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# GOVERNMENT FUNCTION IN A STABILIZED NATIONAL ECONOMY

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## I. *Premises*

Attempt is made in this paper to explore certain fundamental relationships between economic activity carried on by one or more branches of the government and economic activities carried on by nongovernmental organizations and by individuals. Except incidentally, the objective is to examine the basic problems rather than problems merely incidental to readjustment when hostilities cease.

Certain premises are accepted in this paper and are briefly stated:

*First:* That every government, and particularly every democratic government, will be under an impulsion to attempt to provide for the economic needs of substantially all its people;

*Second:* That the method will be an attempt to assure substantially general opportunity for useful work at adequate pay, accompanied by social security provision for the nonproductive periods of life, including childhood, maternity, sickness, and old age;

*Third:* That whenever any substantial gap appears in the generality of the provision achieved, government will be under pressure to fill that gap through direct entry into economic activity heretofore commonly carried on by nongovernmental agencies;

*Fourth:* That economic readjustments in large countries may be presumed to create problems of such magnitude that purely private activity cannot provide for them.

To these I should like to add a postulate about government finance which I think can be generally accepted. This is, in substance, that neither government expenditure nor government debt entails inflation any more than does private expenditure and private debt, *provided* expenditure and debt are so handled as to maintain a relatively constant relation between the monetary system and the available goods and services. In other words, the mere fact that government plays a part in the field of economic stabilization and that such part entails the use of government finance, does not threaten inflation so long as it is so handled that it increases rather than decreases the productive assets of the country and the productivity of the assets already in existence.

The writer states the foregoing premises, in the belief that they can now be accepted as a part of the datum of economic thinking.

Until recently, acceptance by the state of the obligations implied in these premises was primarily a political issue. In the agricultural era,

proposal that the state should attempt assurance of the economic welfare of its people by direct entry into the economic field was matter of acute debate between politicians, publicists, economists, and philanthropists. But with the evolution of modern industrial technique, including large-scale production, creation of large-scale business enterprises, rapid relative decline of small business, and increasing lack of "automatic" economic equilibria, the government in one or another aspect has been forced into the economic field.

This impulsion can be stated, according to one's choice, in terms of politics, of social ethics, of military necessity, or of philosophic definition of statehood. But, save for a lingering nostalgic remnant, it has ceased to be a matter of partisan politics. The problem now is the degree to which government action is taken, the limits on such action, the methods to be used, and the instrumentalities to be selected; and these, no doubt, will be fields of debate for a considerable period of time to come.

Let us state the proposition as a matter of elementary politics.

In the depression of 1921, following the first World War, economic factors beyond the control of any individual businessman, enterpriser, worker, or farmer, forced out of employment a number of workers roughly estimated at five millions. The pressures on the American Government were considerable, but not sufficient to require general measures. Nevertheless, in various branches of government, especially state and local, necessity was felt to assure a minimum subsistence through the various channels of relief, and through measures designed to promote re-employment.

In 1929, when a new depression, likewise beyond the control of any individual or group of individuals or any set of private enterprises, resulted in the dislocation of a group of workers loosely estimated at eleven million, to which must be added the distress of farming communities aggregating not less than four or five million more active workers, the then government attempted to deal with the situation without direct entry into the field. Local governments, of course, were forced into the task of relief, and a number of them in one way or another attempted direct re-employment; and the government itself attempted provision through programs of "share the work" and through indirect programs of encouraging large business to undertake programs of expansion offering the hope of re-employment. These measures proved insufficient and the political and governmental pressures resulting made it inevitable that there should be a major change in the situation. In result, in 1933 the federal government assumed responsibility and undertook the task of gradually providing for the economic welfare of substantially every American. Failure to do so would, in my judgment,

inevitably have resulted in even greater political pressure. In retrospect, it is sufficiently plain that this pressure would have been applied quite irrespective of the party affiliations or ideology of the administration.

The readjustment following the present World War will be far larger than the readjustments required in 1933. Provision will have to be made for a minimum of five million soldiers returning from war; and the figure is likely to be considerably larger. A fair estimate would probably be in the vicinity of nine million. Of these the youngest age groups will be persons who never held jobs before their entry into the army.

In addition, under present forecasts, perhaps twenty-five million workers will have been absorbed into war industry. These will have to be replaced in peacetime industry. Included in this figure will be not less than five million individuals not heretofore engaged in regular labor; that is, individuals who have not heretofore appeared in "pay rolls" though they were engaged in useful activity in homes or on farms. Experience makes it sufficiently plain that many men and women who have acquired jobs do not in general leave them, except to seek new jobs; the housewife who has become a factory or white collar worker resists being relegated to the standpoint of a houseworker again; and so forth.

