.

Nevertheless an equivalent to the United States Agricultural Extension Service for the promotion of craft, artisan and truly small business (fewer than say 10 employees) might be highly desirable in abetting the development of alternative organization forms.

We need another era of experimentation on business forms and style such as characterized in the New Deals days. One foundation for such experimentation is the development of an employment strategy for economic policy; a strategy which by offering employment to all at some minimum terms creates an "artificially" tight labor market at wages and working conditions that are not "superior" to the minimum terms.



## H. An Employment Strategy

### I. Introduction

Further progress under capitalism depends upon the development of a form which successfully achieves a close approximation to full employment with a price level that is essentially stable. That is, capitalism needs to be changed so that it can avoid debt deflations and deep depressions on the one hand and economically disruptive and poverty inducing inflations on the other. The current strategy of economic policy seeks to achieve full employment by generating investment demand and through creating "apt" financial conditions, by offering fiscal inducements to invest, and by sustaining disposable income and business profits through government contracts, massive transfer payments and the availability of consumer credit. This policy strategy now leads to chronic inflationary pressures, even as it sets the stage for periodic investment booms that <sup>l</sup>cuminate in financial crises. Crisis management by the Central Bank and the government corrects the movement towards debt deflation but this process allows inflationary pressures to continue, even as the stage is set for further financial crises.

When investment demand is sufficiently high so that private demands generate conditions conducive to full employment than the financial system as it is now structured quickly becomes fragile, so that conditions conducive to a financial crisis develop. When an incipient financial crisis is aborted by a combination of lender of last resort actions and a government deficit, then conditions conducive to accelerating inflation are triggered. In particular the revival of investment demand, after a debt-deflation deep depression has been averted by big government and the central bank, means that both an accelerating inflation and a quite quick return of conditions conducive to a financial crisis follow. Ever since the middle 1960s the American economy has oscillated on a four or so year time table between conditions conducive to a financial crisis and conditions conducive to accelerating inflation.

Thus the problem is to develop a strategy for achieving a close approximation to full employment that does not depend upon the inducements to invest, government contracts and transfer payment schemes that characterize the present policy strategy. Such an alternative strategy which emphasizes employment as both the goal and the instrument of policy is sketched here. At the ~~press~~ heart of this employment strategy is the guarantee of an adequate total number of jobs by the creation through direct government demand of an infinitely elastic demand for labor at some "floor" or "conventional" wage. This can only be done if there is a "residual employer" of all who want to work at this wage: government agencies that act as tap employers, hiring all who want to work, are the cornerstone of this alternative approach to economic policy.

An employment strategy has labor market, industrial structure and tax policy aspects; the industrial structure and tax policy aspects were considered in earlier sections. In this section we will take up labor market aspects.

There are four labor market aspects to an employment strategy for economic policy:

1. the development of public, private, and "in-between" institutions that assure <sup>that</sup> jobs at non inflationary wages are available for all.
2. the modification and dismantling of the massive structure of transfer payments.
3. The removal of barriers to labor force participation.
4. The introduction of a measure of governmental constraint on the movement of money wages, and labor costs.

The four facets of an employment strategy are linked. If the massive transfer payment apparatus is to be dismantled then there must be a "guarantee" that the clients of the transfer payments system have alternative sources of income. Similarly if the barriers to labor force participation are removed, then jobs have to be available for those who are now free to enter the labor market. A

policy to constrain money wage increases and labor costs is a corollary of the commitment to maintain tight full employment.

We will first take up the second and third points - the modification of the transfer payments structure and the removal of the barriers to labor force participation. We will then sketch the broadest outlines of direct government employment schemes. These are sketched in broad terms because they are the key to a successful program and the expectation is that the specific instruments used to implement the jobs strategy will be constantly evolving, even though the commitment to job availability need be permanent. We will then take up point four, the money wage problem.

## II. Transfer Payments

The United States has embarked on a course which will lead to a major modification of the ~~xx~~ retirement income aspect of the Social Security Act - the largest transfer payment scheme. A logical corollary of the legislation that forbids the "involuntary retirement" of workers before the age of 70 is legislation that either adjusts the "retirement" benefit of workers according to the age at which they retire or which allows the full receipt of (taxable?) social security benefits, even though the "beneficiary" is employed and earning a wage or a salary. Thus a major barrier to labor market participation, the constraint upon wage income allowed to social security recipients, will soon be "politically untenable".

