FINANCING NATIONAL SECURITY

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Dr. Henry C. Murphy, Economist to the Subcommittee on General Credit Control and Debt Management for the Congress, was born in New London, Connecticut, 15 August 1905. He received his A.B. degree from the University of California, Los Angeles, his M.A. degree from the University of California at Berkeley, and his Ph.D. from Brown University. During the period 1929 to 1935 he was an investment research assistant, assistant vice president of the Union Guardian Trust Company of Detroit, economist to the National Bank of Detroit and a member of an investment counseling firm. In 1935 he was employed by the Treasury Department and in 1939 he became assistant director of research and statistics. In 1948 and 1949 he completed his doctor's degree and wrote his book "The National Debt in War and Transition." Since 1949 he has been chief of the Finance Division in the Research Department of the International Monetary Fund and is now on loan by the Treasury Department to Congress as an economist to the Subcommittee on General Credit Control and Debt Management.

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COLONEL HARDENBERGH: General Holman, distinguished guests, gentlemen: This morning we begin our studies in war finance. The importance of financing for a national emergency cannot be overemphasized, for it affects each one of us in a very direct manner, by taxation, purchasing of war bonds, controls, and our free way of life.

Our speaker this morning has had a tremendous amount of experience in government finance. He has dealt with this all-important subject in high government positions. Dr. Murphy is now the economist to the Subcommittee on General Credit Control and Debt Management. He has been on loan to the subcommittee from the International Monetary Fund. This subcommittee is known as the Patman Committee, which is a part of the Joint Committee on the Economic Report, Congress of the United States. We will hear more about this committee in weeks to come. Dr. Murphy, it is a personal pleasure to welcome you to this platform.

DR. MURPHY: I am going to talk to you this morning about what I consider to be the very fundamental concepts connected with war finance. While I shall give some details, the talk for the most part will be of a very general character. However, I am supposed to be a bureaucrat and not an academician by profession. I have consequently dealt with a great many of the details of war finance. If there are any questions you would like to ask during the question period, therefore, you are welcome to ask them, and I shall answer them if I can.

The first thing I would like to speak of is the nature of economic war-making potential, for it is the business of war finance to convert the economic war-making potential of a country to an actuality. The first approximation we can made of the economic war-making potential of a country is its gross national product. You have probably seen figures comparing the gross national product of different countries, and you will notice that the gross national product of the United States is vastly greater than that of any other country in the world; perhaps as large, or nearly as large, as that of the rest of the world combined.

However, this is a first approximation, and there are a number of qualifications which should be named in converting gross national product to the equivalent economic war-making potential.

In the first place, some types of gross national product are not readily convertible to a war effort. For example, part of the gross national product of the United States consists of the product of the entertainment industry--night clubs, opera singers, and dancers. Part consists of the imputed rent of houses; things of that kind, which, as you recognize, are rather difficult to convert to war purposes.

Another type of gross national product which presents considerable difficulty in converting to war purposes is that of export surplus commodities. For example, suppose Indonesia goes to war--that country has a lot of rubber, a lot of quinine, and a lot of tin. It will never be short of those things, but there is not a great deal it can do with them but sell them to some other country and buy war materials in exchange for them. To convert gross national product by means of international trade is difficult. There are three primary requisites.

First, your trade routes must be kept open. This means that you must have a navy or your allies must have one. In the second place, you have to find somebody who wants to buy your products. Finally, you must find people who have war goods to sell. They must either be the same people who want your products, or people who want your products must be people who will pay in currency which can be converted into the currency of the people who have the war goods to sell.

For a country which has these requisites the production of an export surplus may be very valuable in wartime.

In the early part of World War II, before England could count on the financial assistance of the United States, it was part of the English war program to stimulate exports so that they could buy war goods. At that time production of, say, fine woolens or cashmeres in England was a war industry, because the English could export cashmeres and they could get dollars and buy airplanes. The United States had war goods to sell; the United States wanted cashmeres. But you can't always count on things working out that way.

