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A STRONG DOMESTIC ECONOMY—OUR FIRST LINE OF DEFENSE

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5 January 1951

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GENERAL VANAMAN: Gentlemen, I am sure we will all agree, in the midst of this struggle for our very survival, that adequate military preparedness commensurate with a strong economy is a "must." Immediately several questions come to our minds: What is adequate military preparedness? What is a strong economy? How strong is strong? What is the balance between adequate military preparations and a strong economy?

The Director of Economic Research of the United States Chamber of Commerce has returned to the Industrial College today to discuss these questions with us. He is well prepared for this task by his education and by his varied experiences, as you have noted from his biographical sketch.

It is a great pleasure to present to the joint colleges, Dr. Emerson P. Schmidt.

Dr. Schmidt.

DR. SCHMIDT: General Vanaman, gentlemen: It is a real pleasure to come back and discuss this important question with you: How do you build a strong domestic economy?

I like to think of it in real terms. We produce, according to the late-lamented OPA, something like 8 million different items in this country, besides hundreds of thousands of different services. We have the most variegated pouring out of goods and services, not only in volume but in types, of any country in the world. We have about 4 million separate business establishments outside agriculture, and another 6 million in agriculture. Each of these 4 million businesses is a center of initiative. Every one of those businesses is interested in its survival and most of them are anxious to grow.

Under a competitive system, unlike under a state-planned or over-all, tightly planned society, there is a constant process of testing, selection, death, survival, and growth. So, under our competitive private-enterprise business system—and, of course, coming as I do from the Chamber of Commerce, you expect me to put in a plug for our business system—we have a process, a technique, which tends by and large to mark for death the incompetent and to mark for survival the competent.

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Under this system every business is tested daily, or hourly, not by some governmental standard but by the standard of free consumer choice. Every businessman is really a kind of broker; a kind of middleman. If we grasp this idea, we understand the business system a good deal better.

The businessman is responsible to several groups in the economy. He has a responsibility to the consumer. Unless he responds to the shifting, temperamental, quixotic consumer tastes, he will go out of business. He must be constantly responsive to what the consumer needs, what he wants, as indicated by the free market. We have a free consumer-choice economy, which is one of the greatest expressions of democracy (in the best sense of the word), where everybody has his own choice, so to speak, that you can conceive of. If that businessman does not constantly respond to those quixotic and shifting consumer demands, he is marked for death. For that reason every business is very consumer-conscious; and it ought to be. If the consumer marks him for death on the ground that his prices are too high, or his quality is inferior, or his product is not adapted to consumer needs, he does die, or else he makes a quick turn-round and sees that he gets in line.

He is also tested every day by his workers. He has a responsibility to the workers. They may be organized; they are articulate. And if you would listen to the labor leaders, you would think that business exists only for purposes of its wage-paying capacity, whereas it exists in order to produce a product for the ultimate consumer, although I would not underestimate the importance of sound industrial and human relations.

In addition to that, the businessman has a responsibility to the community. His public relations have to be sound. Furthermore, he has a responsibility to the people who provide the tools of production, the capital. Every day he is being tested by the capital market, by the investor, and by the saver. If he cannot earn an honest dollar—a dollar that keeps pace with inflation, an honest dollar that keeps pace with the alternative prospect that the investor has—that business is marked for stagnation and perhaps death because if a business just "holds its own" it generally soon starts slipping.

So our economy is an entrepreneur economy. It is an economy in which we have these 4 million separate business establishments and each of them has from one to a half-dozen or several dozen executives whose welfare depends upon the success of that enterprise. The businessman is battered about a good deal by these conflicting pressures that are put on him constantly by the public, by government—or however else the public may express itself—by his stockholders, by the labor union, and above all by the consumer.

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I think that is a kind of system that really makes for strength. It is the core, I think, or the secret, of our high standard of living--this self-interest, this selfishness--if you want to call it selfishness--the profit motive, if you want to call it so. The more we can keep alive the freedom of action on the part of these 4 million businesses, the more we can keep them on their toes by the pressures we put on them as consumers, the pressures we put on them as investors by saying to them, "If you don't pay me a decent dividend, I'll just pull out my capital and move it somewhere else"--the more of such kinds of pressures that can be focused on the businessman the better off we will be. I can assure you it is awfully tough on the businessman. As a matter of fact, the average age of death is pretty low. Death from heart failure is higher among businessmen than it is for most other similar age groups. But it is nevertheless the kind of system that really gets the world's work done.