One way to reform the social security act is to treat social security as if it were a fully vested annuity, and the annuity beneficiary has a set of options as to the annuity he wishes to "acquire" at the date his pension is activated. The present social security act provides an annuity at the age of either 62 or 65 to each participant. This annuity has a "present value" or "capital value" which is readily determined: it is approximately equal to the lump

sum payment that an insurance company would require to provide such an annuity. (The equality is approximate because an insurance company would ask more than the actually fair sum because of the need to pay its operating costs and provide for ~~profit~~ profits. Presumably social security is not "loaded" to the same degree as private pensions ~~sk~~ schemes.)

One option that can be offered is to continue working and continue to make contributions to the annuity. These additional contributions and the accumulating compound interest on the age 65 capital value of the pension, together with the age 65 capital value, ~~yield~~, the age 66, 67 etc. capital values. These new capital values "yield" the actuarily sound pensions at the older ages.

The actuarially sound pensions at the "older" ages will yield substantially higher pensions not only because of the increase in the capital sum but also because of the decrease in the life expectancy of the beneficiaries.

Another option would be to have social security begin at age 65 as at present but allow the recipient to continue working. Inasmuch as the "working beneficiary" could presumably save the social security benefits during the years ~~age~~ <sup>such</sup> income is received, the beneficiary under this scheme has the "option" of buying additional retirement income with the funds that are received. Thus the second alternative can be considered as equivalent to the firm.

Such changes in the social security program will remove the barrier to labor market participation by older workers. By making the ~~available~~ available pension increase quite rapidly with the additional time in the labor force, it will tend to induce labor market participation. As such it will remove some of the chronic political pressure for <sup>"</sup>improvement<sup>"</sup> in the social security scheme.

Aside from the social security retirement schemes and perhaps social security disability the most significant status tested

transfer payments scheme is the aid to families with dependent children program. In December 1976 some 3.6 million families were receiving these benefits, approximately 12% of the children under 18 were beneficiaries. (Twenty-one years earlier in 1955 600 thousand families were receiving AFDC and 3% of the under 18 children were beneficiaries). In 1976 the average monthly cash payment was \$75 per participant.

Over the post war era the labor force participation of women has changed markedly. In 1955, 34% of women were in the labor force, in 1976 46.8% were. Even more dramatic changes occurred in the labor force participation of married women (husbands present) in 1955, 28% of married women, husband present were in the labor force, in 1976 45% of such women were in the labor force. Equally dramatic changes have occurred in the labor force participation rate of women with children present, even preschool children. Thus in 1955 16.2% of women with children under 6 were in the labor force and in 1976, 37.4% were in the labor force.

In the early post war period and before World War II the "Social norm" was that married women with children, especially with children under 6, were not in the labor force. Social welfare legislation for the support of dependent children quite naturally reflected this norm and "welfare" payments to mothers with dependent children were available in general only on the condition that the mother did not work! Now that approximately 40% of married women with husband present and children under six do work, the sociological assumptions underlying aid to families with dependent children do not apply.

The average monthly cash payment per recipient for ~~xxxx~~ families ~~xxx~~ who receive this form of aid was \$75 in 1976. However the ~~xx~~ aid to families with dependent children is a "minor" government "payment" scheme in support of children. The major such scheme is the "children's exemption" in the income tax ~~xx~~ code.

This scheme yields a "return" that increases with the family income, for the benefit is the highest tax rate paid by the family times \$750 (the exemption) per child. For a family whose highest tax rate is 20% the children's allowance in the tax schedule is \$12.50 per month (1/6th of the average benefit under aid to families with dependent children), for families in the 40% marginal bracket the tax benefit is 1/3rd the AFDC average benefit and for families in the 60% bracket it is 1/2 the average AFDC benefit.

One first step in eliminating the inequity of the present scheme is to substitute a universal children's allowance for the present inequitable exemption. The level might well be at \$30 per month, which would be equivalent to 40% of the <sup>average</sup> 1976 AFDC benefit and equal to the benefit received from the tax exemption by those who now pay 48% marginal tax rate. Such a universal children's allowance would provide at least a minor benefit for well nigh all and it would go far toward removing those working poor who are classified as poor because of family size from the ranks of the poor. For a low income (\$6,000 per year) worker with four eligible children, a tax exempt receipt of \$360 per year per child, or \$1,440 for four children is a substantial increase in disposable income.

