

FINANCING THE DUAL ECONOMY

Author(s): ALVIN H. HANSEN

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the world market and its health is our business. The poor nations which comprise two-thirds of the world would clamor for development in any event. Yet the gulf between their standard of living and that of the advanced areas has become so wide that it is doubtful whether it can ever be filled.

The least the industrial countries of the West can do to help lessen it is to try to provide what we have come to consider the birthright of free men—equal opportunity to embark on the great adventure of self-sustained growth. But the underdeveloped countries are already too far behind—and too enmeshed in the

vicious circle of low incomes and rising population—to achieve the necessary impetus unaided. If the West lets them down, they are apt to make the attempt with Soviet help and by emulating the Communist method.

If the West wants to avoid this contingency, it has to act decisively and in a concerted manner to counter the attraction of the Soviet example. This is the only way to demonstrate that extensive development can be achieved by democratic methods. The challenge is quite evident, and the need for action has been acknowledged in scattered statements. But, so far, there has been virtually no coordinated re-

sponse by the West as a whole. And while the task is obviously too large for any country to undertake alone, systematic action has barely begun.

What is needed is a drive for greater unity, commensurate with the magnitude of the job at hand. To galvanize the Western community into common action—and the Marshall Plan proved it can be done—a clearer recognition of both the need and the path is essential. The land has been surveyed and the destination set. But the road to collaboration remains to be built. How swiftly can we complete the task of construction? This is the great issue for our international policy in the Sixties. ■

A vital economic issue of the Sixties

FINANCING THE DUAL ECONOMY

by ALVIN H. HANSEN

■ A PARTNERSHIP between private enterprise and government will, in my opinion, become increasingly necessary. The role of private enterprise is now, and will continue to be, primarily that of producing a rich and varied supply of material goods. Owing to automation, however, employment in the material goods sector is declining. Employment in the service area is rising. Just as private enterprise serves best in the material goods sector, so government serves best to satisfy our cultural needs. The role of government will increasingly be that of providing a wide range of services—those services which we have come to associate with the welfare state—social security, health, housing, education, recreation and cultural programs, and community projects.

The further we move into the Dual Economy, the more we shall encounter two problems: (1) the availability of funds for private capital formation and for industrial research, and (2) the “shrinking tax base” as the government sector grows larger and larger relative to the pri-

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ivate sector. Where is the money coming from to keep the Dual Economy going?

Consider first the sources of private investment funds. Formerly such funds came primarily from stock subscriptions, bond issues and bank loans. More recently investment funds have come primarily from internal sources, namely, retained profits, depletion allowances, depreciation and amortization charges. From 1955 to 1959 inclusive \$138.2 billion came from internal sources while only \$58.2 billion came from bank loans, mortgage loans and new issues of securities.

In the earlier stages of development profits were necessarily rather meager, and so relatively little reliance could be placed on retained earnings as a source of funds. One had to look outside of the enterprise

itself for investment funds. Capitalists and banks had to be found that were willing to assume risks and advance the funds necessary to start new enterprises. In the earlier stages of our history as an industrial nation, depreciation allowances played only a small role in new capital financing. The aggregate accumulated stock of plant and equipment subject to depreciation was small. Moreover depreciation accounting had not developed to any high degree of expertness.

Equally important is the fact that, in the days when numerous producing units occupied each industrial field, prices and profits were controlled by competition. Retained earnings could not be “planned” to the degree that is possible under oligopolistic and quasi-monopolistic conditions. In the recent drug hearings in Washington corporation heads testified that fantastically high markups were deliberately made in order to provide ample money for research.

Prior to the advent of “administered” prices, funds for research or

for investment in plant and equipment were more dependent upon the capital markets and on borrowings from banks. Savings and bank credit were the primary sources of investment funds. But now funds for investment may be tapped from consumers via high administered prices bolstered by high-pressure advertising. As far as outlays on research are concerned, this is all the more true since the tax reforms of 1954 permit research outlays to be deductible as current expense. Under this procedure research outlays are made a part of cost to be covered by an adequate price. Prior to 1954 such outlays were regarded as a long-term investment, deductible over a period of years.

