# The Frank E. Seidman Distinguished Award In Political Economy

Acceptance Paper by

## Arthur F. Burns

recipient of the 1978 award

## *The Future of the Free Enterprise System*

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# THE FRANK E. SEIDMAN DISTINGUISHED AWARD IN POLITICAL ECONOMY

The Frank E. Seidman Distinguished Award in Political Economy was established in memory of Frank E. Seidman by Mr. and Mrs. P. K. Seidman. The host college for the Award is Southwestern At Memphis. An honorarium of ten thousand dollars will be given to an economist who has distinguished himself or herself by contributing internationally, in the judgement of his or her peers, to the interdisciplinary advancement of economic thought as it applies to the implementation of public policy.

The purpose of the Award is to recognize and encourage economists who are attempting to extend their methodology into the interdependent areas of the other social sciences. It is applicable to the advancement of social welfare when proper cognizance is given to environmental and institutional influences upon the economic behavior of the individual and groups. The basis for evaluation will be broad enough to encompass both the synthesis of existing economic thought and the pathbreaking development of new concepts.

For the purposes of this Award, the recipient shall be considered an economist by imputation from the quality and importance of his or her professional work and interests. The distinguished contribution must be judged to have satisfied the specific criteria which are stated in terms to reflect the basic objectives of the Award.

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Director

ARTHUR F. BURNS
Recipient of 1978 Frank E Seidman
Distinguished Award in Political Economy

The Honorable Arthur F. Burns has had a long and distinguished career both in academic and public life. Most recently, from 1970 until March 1978, he served as chairman of the Federal Reserve System's Board of Governors. He was formerly Alternate Governor of the International Monetary Fund.

Before joining the Federal Reserve, he was Counsellor to the President of the United States (1969-70).

Among the many other prestigious posts he has held are. Chairman of the National Bureau of Economic Research (1967-78); member of the President's Advisory Committee on Labor-Management Policy (1961-66); John Bates Clark Professor of Economics at Columbia University (1959-69); President of the National Bureau of Economic Research (1957-66); Chairman of the President's Council of Economic Advisors (1953-56); and Professor of Economics at Columbia University (1944-58)

Dr. Burns is a Distinguished Scholar in Residence of the American Enterprise Institute for Public Policy Research. In this capacity, he engages in writing, lecturing and research on a multitude of economic subjects that have been his lifetime concern, including problems of inflation, monetary and fiscal policy, and the business cycle. He also serves part-time as a Distinguished Professorial Lecturer at Georgetown University in the School of Business Administration.

Among his many publications are:

Production Trends in the United States Since 1870 (1934)
Measuring Business Cycles (With W. C. Mitchell) (1946)
Economic Research and the Keynesian Thinking of Our Times (1946)
Frontiers of Economic Knowledge (1954))
Prosperity Without Inflation (1957)
The Management of Prosperity (1966)
Full Employment, Guideposts, and Economic Stability (with P. A. Samuelson) (1967)
The Defense Sector and the American Economy (with Jacob K. Javits and Charles J. Hitch) (1968)
The Business Cycle in a Changing World (1969)

# THE FUTURE OF THE FREE ENTERPRISE SYSTEM

## Address by Arthur F. Burns

Prediction of the economic future has always been a hazardous task. Noting this fact, a distinguished economic historian, Werner Sombart, once remarked that "it is precisely the most gifted men who have made the most fundamental mistakes" in predicting the economic future. While I am by no means sure that "gifted men" are more prone to misjudge the future than are ordinary mortals, there is ample evidence that judgments of the future even by the ablest economists have often been mistaken.

Karl Marx, who revolutionized economic and political thinking over much of the world, provides an outstanding example.

Marx believed that certain tendencies inherent in capitalism would ultimately lead to its destruction. In his vision, small business firms would gradually disappear as capitalism evolved. The concentration of production in a diminishing number of large enterprises would be accompanied by concentration of wealth in fewer and fewer hands. The middle class would thus be destroyed and the masses proletarized. Inadequate consumption would lead to recurring epidemics of overproduction, and depressions of increasing severity would follow. As the misery of the proletariat deepened, resistance to capitalist exploitation would intensify and become more militant. With such powerful tendencies at work, the capitalist order was bound to collapse; it was only a matter of time when the capitalists would be expropriated and all instruments of production socialized.