A second step that is necessary if AFDC is to be terminated is the availability of day care facilities for children. The obvious institution to provide such service is the school system and one way of at least partially funding such schools is to use W.P.A. <sup>and</sup> N.Y.A. labor, to anticipate the positive employment creating programs that are needed.

Thus the reform of AFDC will take the form of substituting a universal children's allowance at about 40% of the present AFDC stipend together with the elimination of the barrier to work of recipients of such universal aid. ~~For this~~ <sup>For this</sup> approach to work it is necessary that jobs be available for the present recipients of AFDC.

In addition to the labor market participation rates of older people and women with children being "constrained" by regulations that tend to withhold benefits ~~of~~ income from work is being earned, the greater retention rates of secondary schools and the greater start up rates at ~~post~~ secondary institutions has meant that the full labor force participation of younger adults is lower than it otherwise might be.

<sup>and</sup> Prior to World War II (the "cohort" that entered 5th grade in 1932 <sup>and</sup> graduated high school in 1940) the retention rates were such that for every 1,000 who entered 5th grade (in 1932/3) 570 entered 11th grade, 455 graduated high school and 160 entered college. For the "cohort" that entered 5th grade 20 years later, in 1952/53, of every 1,000 who entered fifth grade 746 entered 11th grade, 621 graduated high school and 328 entered college. The latest data available as I am writing this are for those who entered 5th grade in 1967 and graduated high school in 1975. Of every thousand in this cohort 870 entered 11th grade, 743 graduated high school and 452 entered college.

Through the middle 1960's it was viewed that additional uninterrupted schooling onto and beyond high school graduation was unambiguously a good thing. It now seems clear that in many instances an alternative to schooling in the form of work and jobs - with the possibility of resuming schooling later - is preferable to continuing in school for many young adults. However any program which points towards alternatives to being in school for young ~~adults~~ must simultaneously assure that a variety of alternative job forms and employment/training alternatives are available for younger workers. Although we will always expect that young adult unemployment rates will be higher than those of older workers; it is obvious that an assertion that school may not be a good thing for all young adults is a meaningless statement when younger workers (16-19 years) unemployment rates are 17.3% for white males, 16.4% for white females, 35.4% for black males, and 39.0% for black females. In order to enable younger adults to experiment with alternative jobs and careers

various programs and institutions that aid and abet the transition from school to work are needed.

It is clear that the present technique of managing demand through government contract spending, transfer payments and taxes is an inefficient way to attack the problems of employment opportunities for the young, the old, and the present welfare poor. Instead of generalized "demand management" particular demands need to be managed. In particular the demand that has to be managed is for the labor that is unemployed with the existing constraints on labor market participation and for the labor that will seek jobs once barriers to labor market participation are lowered.

Without spelling out the details of the reform of the multitude of income maintenance programs - both in money transfers and the right to goods and services in kind - that need to be affected we will assume that all of the barriers to labor market participation in current programs are eliminated. The transfer payments that remain are either by right and do not require abstinence from work (such as social security, veterans pensions and children's allowances) or are truly hardship and social worker cases; we also can assume that with the elimination of the broad income maintenance aspects of the current transfer payments scheme the "country" can afford to and will be more generous to the residual rather small *number of* hardship cases. In place of income maintenance through transfer payments the economy will be so managed that income from work is available to all.

### III. Employment Programs

In order to achieve an economy in which income from work is available to all, it is necessary to have an infinitely elastic demand curve for labor over a wide spectrum of labor types and over a wide range of geographical regions. Furthermore this infinitely elastic demand curve for labor must be such that it not put undue pressures on the supply of labor to other occupations and employers. As a corollary to the above, this infinitely elastic demand curve



for labor must reflect a situation in which unfilled jobs will not lead to an improvement in the terms offered labor: the employer while willing to hire all who are willing and able to work is not committed to hiring any particular number of workers.

What is needed is a series of government funded employment programs in which jobs are available to all at terms that are "below" that which are available in private employment. Because these government employment programs stand ready to hire all who are willing and able to work these government programs will effectively set the minimum wage.