During the Civil War, the South had cotton as its main product and this was a large part of its gross national product. However, the South did not control the Atlantic. England wanted to buy cotton and had war goods to sell, but it didn't do a bit of good. So the South was unsuccessful in converting its gross national product to war purposes.

Next, as the gross national product of a country gets larger in proportion to its population, its standard of living rises and a larger and larger proportion of the gross national product begins to consist of nonessential goods--this is only natural. It would not do the United States any good to have ten times the amount of wheat it has now as part of its gross national product. As the gross national product becomes larger, it goes into a great variety of goods. When one looks at what some people might say is the frivolous character of a large part of the gross national product of the United States compared with the gross national product of a poorer country--say Yugoslavia--one might say, "This is a fraud; it is padded, you can't count on a great deal of it for a war effort." But this is a deceptive conclusion. The mobility of labor and capital in the United States is substantially greater than that in most countries. A great deal of the resources which are devoted to quasifrivolous purposes in peacetime can be diverted to the war effort.

To recapitulate, I have said that the first approximation to the economic war-making potential of different countries is their relative gross national products. My first qualification to that first approximation is the fact that the gross national products are not homogeneous in character. They don't consist of so many units which you can divert to use for the war effort. They are heterogeneous. There are problems of conversion, the nature of which is different in different countries.

In the second place--the second qualification--you must fight a war with a surplus over the minimum of subsistence. The most graphic way I can think of putting this qualification is to say that if the United States were engaged in a life-and-death struggle we could press down the standard of living of the civilian population to where we all would be living like Chinamen. But that is where the Chinese start when they go to war. They are living like Chinamen to begin with. They can only shift civilian resources into fighting a war by living at a standard of living lower than Chinamen. This is the second qualification to the use of the gross national product of a country as a criterion of its war-making ability.

The third and last qualification which I shall make is a qualification in the opposite direction--a qualification which might become of less importance in an extremely vital and an extremely protracted war, but which is of great importance in the first years of any war. It is that in a country like the United States and, to a lesser extent, in countries like those of western Europe and the British Dominions, the standard of living does not compress easily. When we compare the war expenditures of the United States with the war expenditures of, say, Yugoslavia, for example, one of the items we must compare is soldiers' pay and subsistence. I keep saying "soldiers," but I mean, of course, all members of the armed forces. The United States pay for soldiers and its standards of subsistence are much higher than those of Yugoslavia. Yugoslavian soldiers are efficient fighting men; so are Americans. I hope I will be forgiven for saying it, but the difference in their fighting qualities is not proportionate to the difference in their pay and subsistence. The Yugoslavs come from a country with a low-productivity economy. The occupations in which Americans engage in peacetime are much more productive than those in which Yugoslavs engage and have set higher standards of living. This means that you can't really cut down to the minimum of subsistence except in a bitter and protracted war.

In the meantime, waging war is a much more expensive operation and takes more gross national product per unit of military effort for a rich country than for a poor one. You see this point of view put in perhaps its most extreme form in the novel, "The Naked and the Dead." I don't know how much popularity and following that novel may have in the armed forces. One of the principal characters in it, a general, maintains that the people who come from the parts of the United States which have the lowest standard of living are the best soldiers. They take hardships more easily; they are not accustomed to so much ease. Regardless of what weight one wants to give this qualification--and you people are in a better position to weigh it than I am--I am sure it is important. But it is a qualification that diminishes in importance as a war becomes protracted and bitter.

So much for the nature of economic war-making potential and how it varies between countries.

I would like now to say a few words on a subsidiary subject--that is, Can the cost of a war be postponed? Can we, as is sometimes said, place the burden of a war on future generations by means of creating a war debt? Fundamentally, the answer is no. The cost of a war cannot be postponed. The goods which are consumed in the war have to be made before they can be used against the enemy. The cost of each year of the war has to be borne out of that year's (a previous year's) gross national product. There are some qualifications to this statement, however.

