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Joint Committee of the Economic Report

May 29, 1947

Professor Jakob Marschak,
Department of Economics,
University of Chicago,
Chicago 37, Ill.

Dear Professor Marschak:

The Joint Committee on the Economic Report which was established under the authority of the Employment Act of 1946, is now studying national policies designed to achieve and maintain stability and high-level employment, the goals of the Employment Act. To aid in these studies the enclosed questionnaire is being sent to a considerable number of professional economists, outside the Federal Government Service. You will note that it is in two parts, one dealing with the long-run objective of maintaining conditions favorable to economic stability and progress; and the other with some of the short-run problems we face in 1947. We shall appreciate it if you will help us by returning a prompt comprehensive reply.

The primary purpose of the questionnaire is to elicit answers that will contribute to the development of sound thinking, rather than to obtain a statistical picture of the "yes-or-no" views of the economic profession. Hence we hope you will not hesitate to submit fairly full answers in those cases where your interests and the character of the question justify it; likewise that you will feel free to omit any questions which you do not feel prepared to answer. If you have already discussed some of the questions in your published writings we should appreciate the references, or copies of reprints if they are available.

Your answers will be kept confidential unless you indicate that we are free to quote them. Let me give you my personal assurance that we shall value your help highly.

Sincerely yours,

(Signed) Robert A. Taft

Chairman.

The following answers to the questionnaire of the Joint Congressional Committee must not be considered as a Cowles Commission document, but rather as the expression of my personal views. Because of the urgency, no time was available to circulate my answers to staff members and to incorporate their criticisms. This certainly would be the most desirable procedure, and I regret to have been unable to follow it. Nevertheless, I am circulating the answers because the questionnaire itself is rather interesting, and because the answers may evoke some internal criticisms which may prove useful in our further work.

Jacob Marschak

ANSWERS TO THE "QUESTIONNAIRE ADDRESSED TO ECONOMISTS."
Chicago, June 16, 1947

To PART I, Question 1. "The Employment Act of 1946 states that it is the policy of the Government to maintain 'conditions under which there will be afforded useful employment opportunities, including self-employment, for those able, willing and seeking to work, and to promote maximum employment, production, and purchasing power.' What conditions do you consider most important to the attainment of these objectives?"

Answer: "Maximum employment, production, and purchasing power" cannot, presumably, denote within the meaning of the Act, high employment combined with low production ("spreading the work"); or a high level of production of goods which the population does not particularly want to buy. I assume therefore that the aim is to employ labor and other resources of the country as fully and efficiently as possible, and to employ them in producing those goods which are most desired by the people. Conditions necessary to achieve this aim, can be listed as follows:

(1a) adequate total demand--to prevent "non-frictional unemployment."

(1b) high mobility of labor and capital, to prevent "frictional unemployment".

(1c) absence of monopolistic profits or wages--to prevent misdirection of the nation's resources.

(1a) Total demand of consumers, of business and of the government for goods and services must be large enough to absorb the greatest supply of goods and services that can be produced. It must be realized, however, that, as the nation approaches this maximum demand, a rise in price is inevitable because

(1.aa) real returns per additional labor or capital unit may begin to fall ("bottlenecks" of various kinds are reached), while at the same time

(1.ab) labor, organized or not, is able to bargain for higher money wage rates per hour.

This price raising effect of full employment is inevitable regardless of the way by which the total demand has been raised: whether through monetary or fiscal policies of the government, or through free expansion of private industrial or banking activities. For brevity, the words "inflationary", and "deflationary" will apply, in what follows, to any rise or fall in the total demand (in dollar terms). It will be understood that in the neighborhood of full employment, a larger proportion of this rise or fall of demand takes the form of a rise or fall in prices, than when employment is low. It will also be understood that while high employment, production and purchasing power (in physical terms) are desirable for their own sake, as indicated in the Act, stable prices are desirable, not for their own sake, but mainly because strong price changes

(1) change the distribution of real income and thus disturb social peace even though the aggregate real income may be high, and

(2) lead to a speculative boom followed by a depression, with aggregate real income lowered on the average of both periods.