The more we can keep alive this enterprise--I am not talking about the enterprise system; I'm talking about enterprise--the more we keep alive the enterprise or the enterpriser--that is, his resiliency, his willingness to be forward-looking, his willingness to take risks--the sounder and stronger will the economy be in the months and years ahead. So I think it is very important for us to see what is the strength of this system even in a mobilization period.

In a competitive economy such as ours the business unit is constantly being threatened by its competitors, which is exactly as it should be. The Chamber of Commerce and I think all right-thinking Americans are staunchly for the antitrust laws and their proper enforcement. If we can keep this competitive spirit alive, we will put the pressure on the businessmen throughout the country to be responsive to changing conditions.

The profit motive has come in for criticism. Some businessmen are almost to the point where they mention their profits in a low voice. Unfortunately, I do not think the American people understand what is really meant by the profit motive. The profit motive is not different from the salary motive, the wage motive, the interest-earning or dividend-earning motive, or any other motive; it is a selfish motive. I think we ought to keep it selfish. I think we are on sounder ground if we have people do things in terms of their own self-interest. We do, of course, have to do an enlightening job on them in times such as this to show where their true self-interest lies. But the profit motive is a very powerful conserver of our resources.

Every one of these businesses is not only a center of initiative, but every one of these businesses has a budget and it is trying to balance income and outgo, hoping that the income will slightly exceed

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the outgo. The normal profit of a business rarely exceeds 4 percent per dollar of sales. Right now, with the inflation, it is probably nearer 6 percent.

This profit motive has a very interesting and, I think, effective reaction on the mind of the businessman and his team of managers. What it really does is to create 4 million places where costs are scrutinized every hour of every day. What does that mean? You all know how easy and pleasant it is to be wasteful. If we live in an apartment and the hot-water tap runs for 20 minutes, we do not care very much. Whether we turn off the light as we leave our hotel room, does not matter much. It doesn't cost any more whether the light is burning when we are not in the room.

The disposition to get slovenly, to get careless in the use of our resources, whether human or material, is enormous. The criticism levied against the Government and the armed forces is that there is nobody there whose business it is daily and hourly to scrutinize outlays and costs. That is in all probability an exaggeration because I am sure there are many in this room who are constantly worried about the waste that is going on in the armed services, or the waste in government, or wherever it may be.

I do not mean to say there is no waste in business. But what I do want to try to get you to see is that most every one of these businesses is trying to survive, is trying to grow, and is trying to make a profit. What we really have is a set of business executives, from the foreman on up, who are daily and hourly watching costs, trying to cut corners, trying to get more use out of the raw materials, turning out lights when not needed, and turning off the hot-water tap when not needed. When we multiply that spirit of economizing in the use of resources across this land expressed in 4 million businesses, we get a different picture of what we mean by the crucial character of the profit motive.

We turn these enterprises over to bureaucrats whose welfare or progress does not particularly depend upon the balance sheet or the income statement and it is just human nature to be a little more careless; a little less concerned with the control of costs.

When I speak of these 4 million centers of initiative and when I speak of the profit motive I am also speaking of innovation. Suppose the B & O Railroad tries out a brand-new idea--say it is the Diesel locomotive. Most steam-locomotive manufacturers and users have been very skeptical about the Diesel engine. But the B & O people put it on. They say, "We'll risk so many million dollars. We'll put on a fleet of Diesel engines." Suppose the idea works. Pretty soon the B & O begins to reduce passenger rates because costs are down. Later

on it cuts the freight rates. The Pennsylvania railroad has to do it also, otherwise the business will all flow to the B & O and the Pennsylvania will lose out.

Thus every one of these businesses is a constant center for scrutinizing new proposals, new ideas, new inventions, and innovations of all kinds. The beauty of our system is that once the B & O adopts it you do not have to have an order issued, you do not have to go through a lot of red tape; it is the compulsion of the free market for goods and services that forces all the other railroads in the country that are in competition with the B & O to follow the B & O's pattern.

So, when we speak of profits, entrepreneurship, and centers of initiative, we have hit upon a unique economic system. The British have lost it to a considerable degree. I was over in Europe in October and was shocked at the lack of enterprise and spirit of enterprise. In Switzerland, the great watch center of the world, it is illegal to open up a new watch factory. It is even illegal to open up a new watch-parts factory.