Thus, according to Marx's theory, the failure of capitalism in its later stages to meet even elementary economic needs of the working masses would inevitably lead, although not without intense struggle, to the replacement of free enterprise by a socialistically planned regime.

In our own century, another great economist, Joseph Schumpeter, brilliantly challenged Marx's analysis. Shumpeter saw in capitalism a highly efficient engine of mass production and mass consumption. In his view the capitalist spirit expresses itself characteristically through innovation—that is, developing new commodities, devising new technologies, harnessing new sources of supply, devising new market strategies, forming new types of organization. The competition of new products and new ways of doing business against old products and customary procedures—that is the essence of the capitalist process. This competition of the new against the old is what really matters in the business world; it has been continuing at a rapid pace, and it accounts for the vast improvement in living standards wherever capitalism has flourished. Indeed, not only economic improvement, but the ma̓jor achievements of modern times in the sciences and arts are, directly or indirectly, the products of capitalism.

Being a student of business cycles, Schumpeter was well aware of recurring business slumps and their spells of unemployment. But he regarded recessions as temporary phenomena that paved the way, so to speak, to more effective utilization of resources and therefore to still higher standards of living. He went on to argue, nevertheless, that the great economic and cultural achievements of modern capitalism did not assure its future; on the contrary, the very success of capitalism would eventually cause its replacement by a socialist civilization. He thus accepted Marx's conclusion but not the analysis on which is was based.

According to Schumpeter, capitalism would be destroyed by factors growing out of its own inner processes. As business corporations became larger, they would become bureaucratic and impersonal. The entrepreneurial function

of innovating would be largely assumed by trained specialists. Increasing affluence would provide both the means and the will to expand social programs and thus lead to a growing role of government. The intellectual class created and nourished by capitalism would become increasingly hostile to its institutions. Animosity toward free enterprise would be exploited by government officials seeking additional power for themselves. The general public would fail to support free enterprise because the issues debated in the public arena are much too complex and often involve long-range considerations that go beyond popular concern. Even businessmen would become increasingly willing to accept the teachings of their detractors. In this social and political environment, capitalist enterprise would in time be undermined and finally replaced by socialism.

Thus, Schumpeter arrived at precisely the same conclusion as Karl Marx. But whereas Marx attributed the eventual coming of socialism to the failure of capitalism, Schumpeter attributed it to the outstanding success of capitalism.

When we turn from the theories of Marx and Shumpeter to recorded experience, several facts immediately stand out. First, we find that the nations practicing socialism in Marx's and Schumpeter's sense had either banished free enterprise under external military pressure, as in the case of Eastern Europe, or had undergone an internal revolution without ever developing a significant degree of free enterprise, as in the case of the Soviet Union and mainland China.

Second, we find that greater economic success has been generally achieved in nations that extensively practice free enterprise than in nations where it is prohibited or severely limited. The economic performance of the United States, West Germany, and France has been more impressive than that of the Soviet Union or East Germany or Poland. Likewise, the economic performance of Japan, Taiwan, or Brazil has clearly surpassed that of India, Sri Lanka, or Egypt.

Third, although Marx's analysis continues to appeal to many intellectuals, his elaborate theoretical structure has been discredited by experience. Instead of bringing economic misery to the masses, capitalism has produced vast improvements in their economic condition. True, socialism has triumphed in some countries, but the triumph was achieved in a far different way than Marx had envisaged. On the other hand, Schumpeter's theory that capitalism would eventually be destroyed by its very success in improving the lot of people cannot be dismissed so readily. His prognosis may or may not turn out to be valid. But there is no denying that much of what has happened in recent decades in countries that boast of practicing free enterprise fits rather closely his theoretical mold.

Let me speak more specifically about one prominent feature of Schumpeter's analysis—namely, the expanding role of government in economic life. The broad trend of American economic development has been toward increasing emphasis on the service industries, and the government has become the channel through which much of the public's demand for services is satisfied. As our economy has undergone industrialization and urbanization, there has been a steady increase in the interdependence of people—that is, in their reliance on the wisdom and enterprise, and also in their exposure to the folly and indolence, of their neighbors. In such an environment, social and economic problems often arise that cannot be adequately handled by private enterprise and governmental activities therefore tend to expand.