(1b) The flow of labor and capital from contracting to expanding industries can be accelerated by measures such as cheap vocational re-training, subsidizing the transfer of workers' families, and decentralized credit.

(1c) The existence of monopolistically high profits or wages in certain industries implies that the public's desire for their products is not satisfied, ie., the national resources are misdirected (present situation in housing).

Of the three conditions (1.a), (1.b), (1.c), condition (1.a)--total demand equalling our very large potential supply--will probably remain the most important one as long as there exists the danger of insufficient demand due to the lack of understanding of required policies. However, the current needs of our foreign policy and of our national defense make it likely that, after a year or two of hesitation, the government--its executive as well as its legislative branch--will bring about a vigorous demand for goods and services, needed for rearmament, military training, and for supplies to friendly countries overseas. If, on the other hand, the international development should make these expenditures unnecessary, there is a chance (of which your questionnaire is itself a hopeful token) that the political leaders, the business community, the labor leaders, and public opinion in general will advance towards a better understanding of the necessity of maintaining adequate total demand. This will leave conditions (1.b) and (1.c) still unsatisfied, and the need for their fulfillment will persist. Also, with the problem of (non-frictional) unemployment out of the way, the price-raising aspect of full employment will require more attention than it did at the time when the Act was passed.

To PART I, Question 2. "What is the relation, if any, between inequality of incomes and economic instability? Do the following conditions, when present, constitute a threat of business collapse:

2. a. Corporation profits higher than average in comparison with investment, with sales, or with other shares of total national income?

b. Farm incomes very high in comparison with other shares of total national income? Very low? "

Answer: Variations in the degree of inequality of incomes can hardly affect employment much, one way or another, unless these variations are very large, too large to be contemplated as a reality.

To PART I, Question 3. "Is a national debt equal to 18 months' national income a serious obstacle to the maintenance of full employment? "

Answer: We may list three possible effects of the existing debt-- two deflationary effects and one inflationary effect: (see p. 2 for the definition of these words);

(3.a) Deflationary effect via the fear of the government to increase the debt further;

(3.b) Deflationary effect via the operations of debt retirement and interest payment, if financed by taxes, and only inasmuch as the debt is held by banks;

(3.c) Potential inflationary effect via the possible cashing of bonds and spending of proceeds.

(3.a) Should the total demand of consumers and business happen to be insufficient to maintain full employment, and should there be political opposition to financing the necessary supplementary government demand by taxes if not loans, effect (3.a) may become serious. It is based

(3.aa) on an exaggerated opinion of legislators regarding the effects (3.b) and (3.c), especially (3.c); and

(3.ab) on the reluctance to increase the financial powers of the executive branch of the government.

Effect (3.b) is less serious. If the government debt equals 1-1/2 years' national income and if, in a given year, the payments on interest and capital accounts amount to, say, 3 percent of the debt, these operations amount to 4-1/2 percent of national income. But since only a part of the government debt is held by banks, the truly deflationary operations caused by the debt are (in relation to national income) even smaller. The effect of tax-financed servicing of that part of the debt owned by non-banks can be assumed negligible since there is no large difference in the spending habits of the bulk of taxpayers and the bulk of bondholders (other than banks).

Effect (3.c) may be more significant, both in its beneficial aspect as a cushion against deflation (as in 1946) and in its unfavorable aspect as an intensifier of a boom touched off by other causes. However, a large proportion of bonds previously held by the lower-income consumers seems to have been already redeemed or transferred; and the dangerous liquidity elsewhere can be kept under control by appropriate monetary policies, e.g., by adjusting the bank reserve-ratios.

The conclusion is similar to that at the end of the answer to Question 1. As the nature and size of the effects (both inflationary and deflationary) of government debt become better understood, fiscal policy will become more controlled by considerations relevant to the economic and other goals of national policy (high aggregate real income; social peace; national defense, etc.) and less by considerations based on the traditional prejudices against government debt as such. Thus government debt will cease to act as a bar against a rise in government expenditure if and when such expenditures are required by the goals of national prosperity or security.