In England, they are talking about socializing the sugar-beet industry. The Conservative government in 1936 brought together 15 sugar-beet companies and created the British Sugar Corporation. They put on three government people to serve as directors. They provided this corporation with a subsidy which has amounted to approximately 3 million pounds per year. Now the British sugar producers are howling that the government is threatening to take over this industry. "Well," I say, "why not?" I think the government probably could run it about as well as these monopolists, or this cartel. So here they had a Conservative government actually creating a monopoly of the sugar-beet business. No wonder their costs are high. No wonder innovations are creeping in slowly.

In France there is very much the same thing.

In the Union of South Africa, I think it is illegal—I am only speaking from a rather vague memory, having read an article some years ago—even to open a grocery store without first being licensed to do so.

Why do I give you this background? Because we are moving into an intensified mobilization period. We are moving rapidly into a regimented society. We are going to get wage and price controls. We are going to get investment control. We are going to get innovation control because we cannot control prices, we cannot have an excess-profits tax or unduly high taxes, whether on the worker or on business, without destroying the spirit of drive, energy, and innovation.

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I think we will mobilize more soundly our price and wage controls and higher taxes, if we must have them, if we see what is essential to be preserved in the period ahead. I am just afraid now that in our plunging into this defense program we may do the very thing that would please Stalin no end, that is, to pull the teeth of the dynamism of our enterprise system--this drive, this ambition, this spirit of cutting costs.

Take such a thing as the excess-profits tax. During World War II, the excess-profits tax took all but, I think, about 20 cents of the top dollar a business could earn. So what did it matter whether business wasted it in useless advertising, careless experimentation, and frivolous expenditures.

I am not one who believes very much in so-called patriotic appeals. I think they are good; I am not against them. But I do think we always have to harness the self-interest of the individual. Whether it is the soldier, the worker, the businessman, the investor, the saver, or the housewife, we have to sell these ideals and ideas to them in terms of: How will it affect me? To be sure, sometimes people rise above this personal self-interest. But in the long run we build sounder if this individual ambition can be harnessed.

Adam Smith, who is generally regarded as the founder of economics, in his book, "The Wealth of Nations," in 1776 made the statement that he never had seen much good done by those who affect to trade for the public interest. That is a hard thing to say; but Adam Smith was a professor of ethics at Glasgow University and he certainly could be expected to have put the ethical issues first. Nevertheless, he said that and then elaborated on it to a considerable degree. He is still regarded as the greatest free-enterprise thinker of all time. He saw the need for dispersing and decentralizing power as a protection of human freedom.

We are now moving into this mobilization period. The thing that worries me is that we may be in for a long, long period of trouble with the Soviet Union--and I think it is likely to be a long period of exasperation and irritation, more likely than an all-out war. That means that even though we spend 40 or 50 billion dollars this year or next year on the military, much of that will be gone or be obsolete and we will have to do it all over again. We are likely to be in a kind of semigarrison state for a long, long time. Our big companies--GE, Westinghouse, General Motors--are likely to be converted, to a large degree, to war materiel.

The research talent, the talent that gives rise to innovations, is likely to be converted to war. For that reason we may get a kind

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of famine, a research famine, for the civilian economy. Records show that productivity per man-hour declines during war. One of the reasons it declines is that innovation stops. New labor-saving, cost-producing machines and ideas are put into cold storage for many different reasons. One is that it is very easy to sell everything we produce, anyhow. Another reason is that the taxes are so high. Another is that we cannot get what we want anyway in the way of new machines, gadgets, and so on, that may reduce production costs. So what I am afraid of is that in our drive for war material and in converting, say, 50 or 100 of the biggest companies to military production, the general research, invention, and innovation may be seriously neglected.

If this were a short-run affair like World War I or World War II, we could absorb it without serious long-run loss. But if we are to remain in a period of long-run semimobilization, and if over a period of 10 to 20 years we neglect training scientists for the civilian economy, if we neglect encouraging invention and innovation and all that kind of thing, it may gradually weaken and debilitate us. It will be such a slow, imperceptible thing that no one can point his finger at it. It is not the kind of thing that sticks out like a sore thumb, makes itself revealed, and permits something being done about it. It is, rather, the kind of thing that creeps up on us.

We cannot readily say, for example, what has caused the great British Empire to become a second- or third-rate outfit. We cannot put our finger on the causes of the decadence over there. I don't think anybody can. We do know that their machinery, relative to ours, is overage. And yet, we know that in many lines this is not so true. In certain chemical or electric lines they have done remarkably well. In radar, penicillin, and a lot of other things they have been ahead of us.