In what follows we will deal with the employment strategy under three headings. These headings will use the 1930s labels for various programs, the Civilian Conservation Corps (CCC), the National Youth Administration (NYA) and the Works Progress Administration (WPA); henceforth they will be labeled CCC, NYA, and WPA. The labels are from Roosevelt's New Deal. These programs were then viewed as transitory: the great depression was viewed as an aberration. Now that we have forty years of good data on our economy we know that a reasonable approximation to full employment is rarely if ever achieved, even in the face of substantial programs whose effect is to limit labor market participation. Thus instruments to effect direct employment will now be conceived of as "permanent" features of the economy.

The use of the New Deal labels, CCC and NYA to identify two of the instrumentalities of an employment program emphasizes one enduring characteristic of our society since it has become urbanized: we manage the transition from being a youth to being an adult poorly for all except those professions and trades for which schools provide the mechanics for the transition. The CCC and the NYA were youth oriented. A major permanent objective of an employment strategy is to establish flexible instruments designed to facilitate the transition to adult employment.

The third New Deal program, WPA, was oriented towards adult unemployment. It seems clear that reasonable adult unemployment rates will not be achieved either by the present policy mechanisms or by the "normal" functioning of the economy without engendering serious inflation. Thus for the foreseeable future there will be a "cadre" or unemployed workers who will be available for WPA. However WPA will have other tasks in addition to employing the measured unemployed.

One such task for WPA will be the provision of jobs in lieu of adult welfare. One cannot eliminate all but true case book welfare unless one puts something in its place. Jobs can only be put in the place of adult welfare by an open ended employment scheme. In moving to an employment oriented economy from our present system we are entering an exotic environment. In December of 1976 some 11.2 million recipients of aid to families with dependent children broke down into 3.6 million families. This means that there are some 3.6 million adults and some 7.9 million children on this form of welfare, some ~~XXX~~ 12% of ~~which~~ children under 18 were dependent upon welfare at that time. Because we never tried an open ended full employment scheme we have no way of knowing how many of the family heads now on welfare would be on WPA. We would expect that the initial dependence on WPA will be greater than the dependence after some years. This is so because private enterprize can be expected to become more labor intensive as the government spending, taxation, and financial practice reforms that are part of the new strategy take hold.

There will be difficulties in the transition. There is a conflict between being humane towards people who have been affected by welfare dependency and the need to end a program that is as debilitating as the term welfare dependency implies. The transition will be eased by the shift to a universal children's allowance at some 40% of the current average benefit per child - this shift being

being accompanied by removal of the supervision of the beneficiary by the local Welfare Departments. The "transition" from welfare to employment will be accomplished only by making a WPA job available to all.

Given what is now readily accepted as the "characteristics" of a "parallel", "unofficial", or "black" economy, the expectation is that a substantial proportion of the welfare recipient adults would not show up as being willing and able to work on the WPA rolls. We will assume that one to two millions will shift from welfare rolls to W.P.A.; the cost at \$5,000 per recipient will be \$5 to \$10 billion from eliminating welfare and replacing it with WPA.

The combination of WPA plus children's allowances will feed a larger cash income to a welfare dependent family than hitherto available. At a <sup>per month for per person</sup> \$75.00 average a welfare family of ~~xxxx~~ 1 adult and 3 dependents now receives \$3600. yr. At a \$5,000 per year WPA income, pre tax income of such a family from WPA and the children's allowance would be \$6,440. As welfare families largely live in "clusters", the increased cash income due to WPA and the no questions asked feature of WPA will lead to a significantly larger "local demand" within these clusters. Thus a "local multiplier" on jobs will occur, the greater this local multiplier the smaller the WPA need ~~xxxxxxx~~ be to accommodate the present welfare recipients.

Social Security as now constituted is an inflationary burden which, given the demographic changes that are clearly visible, will become greater. In a sense, Social Security together with private and state pensions reveals a weakness in our economy that is symmetric with the weakness that the NYA and CCC facets of the employment strategy attack. CCC and NYA are necessary to facilitate the transition from school to work for youth. A parallel effort is needed to facilitate job succession and to help the transition from more to less physically and intellectually demanding jobs. Thus in the urban fiscal crisis of the middle 1970s the burden of the early retirement schemes for local civil service type employees loomed large. What is needed more than retirement is the provision of jobs that can be taken even as say a physically demanding police job or sanitation worker job is given up.