To PART I, Question 4. "When costs fall because of increased efficiency of management or of labor, or because of increased investment, which type of readjustment is more favorable to stability and further progress--a arise in wages or a fall in prices?"

Answer: The experience of the 1930's gives some slight support against the price-reducing method of adjusting the economy to technological progress. Price reductions without loss, made possible by higher efficiency, may lead to the expectation of further price reductions, and these are not possible, in a unionized labor market, without losses and consequent unemployment. These lead, in turn, to the expectation, and realization, of further losses, etc. It is not easy to think of a policy which would properly offset those expectations.

Theoretically, one might argue that an analogous effect in reverse should be characteristic of the wage-raising method. The upward adjustment of wage-rates in a given industry to a new and higher level of marginal productivity of labor would lead to the expectation of similarly easy bargains on the part of workers in other industries, not blessed by raised efficiency. If these industries are monopolistic, they will be able to grant such wage raises, and increase prices. However, I do not know of any such experience; and price-rises, unless they are very large, are probably in any case preferable to unemployment. (See above, (1.a)).

To PART I, Question 5. "Is it desirable that wages be adjusted promptly to changes, upward or downward, in the cost of living? What are the probable consequences of a failure to do this?"

Answer: This question is answered in the reply to Question 3. The failure to adjust wages to changes in the cost of living means a change in the distribution of real income. Unless this change is very large I don't believe it can have a great effect on total demand though it may considerably disturb social peace and good-will within the nation and is undesirable for this reason.

To PART II, Question 1. "Is the present level of prices, or of some important group of prices, out of line with other factors in the economy? The level of wages? The level of profits? If your answer is "yes", what consequences are likely to follow from the imbalance, if no planned measures are taken to correct it?"

Answer: See answers to Questions 2 and 5 of Part I. As long as profit incentive is maintained, I cannot attach much economic (as distinct from social and political) importance to the relative size of various incomes and prices.

To PART II, Question 2. "What, if any, impediments to a continued high level of production and employment in this country have you observed to exist in 1947? How do they differ from those encountered ever since January 1946?"

Answer: The reconversion of plants and accumulation of inventories by businessmen, and the use of war savings by consumers maintained high total demand in 1946. These factors have diminished in 1947, but got replaced in part by government financed demand overseas. In the second half of 1947 or, more likely, in 1948, increased appropriations for armed services may also come in as a factor, while exports will be maintained by our new line of foreign policy. This politically caused demand may fall short of the demand necessary to maintain full employment, but probably not by much.

To PART II, Question 3. "Is there any way to make analyses of current economic data which deserve sufficient confidence to form the basis of Government action designed either to prevent or to stimulate changes in the business situation, from 3 to 12 months ahead?"

Answer: Actions based on economic data, however imperfect, are preferable to actions based on no data at all.

To PART II, Question 4a. " If your answer to question 3 is "yes", in what indicators would you place chief reliance, for example: a. How much significance do you attach to so-called barometers, such as the levels of short-term interest rates; stock-market movements; the levels of wages and of wholesale and retail prices as compared with some earlier periods, and so on?"

Answer: "Economic barometers" are used for prediction under the assumption that certain sequences of events repeat themselves; this presupposes, in turn, that underlying economic relationships do not change, not even as the result of the very policies that are to be based on those predictions. This is a serious limitation; for example, the removal of rent control or a change in government expenditure may considerably impair the validity of predictions based on mere repetition of certain empirically observed sequences.

In spite of these limitations, the Government should pay close attention to properly selected "barometers", especially those justified not only on empirical but also on theoretical grounds, i.e., those that can be explained in terms of plausible human behavior.

Measures known to produce quick deflationary or inflationary effects must be taken whenever it is necessary to counter-act strong deviations of demand, predicted by barometers and consisting of rising prices or falling employment. Still better are measures creating in advance an automatic response to such deviations in the future. Income taxes and social security contributions have this welcome characteristic, and can be reinforced by making the tax-rates, themselves, automatically adjustable in response to strong changes in the level of employment and prices, and thus independent of politics.