The first qualification made in classical economics is that you can borrow abroad, if you can, and to that extent you can postpone the cost of a war. The most common of the recent techniques of borrowing abroad is to cause balances in your currency to be accumulated in foreign countries either voluntarily or involuntarily. This technique was used extensively by Great Britain in the last war, and was used slightly by the United States. The legacy of it so far as Great Britain is concerned is the sterling balances. Great Britain did not have any of the currencies of Egypt, Iraq, Iran, India, and Malaya, but it spent a lot of money in those countries. What the people got for their goods were balances in sterling, and there were no goods to buy with this sterling. These sterling balances have presented quite a problem in the postwar period.

The United States did the same thing in Latin America. We bought a lot of goods in Latin America during the war and sold them for substantially less than we paid. They took the difference in dollars. But there were two differences between the American and the British cases. In the first place, the Latin American countries could take gold instead of dollars if they wanted it. That was not true of the countries getting sterling. The Latin American countries did take partly gold and partly dollars, and I think I can say authoritatively that they pretty much called their own shots in this respect. In the second place, in the postwar period they have been able to spend their dollar balances freely. They have, of course, complained bitterly that prices in the United States were higher at the time they spent the balances than they were at the time they accumulated them. It can be said, however, that they had their choice of taking gold at the time and that they can still get it at the same rate as during the war. They have been fully compensated, therefore, according to the traditional rules of the gold standard.

The second way of postponing the cost of a war--which is more important in a country like the United States--is to cut down on replacements and maintenance of capital goods. You can go on for quite a while without carrying on the customary maintenance or making the customary replacements of capital goods and still get a large product. Of course, you are piling up a backlog of maintenance for the postwar period, but that is not as important as winning the war.

Another way to postpone the cost of a war is to run down stocks of consumer goods. People can let their clothes get ragged; their houses go without painting; things of that kind.

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Another way of postponing the cost of a war is by depletion of natural resources. As you people are probably as well aware as any group to whom I could speak, the United States did in a real sense finance part of the cost of the last war by the depletion of a part of its natural resources, particularly in the case of petroleum.

The next way you can postpone the cost of a war is by the postponement of education. You can make it up later—in the present case, I think, much more than make it up—by the GI Bill of Rights.

Next you can "run off" the health of the population. I don't think the United States did that at all in the past war. Many countries did. Cavities in teeth were not filled; operations were not performed; people were malnourished. In general, there is a reservoir of human resources as well as one of material resources on which you can draw in time of need.

Finally, of course, the greatest cost of all in war, the financing of which is postponed, is the cost to the country of the crippled and disabled. The greatest part of the cost of crippling is incurred, not at the time the wounds are inflicted, but during the lifetimes of the crippled, most of which is after the war.

Looking at all of these ways of postponing the cost of a war somewhat philosophically, one can ask whether, with the possible exception of the first case, they are really ways of postponing the cost of a war, or whether they are really ways of anticipating it? They are partly the one and partly the other. The reason the United States can postpone the cost of a war by postponing the maintenance of its stock of capital goods is that it has built up a stock of capital goods in advance. The reason we could let stocks of consumer goods run down is because we had large stocks to begin with. The same reasoning can be used with respect to national resources and the health of our population. The last case which I mentioned, however—the human cost of disablement and crippling--I don't think that could be said in any way to be capable of anticipation. It can only be postponed.

So much for the matter of postponing the cost of a war. Of course you can borrow money at home. But when you do this you are not postponing the cost of the war. The cost occurs right then. What you are doing is making provision for redistributing the cost in the postwar period. This should be avoided so far as possible, since it is clear that one of its major effects is to wait for the armed forces to come back so that they can bear their share. This does not make the distribution fairer. This is the strongest argument I know of in favor of financing as much of the cost of a war as you can currently by taxation.

We shall turn now more directly to war finance. War finance has two sides, a positive side and a negative side. The positive side of war finance is to transfer resources to the Government--resources which comprise the economic war-making potential of the country--and to do this by means of the price system. If war finance breaks down, the resources can still be transferred by confiscation. But confiscation results relatively soon in chaos. It is difficult to get new goods produced when the old ones have been confiscated.

The first function of war finance--the positive function--is to accomplish the transfer of resources to the Government through the mechanics of the price system.