One result of the reliance upon early retirement as a technique for constraining the size of the labor force has been the development of a large politically active population that constitutes a pressure group for ever larger benefits. The reform of social security, so that a benefit receiver can work, is a first step in inducing labor market participation by older workers. A modification of social security and other retirement schemes that makes 68 or even 70 the modal retirement age will become a necessity as the demographic changes now "in the cards" unfold. In order to facilitate these changes one of the charges of the WPA might well be to provide full and part time jobs for the retired workers that will supplement present Social Security and other retirement benefits.

In what follows we will sketch the contours of a full blown employment strategy. The proposals take the elimination of

welfare dependency, the integration of the older workers into society, and the transition of youth to adulthood as serious problems. Furthermore it is assumed that present policy is incapable of generating satisfactorily low unemployment rates without inflation, so that a substantial unemployed population would exist in the absence of WPA. It is the responsibility of government to help develop social institutions that facilitates these transitions and eliminates the burden of welfare dependency and chronically high unemployment.

#### IV. The CCC, N.Y.A. and W.P.A.

The Civilian Conservation Corps was the most popular of the job programs of the Roosevelt Administration. One of the enduring political mysteries is why this program was not made permanent. The CCC was absorbed into the preparedness and war efforts, but it could have been resurrected after the war. However the "52-20 club", a prototype for our later doles, and education subsidies replaced it during the demobilization.

The CCC was "poor-mouthed" in the later 1930's because the administrative and housekeeping details of the CCC were <sup>/by</sup> the military. Either regular or reserve officers were in charge of the camps. The projects were selected and administered by the Agricultural Department and the Department of the Interior. There is no doubt that the organizing experience and discipline of the Army were important in making the camps work.

The basic provisions of the CCC approach is that the enrolled youths will be in camp - away from home, in an ordered and controlled living and work situation. The CCC was not, and should not be organized as a "training" school. It will be successful only if it is job and project oriented. The considerable learning that will take place will be by doing. The program might pick up from where the CCC was forty years ago: the maintenance and improvement of the national parks and forests: conservation and the environment could be its major initial concern. The development of more urban oriented programs could come later: once the

corps is in existence there should be many alternative uses for corps workers.

In the 1930s with a population about half of our present population and with enrollment restricted to males the CCC <sup>enrolled</sup> ~~had~~ about 250,000. In the present circumstances and with the admission of women to the program it might not be unrealistic to aim at an initial program in the neighborhood of half a million.

The primary target group should be youths of ages 17-19, those who would be in either the last two years of high school or in the first year of college. The aims of the program would be to provide a means of transition <sup>from</sup> ~~for~~ being in school to being at work for those who prefer to leave high school or to finish school at the end of high school. It also will provide a means for a break in school.

The CCC should provide "keep" and a modest income. Because of inflation the traditional \$1 a day and keep is obsolete. Some \$2,000 a year and keep - with a major portion of the \$2,000 coming in a packet at the end of the enlistment-seems an apt rate. Presumably the keep will run to under \$2,000 per year per person; the program should cost about \$4,000 per enrollee. Allowing for an overhead of 25% a CCC effort for 500,000 would cost \$2.5 billions a year.

Enrollments should be for six months or a year. Half a million enrolled means that some 4% of the 12 million in the target age groups would be enrolled at any one time. This enrollment will have a sizeable impact on youth <sup>/un</sup>employment and would relieve the secondary schools of some of their present custodial functions.

The CCC should not be means tested, it should be a permanent way in which young men and women could "adventure" as they mature.

If the Civilian Conservation Corps is rarely remembered, the National Youth Administration is virtually forgotten. The

problems of youth, especially of youth employment, so much discussed today were evident during the great depression. The famous play "Dead End" and the "toughs" who later made a series of films as the "Dead End kids" attest to the hopelessness, discouragement, and crime of the cities in the thirties. The differences between the urban crisis of the 1930s and the 1970s is that we now have data. Furthermore the urban disarray of the ghetto <sup>of this decade</sup> took place in the midst of apparent prosperity. Programs especially designed to give income through work for young men and women in and out of school are needed. Programs are needed that are aimed at youth that are making normal academic progress as well as at youth that are having trouble in schools and in making the transition to adulthood.