To PART II, Question 4b. "What value do you attach to national budgets ("economic models") based on past income-consumption relations, profit-investment relations, or price-employment relations, as applied to current data and hypothetical new developments?"

Answer: The limitations mentioned in the answer to Question 4a do not exist in the case of "conditional prediction" based on statistical estimation of the response of various economic groups (consumers, manufacturers, landlords, bankers, etc.) to changes in their incomes and the relevant prices. These statistical estimates must use all information available: time series as well as family-budgets, attitude surveys, etc. The response patterns thus obtained (and revised from time to time) can be used to evaluate the effects of any intended policy or change in policy, or of any other given impact from outside of the economic system. Because of the inadequacy of data, and also because of random variations in human behavior, the prediction must be made in the form of a sometimes wide interval of values. But, for any preassigned level of probability, the interval can be estimated with considerable precision. This is an advantage of the method. To predict the possible extremes of the outcome of an action, and to give a measure of reliability of this prediction is as much as can be expected for any practical decision, from any method whatsoever. To ignore the margin of error because "practical people don't understand it," is to deceive everybody, including the practical people.

Some underlying principles are set out in my paper "Economic Structure, Path, Prediction, and Policy," of which a brief abstract is given in the Proceedings of the meetings of the American Economic Association, held at Atlantic City in January 1947. For more details (including those on the necessary revision of statistical methods) see various publications of the Cowles Commission since 1944, in particular the following papers:

Lawrence R. Klein, "The Use of Econometric Models as a Guide to Economic Policy", Econometrica, April 1947;

Trygve Haavelmo, "Methods of Measuring the Marginal Propensity to Consume", Journal of the American Statistical Association, March 1947.

Further bibliographical indications, as well as a reprint of my paper mentioned above, are contained in the forthcoming Five-Year Report of the Cowles Commission, 1942-1946, which I shall be able and glad to send shortly, together with reprints of the articles of Klein and Haavelmo.

To PART II, Question 5. "If your answer to question 3 is "no", is there any sound basis for a stabilization program directed at short-run objectives?"

Answer: Answer not required.

To PART II, Question 6. "Do you believe that the virtual abandonment of price control in 1946 had a favorable or an unfavorable effect on the volume of production?"

Answer: Favorable, though not very much so. Expectation of rising prices led to expansion of both inventories and plant.

To PART II, Question 7. "If price control had been maintained successfully, could the mass of the population have bought more consumption goods than they actually were able to buy after price control was abandoned? If so, where would the extra goods have come from?"

Answer: Yes, though not much. The extra goods would have come through smaller accumulation of inventories.

To PART II, Question 8. "Would an enlarged program of housing construction for 1947-48, supported by government loans, subsidies, or priorities, have a beneficial or a harmful effect on the general levels of prices, employment, and production?"

Answer: Beneficial from the point of view stated in the answer to Question 1 of Part I, item 1.c: resources would be directed towards an obvious need of the people, presumably kept unsatisfied in a monopolistic housing market.

At the same time, an enlarged housing program will increase the total demand (in terms of dollars). This will be beneficial if the fiscal year 1947/8 is not yet affected by the new foreign policy, i.e., if hesitations with regard to the demands of Armed Services and to the recommendations of the State Department continue for another year. Otherwise, the program will be harmful. Not having the necessary political information I can merely venture the guess that a housing program of short duration, if undertaken immediately, will be beneficial--especially if combined with Army recommendations on the forms of industrial relocation and city planning necessary for defense purposes under conditions of modern warfare.

To PART II, Question 9. "What obstacles do you see to the development of what you consider an adequate program of housing construction?"

Answer: (9.a) Obstacles (to modern building methods)which, to my limited knowledge, are at least in part due to union rules.

(9.b) Resistance of private building interests against government activities in general.

(9.c) Uncertainty about the future rent level.