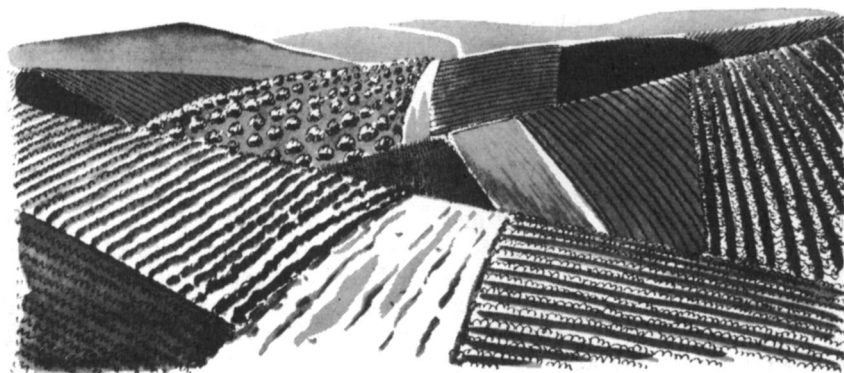
When investment funds are obtained from the capital market, those who supply the funds have a voice in the business. In the final analysis stockholders control, and banks and bondholders have at least a contingent voice. In any event they are paid dividends and interest for their participation. But nowadays the consumer, via the administered pricing system, pays a price sufficiently high to cover current research outlays and depreciation allowances, and in addition sufficiently high prices to provide profits not only for dividend payments but also for adequate retained earnings. This is taxation without representation.

It is said that about one-half of total medical research in the United States is paid by the federal government, one-fourth by universities and one-fourth by drug manufacturers. Government research is paid by taxes imposed by an elected Congress. The taxpayers elect the legislators who vote the appropriations. But the consumer who pays prices which are higher than necessary to cover costs (including normal or "competitive" profits) is in the final analysis the one who supplies the funds which are plowed back into businesses operating under the system of administered prices.

The average annual investment made by corporations in plant, equipment and inventories in the period 1955 to 1959 inclusive was \$31 billion. Internal sources (retained earnings, depreciation, amortization and depletion allowances) averaged in this period \$27.6 billion.

Internal sources were therefore sufficient to finance exactly 90 per cent of the aggregate investment in *fixed capital and inventories combined*. Outside sources of funds (bank loans, mortgage loans and new issues) were tapped to cover the remaining 10 per cent and to finance net accumulations of cash, securities and net receivables.

Depreciation and amortization allowances now supply two-thirds of the funds spent by corporations on plant and equipment. Depreciation allowances have been increased not only by more generous tax treatment, but also by the fact that an



enormous amount of new corporate plants and producers' equipment have been built in recent years (post-war backlog and new techniques). This vast accumulation of new productive facilities is generating a huge volume of depreciation allowances. And the fact that so much of the plant and equipment is new means that replacement is a long way off. Accordingly the depreciation funds can immediately be used, not for replacement, but for net additions to the stock of fixed capital. And those new capital assets, in turn, are again subject to depreciation. In a growing society you are always ahead of the game. Depreciation allowances tend to exceed replacement expenditures. In 1955-59 an annual volume of nearly \$19 billion of corporate depreciation funds was available for investment, and currently it amounts to nearly \$23 billion. In addition there are the retained corporate earnings, amounting in 1955-59 to \$9 billion per year.

We have thus reached a new, and perhaps necessary, stage in financing private investment. Without this de-

velopment it is doubtful if we could have obtained the investment funds needed for growth and expansion. Clearly, however, this development raises questions with respect to governmental supervision or control.

And now the question: Where is the tax money coming from if the private enterprise base, though growing absolutely, is undergoing a relative decline?

Unless one has given considerable thought to this question, the instinctive answer is that private enterprise is the only true source of income. All incomes, so it is argued, are derived directly or indirectly from private

enterprise. Governments obtain their income, it is said, from private enterprise. This works all right as long as the government sector is relatively small. But what will happen, it is asked, should the government sector grow and grow in relation to the private sector? Will not the true source of funds, under these circumstances, eventually dry up?

Frequently one hears the comment that the payrolls of private industry are the source of the whole national income, that government is supported by business, that private enterprise alone is productive.

Here we can learn from the early classical economists. Adam Smith introduced a novel idea into economics—a new concept of productivity. The physiocrats had held the view that agriculture alone was productive. Agriculture supplied the necessities of life for the agricultural population, and if there was a surplus left over, it was possible out of this "net product" to support the "unproductive" town population.

It is not difficult to see how the physiocratic concept of productivity

was born out of the conditions emerging from the Middle Ages. Towns originally were simply the winter residences of great feudal lords. The town population grew up around the court. It performed personal services, prepared food, made rich clothing and ornaments, jewels, laces, velvets, tapestries, clocks and furniture. All this activity was supported and sustained from the surplus which the lord was able to draw from his agricultural domain. Without this surplus, life in the town would quickly ebb away. The town had no independent source of subsistence. It drew its sustenance from the country.