The resurrection of the National Youth Authority can take in a number of forms depending upon the designated clientele. The following segments of the population to be served can be identified: students who are over 16 - the cut off age for the children's allowance - whether in junior high school, senior high school, college or graduate school - as well as young men and women who are out of school. The target population should be 17 - 22 years of age except for graduate school students.

The National Youth Administration will have a number of functions. One will be to provide job opportunities for young men and women which will provide incomes that will more than replace the children's allowance. Another is to provide job opportunities for youth who are in colleges and universities that will aid the colleges and universities; N.Y.A. will provide "aid to education" by paying for student labor that will be available for jobs such as maintaining the schools grounds, fully staffing libraries, secretarial and clerical aid to professors, research assistantships etc. Similarly students who are in secondary schools will be able to earn income from school related jobs.

In addition the National Youth Agency will have responsibility for job programs for out of school youth. Unlike W.P.A. and CCC these job programs may have some training aspects. NYA might also be authorized to offer "wage supplements" to apprentice programs. Another responsibility of the N.Y.A. will be the provision of summer youth employment.

As is evident youth employment is widespread in the United States: the MacDonaldis of the country are largely staffed by youth. The N.Y.A. will reflect this phenomena by acting to facilitate this type of employment. Inasmuch as N.Y.A. will need have a "presence" in every secondary school and college, the presence might well be extended to the provision of employment services on the site in schools. The United States employment service should have a youth division that has facilities in each school.

The wage rate on the youth programs should be 60% of the W.P.A. wage rate for the youngest to 80% for the oldest of the client population, except that the college and graduate student programs might well be at the W.P.A. minimum. The "cost" of the program will be considerable but it replaces many special programs in existence. The six age cohorts in the target population total 24 million; a program that provides \$2 billions for the in school 16 and 17 years old, some \$6 billion in "aid" to colleges and universities and \$2 billion for out of school programs might approximate what is required.

Ever since Economists and Political leaders learned the first Keynesian lesson - that aggregate demand is transformed into a demand for labor - policy actions that directly or indirectly affect aggregate demand have been rationalized on the basis of their employment creating prowess. Programs such as nuclear power plants, military bases, West Side highways and to investment tax credits have been defended as devices that create employment. The "Berlin



Crisis", early in the Kennedy administration, was a "good" in the eyes of one of economic advisors in that it enabled Mr. Kennedy to increase spending in the face of campaign promises to restrain spending. Apologies for wars and various non-war military engagements have been made in terms that these affairs at least yield full employment. It is true that for all the vaunted powers of government and prowess of policy analysts the only times the United States achieved a sustained close approximation to full employment was during various wars and police "actions". The challenging task of devising institutions that help us achieve tight labor markets without war has not been faced. The essential element in achieving full employment is the reintroduction of WPA: revised, modernized, cognizant of our present situation, and most important, permanent.

To achieve a non-inflationary, full employment it is necessary to attack unemployment directly by hiring people, rather than indirectly by expanding demand in an indiscriminate manner. The shape of the program to sustain or expand employment is vital in determining who benefits and whether or not full employment is associated with chronic inflation. To achieve full employment without inflation it is necessary to break new ground. However the ground is new only in its details and emphasis, for the WPA of the depression days blazed the trail. The policy design problem is to build a set of "permanent" institutions around the essential attributes of a W.P.A.

The essential aspect of a WPA instrument is the creation of an infinitely elastic demand for labor at a nominal minimum wage and allow the private economy and the "normal" government functions to build on that infinitely elastic demand. Because the private economy sets different returns to different labor skills, the employment generating programs should ignore market wage differentials. The employment terms of the works administration should be sex, race, and skill blind. As has been mentioned earlier, the terms at which employment is offered will be the effective minimum wage, in all that follows we assume a \$2.50

WPA wage rate, a \$5,000 annual wage.

The WPA program will need to evolve and adjust to changing situations. The major labor force tasks that WPA programs will have to face will be to facilitate (1) the elimination of aid to families with dependent children. (2) The reduction of chronically high black unemployment rates, (3) the reconstruction of employment opportunities in the urban areas with chronic high unemployment, and (4) the integration of older adults into the active labor force. These labor force oriented tasks of the employment thrust will require specific programs and institutional forms. As time passes the importance of these tasks will change: today's welfare mothers will be integrated into the normal labor force, the differential black unemployment rates will decrease, the cities again will become magnets for business, and the normal work span will have increased. Even as these initial tasks are accomplished new tasks are sure to emerge. With the new labor force problems new facets for WPA will need to be created.