In the aggregate, therefore, immediate postwar readjustment will have to take care of the enormous total of perhaps thirty-four million individuals; and this total will include at least five million new workers drawn into war work, plus not less than two million youngsters who have never been at work but have gone directly from their homes into the army.

It is hardly necessary to observe that any government, and particularly any democratic government, will promptly be under pressure to deal with this situation unless the readjustment is immediate, automatic, and complete. Since even without the disturbance of war such adjustments have not been historically immediate and economic, and rarely are complete, the political impulsion which will bear on any government in power is sufficiently plain.

As far as I am able to observe, nothing on the economic horizon suggests that this type of pressure will be limited to postwar readjustment—though undeniably it would be more acute in the immediate postwar era than at other times. Normal peacetime cyclical swings have produced readjustments equally great; and indeed there is a widely supported theory that readjustment after war is followed a decade or so later by a great cyclical readjustment. Further, readjustments occurring after a war, great as they are, do have certain factors making for swift recovery, such as backed up unsatisfied civilian demand, the

existence of savings available for expenditure, and the like. Cyclical fluctuations in peacetime do not have these offsetting factors to the same degree.

It would seem that there are factors of disequilibrium latent in recent economic developments which, except as they are compensated in some way, will increase rather than decrease the disequilibria with which we have become familiar in the past forty years. Three such factors are worth particular notice:

1. The factor of increased machine productivity. Since the depression of 1929, and peculiarly under the pressures of the present World War, the effectiveness of machine production has vastly increased. Specifically, it is possible to get a greatly increased percentage of product per man hour of labor; the necessity for swift production of war material has enforced the development of this efficiency, and the technique, once learned, will plainly not be abandoned when the stress of war is past. Much the same process has gone on in agriculture through the development of better agricultural techniques and, within limits, the application of machines to farm problems so that a considerable part of farming is more nearly assimilable to industrial life than has been the case heretofore.

2. The relative growth of the influence of large or quasi-monopolistic business at the expense of small business. The effect of war has been to accelerate a trend plainly observable in the decade from 1920 to 1930. The causes of it are well known: they include a tax structure which in the main makes expansion of existing small businesses difficult; the necessity for securing latent production and the consequent expansion of large plants with existing organizations rather than building up of new or smaller plants in respect of which the organization had to be created.

Probably most important is the effect of selective service, which has taken from small business a great number of young, strong men, from age eighteen to age forty, and thereby broken up the organizations which these businesses actually had, since small enterprises cannot fill in and replace with the same effectiveness as large organizations.

The rise of these businesses underlines the proposition laid down several years ago by Dr. Gardiner C. Means; namely, that in an economy dominated by large-scale businesses, prices remain substantially rigid; and thereby the automatic adjustment of supply to demand is hampered, if indeed it is not prevented.

3. The constant increase in technical development whereby industries may be superseded by other industries, as highway truck traffic tends to supersede certain elements in railway traffic; as air transport

may supersede certain elements of land and sea transport; as radio communications may tend to supersede wire communications.

Under these circumstances, the problem of postwar readjustment is in a sense merely a huge and rather distorted version of the kind of problem with which every modern national economy is likely to be faced, in varying degree, from time to time. The political pressures in any given instance will vary with the size of the problem; but the nature and the direction of the pressure will be constant since the magnitudes will be too great to be dealt with privately. Since substantially every government in the world has accepted the responsibility of attempting to stabilize and improve its national economy, we must, I think, assume that the government is in this picture to stay, and the main problem is to explore the optimum lines of its action.

## II. *The Scope of Choice of Government Action*

Attempts by government to support, stabilize, and improve the national economic position are not new in history. There are ample chronicles of attempts made during the Roman Empire, notably under the Emperor Claudius; they form a consistent body of history on the Continent of Europe; they appear intermittently in British history from the days of Queen Elizabeth on. A notable chapter indeed is the expedients adopted by the British Government from 1820 to 1840, following the Napoleonic Wars. But the methods vary widely.

Today, there may be the extreme policy of "hands off" by the government, representing a complete denial of the pressures altogether. This is now theoretical only: no major government operates in this way. At the extreme opposite of the spectrum is the assumption by the state of complete responsibility for everyone everywhere all the time, accompanied by a complete system of state operation in all fields: the theory presently adopted by the Soviet Republic.