But, by and large, in the textile industry and coal-mining, which were the great foundation stones of the British Isles--they were the leading foreign exchange earners as well as the leaders in a number of other fields--stagnation set in. But who can put his finger on when that stagnation set in? Who can put his finger on just what took place to cause the great industrial workshop of the world to have to take second or third place, even being outstripped by the Japanese and the Germans and some of the Low Countries in terms of prices, competitive markets, and all the rest?

In other words, it is not easy to identify and put your finger on this decadence, this decay and this stagnation. Anything that can be done, in my judgment, should be done to stimulate research in as many of these 4 million separate businesses as may be possible. And I do not overlook the little fellow either. I think that Jewett of the Bell Laboratories, now dead, always maintained that the bulk of the

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innovations and the bulk of the inventions came from the little outfits and not the big ones. I think we have to take into account all of them. You never know when some little grocer or some other small organization may hit upon, by accident or otherwise, an idea that is worth in the end millions and millions of dollars in the way of cost production. Under the competitive market system that cost reduction, while it benefits the inventor or the innovator, does go down to the benefit of the whole of society.

If we are in for a long pull I think we need to find out what it is that makes for innovation, or makes for a strong spirit of enterprise, that makes a man willing to try out something new.

We all know that it is a thinking process in some ways. We all know it is a materials problem. We all know that it is a financial problem. And if our tax burden moves up—I think we all have to recognize that the tax burden has to move up—we ought to have a tax structure which impairs incentives least.

What that means in concrete terms is not easy to spell out. But certainly a tax that takes more than a certain amount out of marginal dollars, as the British have so sadly found out, is a terrible destroyer of incentive. The British collect their income tax on a weekly pay-as-you-go basis. If a man gets time-and-a-half for Saturday work, because of the very high rates in Britain, he actually gets less than normal pay for working on Saturday. The British have found it practically impossible to drive the miners under ground on a five-and-a-half- or a six-day basis. In other words, they have a tax system that has destroyed the incentive of the worker.

I think we are not at that point just yet so far as the worker is concerned, but we may be approaching that situation so far as the corporation is concerned. The tax rate pre-Korea was 38 percent. The Government took 38 cents out of every dollar. Then, in addition to that, somewhere between 35 and 45 percent of all dividends paid are recaptured in personal income taxes. So that when we figured out how a business paid off, it was not too good, even pre-Korea.

Since Korea we have hiked the rates twice on corporations, from 38 to 45 and last week to 47, plus the excess-profits tax. I am not sure whether we have gone too far; I can't say. That is a problem partly in psychology. It is a problem in many things. But, unfortunately, we have in this country to some extent a Marxian attitude toward profits, reflected mostly by certain labor unions and their fellow travelers, who look upon profits as a cushion, something extra, something that is not really earned. Profits are under a cloud. That attitude gets reflected on the Hill and in the Administration.

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Again I want to say I am not sure whether we have gone too far. I think that from now on we must look at any increase in corporate profits—and I am afraid we are going to get more corporate taxes—primarily in terms of the kind of apparatus I have been trying to paint for you. It is my personal view that a society like ours has to be willing to come to the point where it will tolerate really very large profits for certain individuals or businesses.

Profits are really not the important thing so much as it is profit expectation. That is, if the businessman expects to make a profit, he will act, he will produce. So, I have always put the emphasis on the prospect of profit, the expectation of profit, rather than the realization. For instance, apart from capital accumulation if we could keep businessmen forever believing they are going to make profits we could get full use out of them without their ever making any profits.

So this notion that so-and-so has made too much profit, or another concern has made too big a profit, has never registered with me. I think that is the price we pay for a dynamic economy. A high profit, as any Wall Street operator will tell you, is the surest sign of danger from the standpoint of holding that stock because as soon as any concern has for a period of years exceptionally high profits, that becomes an open invitation for other businesses to move into that field, into that market, produce competitive products, and thereby, under the pressure of competition, profits will be restored to normal.

That is the history of all these concerns making exceptional profits. The only one I know of that is really exceptional is the Ford Motor Company. Why American businessmen did not move in on Ford, beginning about 1909 or 1910, I have never been able to understand. But Ford actually paid 5 percent per month on the investment and plowed back many times that much during the period from about 1905 to about 1925.