If WPA, NYA and CCC increase the income available to the target population over the incomes they now receive then the programs will be inflationary unless the output of consumer goods is augmented in the same ratio as the incremented income of these target groups has to the consumption expenditures of the population as a whole. Because the W.P.A., N.Y.A. and C.C.C. thrust will encourage labor market participation and because it sets an operational and effective minimum wage that is low by world standards, the employment strategy should quite quickly lead to the organ required increase in consumption goods output. (Note that if consumer outlays are \$1,000 billions and the incremental cost of the various programs are \$30 billions then the incremented output of consumer goods need be only 3% of the current output. Because the initial impact is upon the income of the poor and the near poor, the major impact of the increase in disposable income will be in the demand for the "little luxuries" of the poor and near poor. The expectation that the labor force participation will increase by

more than the incremental employment on WPA etc. means that private output will increase as WPA etc. become the major income maintenance programs.

However there is no serious reason why WPA cannot provide some "fee for service" or "fee for output" production. The WPA subsidized theater and music of the depression are examples. The only "requirement" is that the income of the participating "artists" be at the WPA rate.

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

The WPA, NYA and CCC thrust therefore will provide income through job for all who are willing and able to work. The basic wage will be the minimum wage. The suggestion is that the 16 year olds receive 60% of this minimum, the 18 year olds 80% of this minimum wage on NYA; thus if the WPA wage is \$2.00 an hour, the minimum effective wage for 16 year olds will be \$1.50 an hour and for 18 year olds it will be \$2.00 an hour.

Minimum wage legislation has been a cruel hoax insofar as jobs have not been available for all at the minimum wage. The WPA, NYA, and CCC program thrusts make the minimum wage laws redundant, they replace minimum wage with a much more honest device, the availability of jobs at a particular wage rate. Because the government programs recognize that youth wage rates can be lower than adult wage rates, private employers will also be able to pay less for youth than for adults. However because the number of youths in the labor force are limited serious use of youths to undercut the wage standards of adults is unlikely to take place.

## V. Money Wages

The standard analysis of the relation between money wage rate changes, price level changes and unemployment is based

upon the assumption that increases in aggregate demand takes the form of an increase in the demand for goods and services. The increase in the demand for labor is derived from this increase in demand for goods and services. This process of deriving demand implies that increases in employment will be accompanied by upward pressure on wages and prices.

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

Once the structural aspects of the shift to an employment based income maintenance program have been assimilated then cyclical variations in employment will take the form of variations in the proportion of workers "on WPA". When demand for investment and consumption goods falls then private employment will decrease and lower wage WPA employment will rise. When the demand for labor by private employers increase then the proportion of workers on WPA will decrease. The use of WPA as a contracyclical income maintenance scheme means that the attempt to turn around a fall in aggregate demand will not depend upon increasing inducements to investment or lowering tax rates. The inducements to invest and the tax schedules can be cyclically invariant. The WPA income maintenance scheme will provide employment and income.

Whereas the current system attempts to maintain stability by managing demand the alternative system operate to maintain stability by managing employment. Because the demand for labor is the primary impact point of government policy, the policy will have a smaller inflationary potential than the current policy.

However the employment strategy will impose permanently tight labor ~~xxx~~ markets on the economy. There will be a wage structure for alternative employment that is based upon the

WPA wage as the standard; the question is whether the ratios of various wage rates to the WPA standards will rise so that inflationary pressures will result.

In Chapter it was shown that

$$P_c = \frac{W_c}{A_v} \left( \frac{W_I N_I}{W_c N_c} + \frac{Df}{W_c N_c} + \dots \right)$$

The question is whether  $W_c$  or  $\frac{W_I}{W_c}$  will tend to rise because of tight labor markets that are the result of a WPA type of intervention.

In the price formula a decrease in the private autonomous component of aggregate demand ( $W_I N_I$ ) will be offset by an increase in the deficit, symmetrically an increase in  $W_I N_I$  will be offset by a decrease in the deficit. In principle there should not be any significant shift in the mark up.