Between these extremes there is a multitude of choice. The state may intervene indirectly, and may attempt to build a system of tariffs designed to increase industrial activity and employment by preventing external competition. It may, still through indirection, endeavor to influence nongovernmental activity by cheapening credit: the familiar operations of reserve banks and bankers during the first thirty years of this century. Approaching the field of direct intervention the government may subsidize certain desired lines of activity; still more directly it may attempt to maintain prices, thereby assisting certain groups within the community. More directly still, it may enter upon public works programs, thus approaching direct entry into the economic field; and the widening scope of works defined as "public" increases the degree of

direct state participation. Finally, there is direct participation through the operation of doles, bonuses, and the like.

Actually, in the United States today, there is (and has been for several decades) a vast combination of direct and indirect participation in economic life the true extent of which, I think, has never been adequately appraised by economists. Much of the operation of our combined system of tariffs, taxation, public works, relief, etc., has in effect constituted a series of subsidies, usually indirect, to one or another class of enterprise—a theme not here elaborated.<sup>1</sup>

But in the choice of method, an element enters which turns on political theory. I believe the basis of this choice must now be discussed by economists, since it suggests that economics as a technical subject can now no longer be divorced from the scientific study of governmental theory.

The consideration which is dominant in making this choice is the extent to which governmental theory, backed by the prevailing philosophy of a country, seeks to preserve free choice by individuals of their way of life. This consideration is vital. Employment was full, complete, and continuous in slave-holding civilizations, for slaves by hypothesis are always more or less employed. A totalitarian state, in theory at least, arrives at full employment by methods only slightly less direct. The leader of the Nazi Labor Front, Robert Ley, in a confidential discourse in Prague shortly after the fall of France, stated quite brutally that the German Government proposed to introduce a new form of slavery, and he was not speaking metaphorically. He meant exactly that. A free and democratic government will seek full employment, but only under conditions which give the maximum possible choice of life to the individuals composing its state; and its direct entry into the economic field will always be restrained by this consideration.

For that reason, and historically, free governments, as they have obeyed the impulsion to enter the economic field and to provide full employment and activity for their people, have sought, in order:

1. Methods by which the individual was assisted to enter new fields of production: for instance, the land grant policy followed after the American Revolution, and in economic crises during the nineteenth century.

2. Indirect encouragements to provide enterprise in the hope that this stimulation would provide the necessary activity and employment: tariffs, indirect subsidies, temporary monopoly, such as patent rights, and the like. This intervention, forecast in Hamilton's report on manu-

<sup>1</sup>For further discussion of this, reference is made to the writer's memorandum to the Temporary National Economic Committee, August 19, 1938.

factures, was the norm during the latter part of the nineteenth century and through to 1930.

3. Direct intervention in the economic field, but oriented toward private individual and enterprise, and carried out through direct financial assistance. This was the policy to which President Hoover's government was eventually driven when the Reconstruction Finance Corporation was formed, when the Federal Reserve banks were empowered to make direct loans to industry, and when a program of railroad aid was commenced.

4. Direct entry into economic fields, limited, however, strictly to nonprofit or nonprivate operations, such as conventional public works (roads, bridges, public buildings, and so forth), with which must also be bracketed low rent, public-assisted housing, and certain other similar operations in fields which for one reason or another private activity was unable or unwilling to occupy.

5. Direct intervention in direct production in certain fields in which government is able to work, but in which private enterprise is also able to work, for the purpose, largely, of assuring that the work shall be done and the production made available at times and under circumstances in which for one reason or another (perhaps temporary), private activity is unable or unwilling to advance.

This is, roughly, the spectrum of possible activity in a government dedicated to preserving the widest possible scope of individual choice of life. The degree to which a state is forced to emphasize any one of these elements against the other turns on the degree of impulsion—the pressures behind it. As pressures increase, governments will be driven to abandon the indirect and enter the direct fields.

There has been controversy at every point in both indirect and direct intervention of government in economics; but the controversies have invariably come to a single end. To the extent that there was need or impulsion, every government, irrespective of its political philosophy, has been forced to move in the direction of meeting the impulsion. The controversy indeed has tended to increase rather than to reduce the impulsion. For when private interests seek to resist the government entry into the field, they are likely to discourage both themselves and their associates from alleviating the situation which forces the government to act; and to the extent that this increases distress, they put greater rather than less pressure upon the government to act.