The spread of political democracy has accentuated the trend toward seeking governmental solutions of economic and social problems. With more people in the lower income groups taking advantage of the right to vote and with advocates of all sorts active in legislative halls, demands on the government have been mounting—to eliminate or regulate private monopoly, to conserve natural resources, to strengthen trade unions, to raise minimum wages, to protect the environment, to improve housing conditions, to

protect unwary customers, to subsidize agriculture or other industries, and so on and on.

The range of governmental activities has thus been steadily expanding and so too has the cost. In 1929 governmental expenditure—that is, the combined total of Federal, State, and local spending—amounted to 11 percent of the dollar value of our Nation's entire production of goods and services. The corresponding figure rose to 20 per cent in 1940, 23 per cent in 1950, 30 per cent in 1960, 35 per cent in 1970, and 37 per cent in 1977.

The sharply rising trend of governmental spending has, of course, involved a steady increase in the fraction of the nation's labor force that works directly or indirectly for the government. But our government affects the economy not only by employing people or by purchasing supplies and equipment from private industry. In addition, vast sums of money are transferred by the government to individuals not involved in current production—that is, beneficiaries of public retirement funds, unemployment insurance, medicare, aid to veterans, food stamps, etc. And our government also affects the economy by guaranteeing a variety of private loans and by regulating numerous industrial, commercial, and financial practices.

All these activities, particularly transfer payments and governmental regulation, have grown by leaps and bounds in recent years. Transfer payments, which were merely 3 per cent as large as the Nation's total wage and salary bill in 1930, rose to 11 per cent by 1965 and reached 21 per cent in 1977. The *Federal Register,* which records governmental regulations, ran to 3,400 pages in 1937, but swelled to about 10,000 pages in 1953 and to 65,000 pages in 1977. At least 90 Federal agencies are now involved in issuing governmental regulations. Funds allocated for regulation in this year's Federal budget amount to $4.5 billion —more than twice the expenditure in 1974. This figure, of course, omits the expenditures on regulation by our State and local governments. And it omits also the enormous costs of compliance imposed on private industry. According to a recent investigation by the Center for the Study of American Busi-

ness at Washington University, these compliance costs amounted to $63 billion in 1976.

The proliferation and increasing cost of governmental activities in our country have resulted in a growing burden of taxation—higher income taxes, higher sales taxes, higher propery taxes, higher social security taxes. Even so, the willingness of our government to raise revenue by taxation has fallen distinctly short of its propensity to spend.

Since 1950 the Federal budget has been in balance in only five years. Since 1970 a deficit has occurred in every year. Budget deficits have thus become a chronic condition of Federal finance; they have been incurred in years when business conditions were poor and also when business was booming. Not only that, but the deficits have been mounting in size. In the fiscal year now ending, the deficit is likely to exceed $60 billion when "off-budget" outlays are included in the total—as they should be. Instead of vanishing or diminishing as the economy improves, which was once accepted practice, the deficit has been increasing in the course of the current economic expansion.

The persistence of substantial deficits in our Federal finances is mainly responsible for the serious inflation that got under way in our country in the mid-sixties. Let us never forget the simple fact that when the government runs a budget deficit, it pumps more money into the pocketbooks of people than it takes out of their pocketbooks. That is the way a serious inflation is typically started and later nourished. And when the deficit increases at a time of economic expansion, as it has been doing lately, we should not be surprised to find the rate of inflation quickening. Of course, other factors—particularly, money creation by our central bank and the power wielded by trade unions—have played their part in the inflationary process.

The growing intervention of government in economic affairs that has taken place in the United States has been matched or exceeded by similar developments in other countries that we think of as continuing to practice free enterprise. The causes of this increasing penetration of government into the economic life of individual countries have

been broadly similar—namely, industrialization and urbanization, increasing interdependence of people, faster communication through radio and television, rising expectations of people, wider participation of citizens in the political arena, and increasing reliance on government for the solution of economic and social problems.

The degree of government participation in economic life has thus been increasing in every industrial country outside the Socialist sphere. To cite some examples: government expenditure in the United Kingdom amounted to 34 per cent of the gross domestic product in 1962 and to 44 per cent in 1975. Corresponding figures in the case of West Germany are 34 and 42 per cent; in the case of France, 36 and 40 per cent; in the case of Canada, 29 and 41 per cent; in the case of Australia, 24 and 32 per cent. A similar trend appears also in Japan; but it is worth noting that governmental spending amounted to only 23 per cent of the gross domestic product of Japan in 1975—a substantially lower figure than in other major industrial country.