This leaves the question of whether market or extra-market institutional factors exist which give rise to chronic and even accelerating pressures in wages through a rise in  $W_c$  or  $W_I/W_c$ . In the investment/contract/transfer payment scheme of public policy aggregate demand is sustained by sustaining the pace of investment. This means that demand for labor that produce investment output including construction is maintained. This sectoral emphasis leads to an accretion of market power by the producers of investment output and by their labor force. Thus pressures that push  $W_I/W_c$  up so that for any given employment in the production of investment goods,  $W_I$ , the mark up is higher. Chronic rising wages in investment goods production leads to a rise in the mark up and thus chronic inflationary pressure on money wages.

In the recent past one element in the rise in wages and prices has been the chronic government deficits and the chronic upward pressure on money wages in government employment and in

government funded operations. In many instances government has abdicated control over the prices it pays for services and goods it purchases. Indexing of governmental wages, pensions as well as social security has become a dominant factor. The government allowed medical service suppliers to set the prices for their services even as the government became a major "payer" for the service. If government must be big for both the positive values of government output and for the contra debt-deflation/deep depression protection that government provides, then government must retain control over the prices it pays for goods and services and the wages it pays for the labor it hires.

It is perhaps politically naive and utopian but <sup>as</sup> long as government programs <sup>cause</sup> ~~make it sure~~ that there will be adequate aggregate employment government can act to stabilize its own money wage rates and the money wage rates that are paid on government contracts. The stabilization of those money wage rates that are paid by government and that reflect government demand for goods and services will go far towards stabilizing all money wages and prices.

Labor costs reflect money wages, fringe benefits and productivity. The growth of fringe benefits largely but not completely, reflects the income tax advantage of fringe benefits. The appropriate way to control these costs is to largely remove the tax advantage of fringe benefits: the employers costs on fringe benefits are to be part of the income tax ~~and~~ base of the employee.

In the United States strong autonomous upward pressure on the overall wage structures from Trade Union activity cannot be ~~ep~~ proven to exist. Trade unions have been progressively weakened in the post war era, and the rate of inflation has increased even as union strength has waned. The sources of inflation are in other than autonomous wage increases, however the government has a special responsibility to assure that the wages of government

employees and of the employees of suppliers to the government lag behind any general level of price increase when prices are rising rapidly even as government wages can be allowed to increase relative to other wages when price and market wages are falling.

The employment strategy therefore is not a cure for all ills. The possibility exists that the artificially tight labor market generated by this floor demand for labor will be associated with chronically rising prices, but the likelihood of such chronic price increase is smaller than the likelihood of chronically rising wages from the present techniques.

The employment strategy guarantees an adequate number of jobs for all who need work at some floor money wage rate. It does not guarantee any particular job nor any particular money wage. It is a system that looks toward work as one of the fulfillments of life, even as it provides for job succession through life.

## I. Conclusion

All policy can do is start a process, it cannot mandate results. This is true for policy in general but it is "true in spades" for those aspects of policy that involve institution modification and building. WPA/NYA/CCC as a replacement for the contract and transfer payment system of maintaining incomes and employment, will lead to a shift in the types of production processes that private businesses will use. The change to WPA etc. will make a large pool of labor available to private business at a modest markup in the WPA terms.

If the shift to WPA is combined with the removal of items from the tax systems that bias production processes in <sup>favor</sup> ~~form~~ of capital-intensive production techniques, then the transition to private labor intensive production will be expedited. The development of agencies to promote cooperative producing units in the cities and to help develop urban craft and artisan production are measures

to aid and abet developments that are in the cards once employment is taken not only as the ultimate objective of policy but also is used as the proximate tool of policy.

If within the framework of an employment strategy the government holds firm on the money wage rate on the WPA schemes, the money wage rates on full scale public employment and the prices it will pay for products it buys, then the wage push aspects of inflation will first be decreased and then disappear. If this is combined with a constraining approach to the rate of increase of business financed by means of money expansion and a close approximation to a balanced budget in prosperous time, then the prospect is for a gradually falling price level, as the average productivity of labor and in the production of consumers goods and as the proportion of the total consumers demand that is due to income derived from the production of consumers goods both increase.

There is a natural thrust towards a falling price level due to productivity increase. The current investment, contract, transfer payments strategy of policy more than offsets this thrust. An employment strategy will unleash this thrust.