Town life was a luxury which could only be supported out of a richly productive countryside. Town life could develop only so far as an agricultural surplus could be produced and, through feudal rights and privileges, drawn off from the land to enrich the town life of the landed aristocracy. If king and country were to become rich and powerful, it was necessary to encourage agriculture. Agriculture alone was really productive. All other pursuits were sterile and unproductive. This was the doctrine of the physiocrats.

Fountainhead of wealth

The thesis that agriculture was the fountainhead of all wealth, that agricultural pursuits alone were productive, was once and for all disposed of in Adam Smith's great book *The Wealth of Nations*. The view he challenged had seemed so self-evident and plausible that none had seriously questioned it, precisely as is the case today with respect to the role of government. Yet increasingly, as manufacture and trade developed, it was inevitable that sooner or later it would become apparent to an original mind that the old thesis simply did not fit the facts of a more highly developed society.

The opening paragraph in *The Wealth of Nations* strikes directly at the fallacy of the *produit net* philosophy. Smith regarded labor, not agriculture, as the basic source of wealth. Through division of labor and exchange, productivity is increased. If one exchanges one's agricultural surplus against the products of specialized and efficient town craftsmen, one increases one's own

product. Exchange with the town enriches the country.

Now, in point of fact, this analysis did not represent merely a new interpretation of the same facts. To some extent the facts themselves had changed. At the earliest emergence of town life, the town, as we have noted, was simply a collection of families catering to the wants of the lord and his court. It had no independent existence. The activities of the town represented the lord's method of consuming his agricultural surplus.

But gradually some of the mechanics of the town acquired an independent status of their own. They offered their own wares in exchange. Country barons and squires exchanged their agricultural surpluses for the products of the town's craftsmen. Thus a real exchange developed between country and town.

Exchange process

The breakdown of feudal privileges in the French Revolution developed and expanded this exchange process. The peasant, having acquired a new status, was in a stronger position to retain control over his surplus product. By the time the development of social institutions had reached this point, it was possible to recognize that the country no longer supported the town any more than the town supported the country. It was no longer meaningful to say that agriculture was productive while manufacture was not, or even that agriculture was more productive than manufacture. Both activities satisfied human wants.

But while Adam Smith freed the thinking of his time from the physiocrats' narrow concept of productivity, he failed to liberate himself and his generation wholly from the basic physiocratic error. While urging that manufacturing was equally as productive as agriculture, he nevertheless held that only those workers engaged in making material goods were really productive. Thus, he argued that not only menial servants, but also churchmen, lawyers, physicians, men of letters of all kinds, players, musicians, opera singers, etc., were unproductive laborers. It is remarkable that, once he had taken the first step in the right direction, he should have made

this error. If manufacture is productive, since it no less than agriculture satisfies human wants, surely the opera singer, the physician, the teacher are equally productive. At a later stage in economic thinking the logic of Adam Smith's own position, which he imperfectly applied, was pointed out and universally accepted by all economists.

But the logic of this thesis is frequently challenged with respect to governmental expenditures. Public investments (parks, roads, playgrounds, hospitals), it is often asserted, are in some sense unproductive; only private capital expenditures are regarded as productive.

Sharp distinction

In discussing the productiveness of private business expenditures, it is important to make a sharp distinction between (1) the creation of a flow of real income of goods or services and (2) the creation of new instruments of production which increase the efficiency of labor and result in a larger flow of real income than might otherwise be possible. The former is a utility-creating expenditure; the latter is an efficiency-creating expenditure. Investment which duplicates existing plants in accordance with the requirements of growth (as, for example, the erection of another shoe factory) is of the former type. Investment in improved machinery is of the latter type.

The view that public investment is unproductive, while private investment is productive, will not withstand careful analysis. Public investment, like private investment, may be simply utility-creating or it may be also efficiency-creating. The development of a public park, swimming pool, playground or concert hall makes possible a flow of real income no less than the erection of a shoe factory. Public investment in natural resources or in the construction of school buildings may contribute to raise the efficiency of labor no less than private investment in improved machinery. Public investment, like private investment, if wisely made, may be utility-creating or both utility-creating and efficiency-creating. And in addition to being (1) utility-creating and (2) efficiency-creating, public expenditures no less than private expendi-

tures are also (3) income-creating in the sense that they tend to expand aggregate income and employment.