The negative side of war finance is to avoid inflation. I shall explain in a minute why war has almost always been accompanied by inflation. But the positive side of war finance must take precedence over the negative side. Survival is more important than solvency. It is probably the first rule of war finance that anything which is physically possible should be financially possible. If you are told that it is not, you should get new financiers. In making any remark of this kind, I am always assuming that you don't go into any all-out war unless it is very important. If it is more important to maintain the niceties of the financial system than it is to win the war, then the war is one you should not have been in.

But, in any event, you can't preserve your solvency unless you win the war. As Mr. Leffingwell of J. P. Morgan and Company has said, "If you lose the war, the enemy comes in and inflates you, and he does a better job of it than you would do yourself." Look at the postwar experiences of Japan and Germany. They didn't lose wars because of conservative finance, but they did lose. They suffered postwar inflation which transcended any wartime imagination--Germany after the First World War; Japan after the Second World War; and, to a lesser extent, Germany after the Second World War.

So, even if fighting inflation were our number one goal, we would still have to consider victory an instrumental good. You can't avoid inflation without victory. Therefore, victory has to come first.

No great war in modern times has been ended for financial reasons. It is interesting to go back to 1914, when you might say modern war sprung into being rather suddenly. People then said, "This war can't last more than a few months; it will bankrupt the countries. They have never spent money like this before." But countries don't bankrupt easily. That is one of the most important lessons we have learned from the experience of two world wars. Many people thought the same thing of Nazi Germany. "Their financial methods are unsound. There will be a collapse," they said. There was a collapse, but it was for other reasons.

Nevertheless, there is a connection between what I shall call financial regularity--good sound finance--and the achievement of victory. I shall come to the nature of that connection in a few minutes.

But, first, we must consider why war basically causes inflation; it is rather simple. If we consider the gross national product as consisting of 100 units--that's always a good number--every unit of product creates a unit of income. The product has a price and the persons who produce it receive that price as income to them. So, the persons who buy the products receive 100 units of products; the persons who make the products receive 100 units of income. But suppose that 50 units of the 100 produced are not for sale; they are being used to fight the war and nobody can buy them. Then you have 100 units of income and only 50 units of goods on which income can be spent. Unless something is done, prices will go up.

It is necessary statistically to consider all government expenditures rather than war expenditures only. Suppose that prior to the war, of the 100 units of total product the Government was spending 20 and taking 20 in taxes; the other 80 were spent by the private economy. During the war, suppose the Government takes 50 instead of 20 of the total 100 units. The units available to the private economy drop from 80 to 50, but they still have 80 units of income, unless the Government raises its taxes. So we are sure of an inflation unless the Government balances its budget. War is inevitably inflationary in its tendencies, and--for reasons I hope I shall be able to discuss--it is inflationary even with a balanced budget.

Now, as I have said, the positive side of war finance is to get resources for the Government. That is relatively easy, at least in a short-run war, if you go about it in an uninhibited manner. The thing that is hard in war finance is to avoid inflation. The primary task of war finance is to block private expenditures. If you can block private expenditures, everything else will take care of itself. The Government will get the money, in any event, but, if expenditures are not blocked, the Government and the private economy will be competing in the market for goods and services; and prices will rise. Furthermore, they will rise without limit unless something is done. It is not a matter of closing up a given gap; and when you close it, it is closed. As prices go up income goes up, too, and the people have more money to spend. The inflation feeds on itself.

The two principal instruments of war finance are taxes and borrowing. Both of them get the money for the Government. So far as the positive side of war finance is concerned, they are on a parity. But, they are far from on a parity on the negative side.

The fundamental difference between taxation and borrowing is that tax receipts make men feel poorer and war bonds make men feel richer. When the Government gets its money by taxation, the people from whom it has gotten the taxes feel poorer. They try to retrench. Their incomes are reduced, maybe some of their assets are used up. In order to restore their position or, in any event, keep it as good as they can, they try to cut down all the way along the line. But if the Government gets its money by selling war bonds, people may retrench some—they doubtless will—but they will look at the bonds and say, "We are not so badly off. We used to put so many dollars a month in the bank. We don't have to do this any longer. We have these United States bonds; they are good assets. Maybe we can sell a share or two of stock also. We don't have to pull in our belts. We don't have to retrench in the same manner we would if we were sitting there holding tax receipts."