And just as the rapid expansion of governmental activities in the United States has been accompanied by persistent budget deficits, that too has happened in other industrial countries. Indeed, loose governmental finance and rapid inflation have often been practiced more intensively outside the United States, and they have recently become characteristic features of major economies that still boast of free enterprise.

The world-wide inflation that has been under way since the late 1960's has become a serious threat to the free enterprise system. The fact that inflation masks underlying economic realities makes it all the more insidious. For example, the trend of retail trade and housing starts began to weaken in the United States early in 1973, but many members of the business community paid little attention to that ominous development. Nor did they recognize that standard accounting practices, which rely on historical costs in reckoning inventories and capital consumption, were resulting in enormous overstatements of their profits. Caught up in the euphoria of inflation, they built up inven-

tories out of all proportion to actual or prospective sales, and thus set the stage for the subsequent sharp decline of production and employment. What happened in the United States was paralleled in greater or lesser degree in European industrial countries and in Japan.

The corrosive effects of inflation go far beyond the distortion of businessmen's perspective. Inflation erodes the purchasing power of everyone's money income. Inflation weakens the willingness of many people to save for the future. Inflation drives up the level of interest rates. And once businessmen become aware of the illusory element in profits, inflation adds to uncertainty about the future. In an inflation-ridden environment, businessmen have no good way of judging what their costs of production may turn out to be, or what prices they may be able to charge, or what profits, if any, will accrue when they undertake new investments. The risk premium that attaches to calculations of prospective profits from new investments therefore goes up. This discourages business capital investment and hampers the improvement of productivity.

Nor is that all. As the effects of inflation spread across the economy, they in time weaken the capital market. The classical view that inflation tends to favor business profits and therefore higher stock prices no longer fit today's world of powerful trade unions, high interest rates, and a governmental bias toward consumption. Recent experience in the United States and in other countries has demonstrated that persistent inflation adversely affects stock prices as well as bond prices. Even now, despite the recent upsurge in stock prices, the Dow-Jones industrial average is below the level reached in 1965; and in view of the huge rise in the general price level since then, the stock market has obviously suffered a severe depression.

As a result of the disappointing performance of the stock exchanges, the interest of investors in equity securities has greatly diminished during recent years. Some wealthy individuals, seeking a refuge from inflation, have turned to investing in works of art, or in real estate, or in foreign currencies, gold or other commodities. Many members of the

middle class, being similarly disillusioned with equities, have sought an inflation hedge by purchasing a home or an extra house when they already owned one. But the many millions who lack financial sophistication, and even some who possess it, have found no better way to protect themselves against the ravages of inflation than to let cash pile up in the form of bank deposits or other liquid assets—with the result that the purchasing power of their monetary savings has generally kept eroding.

Many professional money managers, likewise discouraged by the behavior of common stock prices, have found solace in the high yields that have become available on corporate and government bonds. And they have also displayed some tendency to shorten the maturity of their investments, so that they could shift to higher-yield securities if faster inflation served to raise interest rates another notch or two in the future. With institutional as well as individual investors switching from common stocks to other investments, brokerage firms and investment advisory services have suffered reverses. Numerous firms of this type have closed down their operations or sold out to more enterprising members of their industry. These in turn have reacted to the declining interest in equities by becoming department stores of finance—that is, by offering to their troubled customers stock options, commodity futures, municipal bond funds, money market funds, tax shelters, and so on, in addition to the more traditional services. Adjustments of this type have enabled some brokerage and advisory firms to survive and even to prosper.

But what matters most for the future of our economy is the erosion of investor interest in equity issues. In 1965 corporate shares constituted over 43 per cent of all financial assets of American households; by 1977 they were down to 25 per cent. Between 1970 and 1975 the number of individual shareowners in our country fell from about 31 million to 25 million. More significant still, this decline was concentrated among young and middle-aged people. Net purchases of equity issues by private pension funds have also slumped in recent years. So-called "equity kickers", once a

prominent feature of loans placed by insurance firms, have practically vanished. As a result of this declining interest in equities, the supply of venture capital has drastically diminished in our country. Public issues by small firms have dwindled and we rarely hear nowadays of the formation of new high-technology companies.