The Dodge Brothers, as you know, made the engines for Mr. Ford. They said, "You dirty so-and-so, holding back profits." Mind you, they were getting 5 percent a month. They then set up their own company. Once Chevrolet and Plymouth moved into that picture, what happened?

I made a calculation some years ago and I found that if Ford had liquidated in 1925 and had put his money in postal savings, he would have been better off. So, from 1925 to 1940 practically all the Fords we bought were at cost so far as the manufacturer is concerned.

The point I am trying to make is that we need to be realistic about this question of profits. I am not here this morning to defend profits for any narrow reason. I am here to defend profits as the

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great dynamic of this system. We have to get to the point where we will say to Dumont or anyone else who is a real innovator, "The more profits you can make, the better." But in the meantime let's keep freedom of entry so anybody can get into the television business. In that way Dumont will have to face up the competition.

That is the kind of system we must have. I am hoping, regardless of how far we have to go in this war, that we can keep that spirit alive. Especially since it may run on for a long time it is important that we keep the spirit of innovation, the spirit of ambition alive, so that they will pay off in terms of research, innovation, and cost reduction.

Furthermore, we need to keep our economy highly flexible. Unless you have studied the shifts in consumer demands rather closely, this perhaps won't mean too much to you. But the way in which the fickle public shifts its tastes and its demands from one product to another, or one company's product to another, is something enormous, and people's demands over the period which lies ahead will continue to shift. We do not want to freeze the number of baby buggies vs. rocking chairs into our economy. We may need more of one and less of the other because of changing birth rates, population age distribution, and all the rest.

Well, that same kind of thing runs through the whole economy. We must keep it flexible. If we control investment--as we are already beginning to do through the NPA--and if we control profits, and if we control many other things that make this system so dynamic, we may freeze the economy and we may be confronted with growing scarcities and growing shortages. It does not take very long for emergencies to snowball and for inefficiency to creep up on us.

Suppose the boss' secretary is ill. She is the only one in the office who knows the files. The boss comes to work in the morning; the secretary is not there. What happens to the efficiency of that office? It has lost one person; true. But actually it has lost anywhere from 50 to 80 or 90 percent of the output of the executive of that organization for that day. In other words, if there is a loss of 5 percent efficiency in a factory or in a distribution organization, on the part of every individual, that may turn out to be a 30 or 40 percent over-all loss of efficiency.

We are now going into a period in which American industry will be deprived, for military reasons, of a great many small, in terms of quantity, materials. They are very crucial materials. I know that some of the top executives in the country are very worried about what will happen to costs when they have to redesign paints, materials for mountings, the hardware or household appliances, automobiles, or whatever it may be, because when one thing is redesigned many other things may have to be redesigned. The process causes costs to mount.

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So that is the problem. I do not know whether there is much we can do about it. We must have certain key minerals. If our imports are cut off for military reasons, I do not know what can be done about it. But if we are in this emergency for a long time we will have to watch the question of efficiency. We ought to be very impatient with any controllable factor that is causing inefficiency in the system.

Perhaps I have said enough to give you some idea of what I think of the business system in the period which lies ahead. I think we must put the emphasis on innovation, cost control, efficiency, and invention in order that we can continue to harness the self-interest of as many of these 4 million separate business establishments as we possibly can. If we do that, I think we will keep a strong domestic economy; one that will redound to our security and contentment. Although inevitably it is going to mean some decline in our standard of living in the period ahead, it will make us a strong military nation; one which Stalin will attack with a good deal of trepidation.

Thank you.

QUESTION: Although I do not want to challenge what you said, I would like to ask if you would give your point of view on this hypothetical problem.

Let us assume that in a certain country the economy is an unbalanced one in that it has been, for many generations, basically exporters of raw material and semifinished material. It wants a more balanced economy. It, therefore, wants more of these 4 million businesses that you speak of.

Let us say its citizens feel this way: That the short-term problems of mobilization are in conflict with the long-term needs of the growth of a balanced economy. You have mentioned a few of the large businesses in this country. They have their counterparts in their country. It is undoubtedly so that the progress of mobilization results in the contracts for aircraft armament—and now with the new accent on electronics—going to these large companies. They do put out a lot of contracts into subcontracting, true; but those subcontracts go to medium-sized companies that are established and have the skills for making the tools of mass production. That seldom results in the building up of new small industries to add to the quota of the 4 million.