It is sometimes said that there is an important difference between business expenditures and governmental expenditures, in that the former are self-sustaining while the latter are not. But this will not withstand careful scrutiny. No private business can sustain its sales volume unless the outlays of other businesses or the government continue to feed the income stream. The sales receipts of private business, no less than the tax receipts of government, depend upon the maintenance of a high national income. And the outlays of government can and do contribute to a sustained national income, no less than the outlays of private business. Indeed, when private business outlays decline, the government may be the only agency that is in a position to go forward and sustain the national income through increased expenditures.

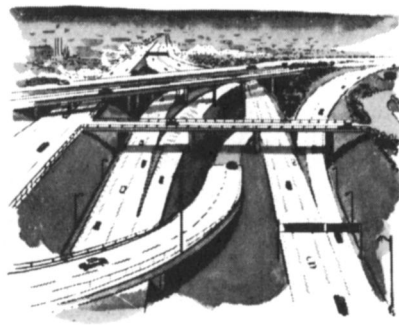
When it is said that public expenditures are "sustained out of" private income, it will be disclosed, on careful analysis, that the reasoning is precisely similar to that of the physiocrats. Manufactures were sustained, it was said, out of the surplus product of agriculture. The true fact, however, was that the real income of the community was raised enormously by diverting a part of the productive resources to manufactures. In like manner, under modern conditions, many wants can be satisfied only by governmental action, and in other cases more effectively by governmental action. Roads, streets, sewage disposal, reforestation, flood control, parks, schools, public health, hospitals, low-cost housing, social insurance, public playgrounds, and other recreational and cultural facilities—all these represent ways of enlarging our real income far beyond what it could be if these things were not undertaken by government.

Each segment contributes

These activities are utility-creating and in part efficiency-creating, no less than the activities of private enterprise. The governmental expenditures are not supported out of private enterprise any more than manufacture is supported out of the agricultural surplus. Just as the man-

ufacturing population buys the surplus of agriculture in exchange for its products, so also the services of government enter into the exchange process and enrich the income stream. It is true that part of the exchange payment is in the form of taxes, but this fact in no way alters the fundamental fact of exchange. In this process of exchange it is not true that any one segment of the exchange economy supports any other segment. Manufacturing is not maintained out of the surplus of agriculture and government is not maintained out of the surplus of private enterprise. Each segment contributes to the total flow of real income and each takes its share out of the income stream either by charging a price or by collecting a tax. Outlays create incomes and incomes cover costs.

In the sense that the most essential necessity of life—food—is produced by agriculture, it may be said that



agriculture is basic to all other economic activity. This seems to give it a sort of priority. But this priority has a meaning only in primitive societies where it is necessary to devote all, or nearly all, of productive resources to the procurement of food. As a society becomes more productive, agriculture loses its right of priority. The very superabundance of agricultural products implies that more emphasis must be placed upon other economic pursuits. Manufacture, indeed, may now become the really important branch in that its products are relatively scarce in relation to the products of agriculture. In an agricultural-surplus society manufactures may assert a certain claim to priority.

The same analysis applies to gov-

ernmental activities: once society becomes surfeited with material goods, public needs demand prior consideration.

Income creation

I have discussed the problem of income creation and I have tried to show that the employment of productive resources, whether by government or by private enterprise, involves the payment of money incomes to the employed factors of production. And the income thus paid out is sufficient to buy back all the goods and services produced. Whether this "purchase" comes about via the price-tag mechanism or via taxes is from this standpoint quite immaterial. The costs of production are in fact the income receipts of the factors of production. Incomes spring from costs and expenditures (whether via the price tag or via taxes) spring from income. Costs, income, expenditures—the circle is complete. It is Schumpeter's circular-flow economy.

The publicly provided goods and services are either produced directly under government management or else they are purchased by the government from private producers. Government management could mean either a department like the Post Office Department or a government corporation like the TVA or the Export-Import Bank or the Commodity Credit Corporation. Government purchase of goods and services from private business is illustrated by contract construction work or by the vast governmental purchases of military equipment from private corporations. But whether the government itself produces the goods and services or buys them under contract from private parties, the net effect, as far as income creation is concerned, is the same. Money is paid out which goes into the pockets of individuals, whether wage or salaried workers, or stockholders of the private corporations that do contract work for the government. The entire cost of production is paid out in this manner. The government in its turn recovers the costs thus incurred either by selling the goods and services to the public at a price or else by collecting the cost of their services from the public by means of taxation. ■