If the skepticism about equities that has marked recent years continues in the future, it will become difficult even for some well-established corporations to finance their long-term investment projects. This difficulty will be accentuated if internally generated funds continue to provide a reduced share of total financing needs—as has been the case during the past decade of high inflation. Furthermore, if business firms are forced to rely more heavily on short-term funds, the corporate economy will become more vulnerable to financial strains in the future. In such an environment a business recession could be even more disruptive than the recession we recently experienced.

In short, the changes wrought by inflation have already weakened the framework of our economic system. They threaten to do so to a greater degree if the inflationary bias of the economy is extended. I judge from the sluggishness of stock exchanges in other major industrial countries during the past decade that, with the exception of Japan, their experience has been similar to that of the United States. If inflationary trends should persist, the economies of these countries will also face a very uncertain future.

Serious as these longer-range economic consequences of inflation appear to be, there is even greater reason for concern about its impact on social and political institutions. Inflation has capricious effects on the distribution of income and wealth among a Nation's families and businesses. Inflation eventually leads to recession and extensive unemployment, and such adversities are generally followed by new measures of government intervention. Inflation robs people who in their desire to be self-reliant have set aside funds for the education of their children or their own retirement. Inflation hits many of the poor and elderly especially hard. More ominous still, by causing disillusionment

and breeding discontent, inflation excites doubts among people about themselves, about their government, and about the free enterprise system itself.

Such anxieties tend to spread from one country to another. In particular, when the value of our own dollar depreciates in foreign exchange markets, as has happened again during the past two years, confidence in the international economy as well as in our own tends to weaken. The ultimate consequence of persistent inflation may therefore be a decline in both the scope and the efficiency of free enterprise on a world-wide scale.

At the beginning of this address, I reviewed the theories of capitalist evolution by Marx and Schumpeter. It is interesting to observe that while Marx visualized numerous developments that would weaken capitalism, persistent inflation was not among them. Nor was this threat to our free enterprise system foreseen by Schumpeter in the early editions of *Capitalism, Socialism and Democracy.* Nor, for that matter, was it foreseen by Keynes; both he and his early followers were concerned about vanishing investment opportunities and unemployment, not about inflation. These failures of economic vision counsel humility in any judgments about the future; and yet I keep wondering whether the inflationary development that Schumpeter had failed to foresee may not be reinforcing the very processes on which he dwelt so provocatively.

Ours is still a dynamic and prosperous economy, but the prosperity around us has become uneasy and even joyless to many thoughtful citizens. Inflation is certainly our Nation's main economic problem, but it is by no means the only economic problem. Unlike earlier times, when we were troubled either by inflation or unemployment, we have experienced in recent times a disconcerting rise of the general price level even when unemployment was extensive. And our social economy has been beset by other problems—among them a growing burden of taxes, excessive governmental regulation, excessive power of labor, restrictive business practices, depressed business profits, deteriorating central-city areas, decline of the work ethic, and widespread crime. Not all of these ills can be ascribed to infla-

tion. And yet this factor has had a more ramifying influence on our economy than may appear at first glance.

I have already observed that inflation ultimately leads to recession. In turn, extensive unemployment creates an environment that is favorable to new or larger welfare programs and other increases in governmental spending—increases that often outlast the recession. Again, it is at least partly because of inflation that workers, particularly when they are well organized, can achieve increases in wages that far exceed improvements in productivity. It is at least partly because of inflation that the statutory minimum wage keeps rising—thereby causing unemployment among young people and breeding crime. It is at least partly because of inflation that many of our cities have suffered physical and cultural deterioration. And, needless to add, the poverty that persists in the midst of our plenty is in no small degree attributable to inflation.