Now, the long-term needs of that country are for a more balanced economy with more small and medium-sized businesses across the very thin population fringe that it has. But the short-term needs for mobilization will result in strengthening the large corporations.

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DR. SCHMIDT: Your thinking is sound. I have no short-run solution for it. We face the same problem. I think one of our procurement laws does require that the procurement agencies give high priority to small contractors and small suppliers. As a matter of fact, we have two congressional small business committees and a division in the Department of Commerce constantly reviewing this situation. It is a problem for which there is no easy solution.

I was associated some years ago, during the early phases of World War II, with a little research project that was designed to help solve that problem. It was called "The Mid-Continent and the Peace," published by the University of Minnesota in cooperation with the University of Manitoba. The Premier of Manitoba--at that time John Bracken--and we worked out a scheme under which the automobile industry, as a guinea pig, would be "internationalized," so to speak, in so far as markets were concerned. That is, they would have the same market for automobiles. They would have our market and we in turn would have their market.

Since their plants are just about as well located as ours, in terms of matching our market--that is, across from Detroit and Buffalo--the theory was if they got a larger market they then could get the benefits of diversified research that we got. In other words, that was just an entering-wedge which, unfortunately, the financial people of Toronto did not wish. If they could move in that direction, in the long run--and it would be a long-run solution--their markets would diversify automatically; would immediately encourage the location of new plants so that what they would get would be a better balanced economy. They would then get away from being so heavily a raw-material producer.

But it is an important problem. And it merits some innovative thinking. We must have innovation in these political matters as well as on the industrial side.

QUESTION: Dr. Schmidt, you mentioned, either directly or indirectly, several times in the course of your talk that the excess-profits tax would destroy the initiative of the American businessman. Would you care to discuss what kind of taxes you would propose whereby we could finance our tremendous expenditures at the present time and not destroy this initiative?

DR. SCHMIDT: In general, I think an increase in the general corporate rate is preferred to an excess-profits tax because an excess-profits tax is measured by above-normal taxes; in other words, the concern that is doing the best job, making the most money. Under the competitive system only a concern that does a good job for the

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consumer can make any money. Its profitability depends on consumer response. So we whack that company that happens to make more than the normal rate of profit. The most innovative, the most enterprising concerns get whacked. I would prefer increasing the corporate rate to perhaps 50 percent, or maybe even 55 percent, rather than have an excess-profits tax.

Second, I think it is going to be essential to have an increase in personal income taxes. There, the bulk of the money will have to come from incomes of \$5,000 and less. That does not mean that the income tax on the upper bracket won't have to go up also. I haven't the figures with me; however, I could send them to any of you who are interested. But when you talk about total dollars in billions, there is not much left in incomes of \$25,000 and \$30,000 and up that is taxable. It would not do much in the way of financing the defense program. So we will have to reach into the bracket where the great bulk of the income is. To be sure, no one getting \$5,000 or less is "making a kill." But because there are so many people in that bracket, you have to go there. When you multiply the great number of people by the potential tax taken in, it comes to 70 or 80 percent, or perhaps even more, of the total remaining income that can be taxed.

But finally--and this is very important, I think--we will have to go to more excises, even if they are selective and somewhat varied. In general, perhaps we much prefer to see a straight excise tax of 2, 3, 4, or 5 percent, or whatever it may be. But we could have a selective excise tax which would discourage consumption by putting very high taxes on certain things, if we feel that the war effort requires discouraging the production and consumption of certain lines. The British have taxes running up to 100 percent on the things they do not want the domestics to buy. That tax, of course, does not apply if the goods are exported from the British Isles because they want to build up their export market.

I think we are going to have to go very heavily into excises. The NAM has proposed, I believe, an across-the-board manufacturer's excise tax. Every manufacturing concern buys many things from other manufacturing concerns, and if a manufacturer is taxed every time he sells something we will have a terrific pyramid. The Canadians have had for years a manufacturer's excise tax of 8 percent. They have digested it and hardly anyone is even conscious of its existence. To be sure, it raises their prices, or reduces their standard of living, whichever way you want to look at it.

I think we will have to rely very heavily on increases in all three; plus some loophole, perhaps, which you might call some "fringe" issue, such as state, inheritance, or gift taxes. I do not like to suggest these things; they all impinge more or less. Every tax is a

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burden. But I do nevertheless think our primary reliance will have to be on a slight "upping" of the corporate tax, a substantial increase in personal income taxes and, I would say, a very heavy increase in excises because excises do the least to impair incentives to produce.