The great contribution, it seems to me, which economists can render is to reduce the area of this classic controversy, if not indeed to eliminate it altogether. Clear economic thinking in these situations should make it plain that the area of interest between private enterprise



and government is vastly greater than any minor area of conflict. Certainly, when the impulsion is as great as that which will be on us after the present World War, a failure to meet the situation is far more likely to destroy alike private enterprise and the chance of individuals to enjoy free choice of life. With the relatively minor adjustments and readjustments which had to be made up to 1921, governments could weather a period of distress. Impulsions as great as those of the depression of 1929 forced a considerable change in theory. The hydraulic impact of the pressures which will exist after the World War, if they are not met by common action, may produce reactions so great as to force direct intervention in many if not all fields.

This was the experience of most governments in Europe following the first World War. It led directly to change not only of governments (which might be merely political) but also to a change of the economic theory on which governments were based, respectively in Italy, Germany, and many of the Balkan countries, and very considerably shifted the area of British governmental action. In most of these cases the violence of the result was due to an attempt by certain interests to resist the impulsion and the measures towards which the government was forced, instead of an endeavor to work out the situation by taking account of all of the elements and endeavoring to assign to them different spheres of action, or to effect a frank co-operation so that the impulsions might be accurately and definitely met.

### III. *Enlarged Basis of Economic Theory*

We must digress for a moment to make certain observations which go perhaps to the very root of economic theory.

Most of economic theory is based on premises which are assumptions as to what individuals will do. These assumptions are derived from observation and historical experience.

Gresham's Law, for instance, is based on an assumption as to what individuals will do when they are faced with a choice between hard money and soft money; between currency which is cheap and likely to get cheaper, and currency which is valuable and likely to remain so.

Much, and perhaps most, of Lord Keynes's study of monetary theory is based upon assumptions as to when individuals will save money, when they will invest money, and when they will spend it.

Many of the economic postulates underlying central banking theory are based on the assumption that individuals will direct their capital towards the area of highest rate; and that businessmen will borrow money for productive purposes when interest rates are low.

Much of the reasoning relating to the ratio between price and production is based on the assumption that individuals will buy more widely

when the price falls. Illustrations could be multiplied, and they are found at the root of almost every branch of economic theory.

Classically, these assumptions are based on the behavior and habits of individuals, since the original reasoning was done by economists who lived under conditions in which both enterprisers and consumers were individuals; and they reasoned from a state of affairs which was normal to them and has been considered normal in subsequent economic thinking.

I think an epoch-making change in the basis of economic theory was made a few years ago, when Dr. Gardiner C. Means, after a meticulous examination of the field, demonstrated statistically that the behavior of certain aggregate nongovernmental units, especially corporations and large-scale productive units, was radically different from the assumptions made as to individuals. In his justly famous study of price rigidities, he pointed out that when effective demand was weak, prices tended to fall, whereupon individuals bought more freely, the demand thus increased, and once more tended to balance production. But, he pointed out that large-scale production, particularly the large corporate units, did not behave in this way at all. When prices tended to fall, price behavior was quite different. The price was maintained and remained the same; but produce fell, with consequent increase of unemployment. The phenomena he assumed were so widespread as to justify the assumption that aggregate units in this respect at least had a norm of behavior which had to be taken into account. By consequence, economic theory now had to enlarge its base. It had to include assumptions as to the behavior of individuals under given economic conditions; but it also had to include assumptions as to what large-scale nongovernmental economic units would do, and to reckon with the fact that large-scale economic units have habits of action of their own.

I submit that economic thinking now has to reckon with a third extension. It must take into account as a basic premise the fact that governments likewise are under impulsion; and that in certain great fields, it may be taken for granted that governments also will enter the field, more or less irrespective of local or partisan or party differences.

In brief, the impulsion upon a government to enter the field and tend to stabilize or increase employment, or to stabilize or increase certain sorts of prices (such as farm prices) in respect of which considerations apply which closely approximate those applying to wages and employment, is as constant and as likely to occur as the impulsion on a merchandiser to buy in the cheapest market and sell in the dearest.

No doubt, as experience progresses and as economic history improves, we shall be able to locate and define other impulsions to governmental

action, equally constant, which may then become postulates on which the increased scope of economic reasoning may be based.