The burden of taxes has also risen because of inflation. Although deficits at the Federal level of government have become our way of life, taxes have increased along with expenditures. Indeed, Federal revenues fell below 90 per cent of Federal expenditures in only seven years since 1946. Since our individual income tax is highly progressive, the tax burden on workers goes up, just as if Congress had legislated higher taxes, even when real wages remain constant—that is, when wages in dollars simply keep pace with increases in the consumer price level. The corporate income tax, to be sure, is essentially proportional; but under conventional accounting techniques, inflation creates phantom profits on which corporations have been paying many billions of dollars in taxes. And the consequences of inflation for the capital gains tax have been still more drastic. A recent study by Professor Martin Feldstein of Harvard indicates that in 1973 individuals paid taxes on more then $4.5 billion of capital gains from corporate shares; but when the costs of the shares are adjusted for increases in the general price level, it turns out that these individuals actually experienced a real capital loss of nearly $1 billion.

Human nature inevitably takes its toll. If intense effort or large financial risks are no longer compensated by the possibility of earning large rewards, the effort and the risks will be less readily undertaken. That is the condition toward which we have been generally moving. And it is precisely because a grim future may eventually become our lot and that of other nations still enjoying freedom that big government and the disease of inflation that comes in its train must be resisted by an alert citizenry. This need is now more widely appreciated than at any time since World War II, but it's not yet understood widely enough.

There are some faint flickerings, however, that the American people are becoming less passive about the dangers facing our Nation. The recent tax revolt of California citizens may be a symptom of a general awakening of the middle class. Of late, many politicians have been vying with one another in proclaiming inflation as our Number One problem. Trade unions have been unable to persuade Congress this year that their market power needs strengthening. Much is heard these days in Congressional halls about the importance of reducing business taxes. A move to cut back rather than increase the tax on capital gains has won widespread support. And of late we have even witnessed some minor reductions within the still swelling total of Federal expenditures.

These are interesting and promising events. As yet, they are much too tenuous and uncertain to justify extrapolation. They nevertheless suggest that the time may be right for a serious attack on the inflation that has been plaguing our country. That will not be an easy task, but it will be even harder if we hesitate or delay. Once an economy has become engulfed by expectations of inflation, economic policy makers no longer have very good choices. Still, much can in time be accomplished with determined leadership.

Restrictive monetary and fiscal policies, if pushed far enough, are always capable of bringing inflation under control; they might, however, also unsettle the economy by bringing on extensive unemployment. To minimize that risk, it would be wise to supplement monetary and fiscal

policies with carefully selected structural policies. A prescription for a balanced attack on the inflation problem might therefore run as follows in today's environment: first, that the Federal Reserve continue its present moderately restrictive monetary policy without interference by the Congress or the White House; second, that the budget for next year permit a substantial cut in the Federal deficit and that the move toward budgetary balance be completed within the following two years; third, that this and next year's increase in the salaries of Federal employees be scaled down to one-half the figure suggested by wage comparability studies; fourth, that the President cut his own salary by, say, 10 per cent and call on all Presidential appointees and members of Congress to do likewise; fifth, that the President reinforce these examples for the Nation by calling on top corporate executives to refrain from any increase in their compensation over the next two years; sixth, that a national center be promptly established for encouraging the organization of productivity councils across the nation, factory by factory and shop by shop, with a view to cooperation by management and labor in raising output per manhour; seventh, that we make a start towards blunting the cost-raising measures that we have allowed to flourish—such as tariffs, import quotas, farm price supports, and minimum wage laws, and that we also postpone the target dates that have been set for environmental and safety regulations.

In the course of my remarks this evening I have dwelt on the corrosive influence of inflation because I consider this the greatest danger to our free enterprise system. I am convinced that inflation is a disease that can be brought under control; but that will happen only when the will to do so becomes strong enough. In our country there is a powerful political constituency behind each of the government's spending programs, behind every tariff and import quota, behind every regulation that protects a particular group from the pressures of competition. We have powerful political constituencies in favor of other public or private arrangements that benefit some groups but raise prices to

everyone. Our urgent need now is for a nationwide constituency that will fight for the paramount interest that we as a people have in a dollar of stable purchasing power.

Other nations—notably, Germany, Switzerland, and Japan—have demonstrated that inflation can be unwound. Even Great Britain has recently succceeded in reducing its inflation rate sharply. If we and other inflation-ridden nations succeed in curbing inflation within the framework of our basic institutions, we may yet experience a true economic renaissance in the Western world. On the other hand, if the present world-wide inflation continues, a command economy may eventually be the bitter fruit of this generation's complacency and neglect. It is the duty of each of us to do what we can to prevent this from happening.

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