QUESTION: Dr. Schmidt, I would like to ask you a few questions about your recommendations for future taxation.

I was thinking first in terms of the excise or surplus-profits tax. I have been doing some reading lately which indicates that the volume of business done as a result of war contracts is generally much greater than we do in normal times; that even a relatively small percentage of profits is considerably greater than the profits made before the emergency period. That is one thought.

The other thought relates to the political features of taxation. We are trying to stem inflation. An important feature in the stemming of an inflation is to fix wages. It would seem to me rather difficult to keep wages down if profits were not kept down during the period when the idealistic motive might be considered more important than during normal periods.

I wonder whether you would care to comment on those two things?

DR. SCHMIDT: That is a very crucial issue.

My primary objection to the excess-profits tax is that it destroys cost-consciousness. It makes the businessman inclined to say, "Well, if I spend another \$5,000 on advertising (let's say), it costs the U. S. Treasury \$4,500. That \$500 will come out of our net for the year." So, instead of measuring the cost of the item against the actual cost, it is measured only against the residual that it will cost after the excess-profits tax.

The other point you mentioned--the question of wages--I think works both ways. I think it is perhaps an open secret that the primary pressure for price controls, on the part of the people who really think about it, comes because of the need for wage controls. We have excess-spending power. That is our fundamental problem. You read the Council of Economic Advisers' Report and you will find they mention on page after page that our problem today is excess-spending power. The upward pressure on prices does not now come primarily from the cost side; it comes from the demand side; that is, every business now can sell everything it can get its hands on.

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The President's Council of Economic Advisers says that is the problem--to hold wages down. In fact, they discussed the possibility of cutting them. However, they rejected that as a practical solution. But they do say that we must under all circumstances hold down wages because of the excess-spending power that is in the market. If we put on an excess-profits tax then management says, "Well, let's see. I would rather have my boys in the shop get this extra money than the U. S. Treasury. They are clamoring, anyway, for it. They are all dissatisfied. They are talking about high prices. If I give them a wage increase, it will cost me a million dollars a year. That will be their wage increase, but it will come out of the excess-profits-tax bracket. The Treasury will take two-thirds or three-fourths of that wage increase and I will have my boys contented. The dollars will stay at home in the community. Everything will be fine for all concerned."

I think it works both ways. The unions are saying, "What you imply in that is those profits are so high and fabulous"--as they put it which, incidentally, is not correct, as I could show you if I took a little time--"let's raise wages."

Well, that gives you what I think is the sound policy for maintaining or trying to cut down on consumer purchasing power. Certainly we need a tax system which will drain off this excess-spending power or induce it to go into savings.

QUESTION: Dr. Schmidt, it seems from the tenor of your discussion that you do regard long-term and also short-term maintenance of the free market as a fundamental price for the benefits of cost watchdogging, initiative, and so forth. You have made some very cogent remarks relative to the problem but have at the same time indicated that our steps may have been less effective in this country than in some others.

Would you care to discuss the possibilities with reference to keeping the generation of new competition running along on a reasonably even keel, in sufficient quantity, through the maintenance of new sources of competition during the emergency, which tends to increase the business of the large- and medium-sized companies?

DR. SCHMIDT: I am not sure I fully understand your question. But certainly anything like cost-plus war contracts are bad. Now, maybe they are inevitable in the hurry of things. But they certainly destroy the free market. They destroy the incentive to watch costs, to get them down lower. We ought to be innovative. We ought to be inventive in trying to find a better substitute than cost-plus to give management an incentive to keep costs under control.

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It is because we all view this struggle that we are moving into as a long-run proposition and not a war to be gotten behind us and settled quickly that I put the emphasis as I do. If I thought the war would last a year or two and that we would get it over quickly, than it would not be too important. But if we are in it for decades, it seems to me we must be sure that we identify intelligently the source of strength, the system, and try to keep those motivations and those energizing forces in as full operation as we possibly can.

I think we can do it, provided we are not in too big a hurry. If we become hysterical--as I think we have--and we decide to move too rapidly and get our military procurement rate up too high too soon, it will certainly destroy the viability, the flexibility, the incentives, and all the rest.