But in dealing with an enlarged base of economic theory occasioned by habits of government, we are faced with a rather more complicated set of phenomena than usually exist when there is an endeavor to estimate the habits of individuals. An individual is commonly faced merely with a single choice: to buy or not to buy; to save or not to save; to sell or to withhold from the market; and so forth. But a government may be in a position to exercise any one of a number of choices. Further, it may obey the impulsion under which it acts in any one of several ways. At this point the economist is obliged to work closely with the political scientist, whose task it is to study and evaluate the philosophical and historical bases of governmental action, the institutions by which such action is carried out, and the degree of success or failure of such institutions in that regard. A communist government is under the same impulsion to take care of its people as is a democratic government; but it will act in one fashion, whereas a democratic government, obeying the same impulsion, will work out the problem through an entirely different set of institutions. A communist government may substantially eliminate the factor of individual behavior or of non-governmental aggregate behavior, as, for instance, that of large corporations. A highly individualist government may endeavor to eliminate direct governmental action, and substitute indirect governmental action, as long as indirect action appears to meet the essential impulsion. But both the communist and the individualist governments will be driven to pursue a course of action which eventually meets the underlying and essential need.

#### *IV. A New Theory of the Division of Powers*

Since we have now been forced to call in the political scientist, it is appropriate to note that the problem with which we deal (namely, that of combining liberty of the individual and free choice of life, on the one hand, with reasonably full provision of opportunity for economic life through productive activity, on the other) is merely a new form of an old story. The political scientist has dealt with it before, and he can be of help.

In agricultural civilizations, the threat to individual choice of life arose largely from the combination of all forms of governmental power in a single hand. Governments so organized that the executive was also the judge, and his fiat was law, directly threatened human liberty. An important part of the French Revolution stemmed directly from the Physiocrats, who fought for the institution of private, individual prop-

erty, because without it the individual was so completely in the hands of the state that he had no independent choice of life. In the British system, a somewhat similar factor had been pounded out through the long history from Magna Carta to the American Declaration of Independence, as law guarded private property, and governmental institutions were set up which made the protection valid.

Both British and French political scientists, notably Montesquieu in France and Jeremy Bentham in Britain, formalized the doctrine of what is called "division of powers." By more or less rigidly separating the executive from the legislative and the legislative from the judicial, they considered that those individual rights which a man had could be protected from arbitrary action, that there would in that case be "a government of laws and not of men."

Perhaps we can call on this line of doctrine to assist us in organizing the newer forms of economic activity into which most governments will be driven, in greater or less degree, by the impulses we have noted.

I believe that there can be a fourth branch of government—a branch devoted towards carrying out, under the law, those direct interventions into economics which must be undertaken in times of readjustments or of great pressure. It may well be that a system, divorced from direct connection with other forms of government, can be worked out offering the greatest degree of adjustment between direct intervention of government and free individual choice of life.

We have seen such operations in other countries. The great co-operatives in Sweden have effected just such an operation. Sufficiently adequate decentralization in the United States has produced similar phenomena: the remarkable success of the Tennessee Valley Authority, once a bone of contention, but now by general consent one of the most successful operations of its kind, offers another example. Use may be made of local governments where they have demonstrated their efficiency and integrity. In certain great nonprofit fields, including hospitals, a very considerable degree of adjustment has been made. It should be possible, if sufficient care be taken in constructing institutions, to make possible that direct intervention in economic activity which may be required at any given time to stabilize and improve economic conditions, without thereby impairing anyone's liberty of choice. Perhaps it is not too much even to hope that enlightened private enterprise will be drawn to see that this sort of activity is as vital to their economic life as it is to the political life of the state. It is, in fact, the only possible insurance against the cataclysmic movements which have eliminated liberty and individual enterprise alike on the Continent of Europe.

### *V. Conclusion*

In the foregoing paper we have sought to examine certain fundamental and underlying considerations as they relate to government and private enterprise.

We have seen that the modern state is under an irresistible pressure to assure opportunity for economic activity substantially to all of its able-bodied citizens.

We have indicated that, properly directed into productive fields, it should be possible to achieve this without serious danger of monetary disturbance.

It would appear that historically governments have been driven from indirect intervention in economics to direct intervention, as the size and scope of economic readjustment has overpassed the limits either of automatic adjustment to equilibrium, or of private ability to cope with it. There remains the problem of adjusting the economic activity to which a government will be forced to a system of free choice of life which must necessarily include a great area of free enterprise.

It has been suggested that the best method of doing this is by the separation, through decentralization or other institutional means, of direct economic activity from the purely political activity of governments.

It is to be hoped that if agreement on principle can be reached, we may see an end of the long conflict between what are usually called private interests and governmental interests, since, as the shape of the future emerges, disaster to one means disaster to both. Success to either must be conditioned upon the success which is shared by all.