I happen to be one of those who does not regard war as probable. I have come back from a very intensive review of the situation in Europe--but who am I to talk on this subject to a bunch of fellows like you? However, I believe it is wholly contrary to the Soviet's interest to precipitate a third world war at this time. The Russians cannot afford to do so. So long as they get what they want--and they are getting it--by the methods they have been using, they would be sheer nincompoops to precipitate a third world war. So, unless we provoke it, my view is that the prospect of a third world war is low. I may be proven wrong even by midnight tonight.

So, all I am telling you is the judgment I use in trying to size up all these problems we are discussing. It is because I view this as a long-range plan rather than something we have to get ready for by midnight that I think it is so important to maintain what I have come to regard as the essentials of the dynamism of our system.

QUESTIONER: In other words, I take it that there has been no panacea for the creation of competition up to the present time.

DR. SCHMIDT: Are you thinking of military procurement or otherwise?

QUESTIONER: No; only the effects of military procurement upon the economy. The problem of the small business in the country has been with us for a long time, if not always. Regardless of what is said, it is considered to be more or less basic to the maintenance of the free market.

DR. SCHMIDT: Of course, the small business problem is to some extent a political problem. Actually, if we look at the figures we will find that small business has in many respects--not in all but

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in many respects--held its own. We actually have more separate business establishments today per hundred of our population than we had in 1900. That is, in spite of all the growth of big business and in spite of all the mergers, we have had a perfectly phenomenal birth rate. We have a birth rate of, I think, 400,000 or 500,000 new businesses per year. The death rate is within 10 percent of that figure, due to bankruptcy, due to the fellow saying, "Well, I guess I'll go back to work for so-and-so. I'll close up this hamburger stand."

I am sorry I did not bring the figures with me, but we have now, I think, more than a third increase in businesses since 1938 or 1939.

The problem of small business is partly a political issue. It is the pet even of the left-winger. I do not for one moment want to oversimplify the matter; I think it is a problem. Small business is "on the make" and it has not quite found its place in many instances. Our problem is to try to get small business to become big business just as Dumont and many others have become.

But the record of profitability, earnings, survival, and birth rate in the last decade has been remarkably good. The Department of Commerce reports on the business population about twice a year. Those reports are really heartening. I think we must be sure we don't do anything that will stop that flow.

COMMENT: Dr. Schmidt, this is simply an observation. Your main theme, or rather you made the point several times in your talk, was that the causes of the British economic decline were essentially historical. I think you said it is one thing on which we cannot put our finger. To some of us here the answer may be less obscure. It seems to us that the primary cause for British economic pre-eminence was their lucky head-start in the Industrial Revolution. This pre-eminence was inherently impossible to continue once France, Germany, and especially the resources of this continent were organized and thrown upon the world market.

When you add to that fact the devastation of World Wars I and II and the further fact that Great Britain was forced to liquidate most of its foreign assets in the Second World War, I humbly submit decadence was not the only answer.

DR. SCHMIDT: I can give you a long story on that.

Veblen wrote on that very subject a book entitled, "Industrial Germany in the Nineteenth Century" in which he raised this question

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which, incidentally, is the only question he tried to wrestle with: Why was it that Germany accomplished, I think he said, in 50 years what it took the British 150 years to accomplish industrialwise? He answers on a somewhat broader base the question you raised, although part of what you say is certainly a part of the answer.

His conclusion was that, in time, a country that pioneers accumulates the folkways, mores, habits, or customs which were excellent for the pioneering period but then loses its dynamism, its capacity for adaptation. The Germans did exactly what the Japanese did. They went over there and took a look at British industry. They took back with them the technology, the science, and so on, without the impedimenta of customs, mores, folkways, such as long weekends from Friday to Tuesday, and the lackadaisical habits which came out of the British system. That is what breeds long weekends. That is what breeds Miami. It is very dangerous.

What you have to say is correct. I would, however, want to broaden it a good deal, to round out the picture. If you will look at the figures, you will find the real trouble began about 1870 in Britain. Then, in 1931 the British decided to put on a tariff. That was, in a sense, the nail in the coffin for they were no longer fully willing or able to compete.

Now, to be sure, their economy was based on the proximity of iron and coal that happened to be found close to them. That was the basis. We are now living in an oil age. They have no oil. We are living in an electric age. They have very little in the way of natural water power. So, in part, the British Isles are being passed by for technological and not human reasons. It is very complicated. I certainly do not want to be dogmatic about putting my finger on any particular point.

COLONEL BARNES: Dr. Schmidt, on behalf of both colleges, I thank you for an excellent and stimulating analysis of this subject.

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