Here I think I can add parenthetically this statement: Even with a balanced budget you would not check inflation entirely. During the war you would have to tax very high to balance the budget. That would mean that many people would be called on to reduce their standards of living very drastically; if they had no other assets, this is just what they would have to do. But, to the extent that they have other assets, they would try to liquidate those assets in order to maintain their standards of living--that is to cut them less drastically. That would cause inflation, even with a balanced budget. The only way to offset this is to find people in the economy whose incomes have been increased quite a bit and induce them not to increase their standards of living proportionately but to buy war bonds so they can improve their postwar position relative to that of other people.

I have now discussed taxation and borrowing as alternative ways of blocking private expenditures during the war period—that is as ways of checking inflation. But there are other bases of comparison.

Taxation is, on the whole, much fairer than borrowing. The main reason for this is the one I have already given. Taxation will distribute most of the cost of the war over the civilian population in wartime and they are, by and large, better able to pay it. Borrowing will wait for the soldiers to come back in order to allow them to share in the payment of the debt.

The next point of comparison, however, is one in favor of borrowing rather than taxation. This is the effect of taxation and borrowing, respectively, on production incentives. We ask people to work awfully hard during the war—overtime, Sundays and holidays. They will do it partly for patriotism; but patriotism wears rather thin after ten weeks of working seven days a week. You have to give them some other incentive. Tax receipts are not worth a d—— as a production incentive. War bonds are pretty good. I shall say something presently about how good. It is necessary, therefore, to keep taxation low enough so people will find it worth while to work to get income. You have to leave them enough of the income so that it is worth trying to get.

In the United States we have spoken and thought of production incentives primarily as management incentives--incentives to make it worth while for management to strive and to economize. But it is probably even more important to have adequate labor incentives--to leave individuals enough to make it worth while to put forth their best efforts. There has been a great deal of discussion of labor incentives in Great Britain, where taxes have been very high--even higher than here.

As you know some taxes bear more heavily on incentives than others, in proportion to their yield. Excess-profits taxes bear heavily on management incentives. They tend to cause wasteful expenditures at a time when such expenditures are the most harmful from the national point of view—at a time when it is particularly necessary to concentrate all efforts on the production of war goods.

During the last war there was a great deal of discussion of a tax on increases in earnings over a base period. For example, if a man's income has increased 100 percent, you would tax the increase much more than the base pay. Such a tax would hit workers in war industries much harder than it would the rest of the country. You can see how it would have a great appeal to people who had not benefited by the war, but its effect on the war effort would be devastating. It would be a tax on people working overtime when it was particularly necessary that overtime be worked. So it is clear that the effects of such a tax on the production incentives of labor would be particularly bad.

My next point of comparison works to the disadvantage of borrowing as compared with taxation. This point relates to the cumulative effects of borrowing. As borrowing goes on it creates more and more assets in the hands of the people and makes them less and less inclined to restrict their expenditures. Borrowing makes the problem of combatting inflation more difficult as the years go on.

This disadvantage of borrowing is particularly important when you are dealing with a persevering foe, and it may be a long war. During a war the amount of consumers' goods available for sale to the people is limited. The people are asked to put forth great effort in exchange for money much of which they can spend only after the war. They will do this only if they trust the money. That depends upon their faith in the country's financial system; so that a financial system which commands public faith and respect is itself a very valuable weapon for achieving victory.

Kenneth Galbraith of Harvard, in commenting on this, remarks that the rationing and price-fixing system in Germany during the last war worked much more efficiently and smoothly than that of the United States, but that Germany could not get the war production we got. The Germans' war production tended to level off. The American people figured that the war offered a good opportunity to save some money. The thing to do was to work plenty hard and save their money so that they could buy what they wanted after the war. The German people didn't figure it that way. Marks had not been good after World War I, and the Germans didn't think they would be good after World War II. So they only worked to get enough marks to use up their current ration coupons. A reputation for sound finance was, therefore, an important weapon for the United States in achieving victory. That is the most important single point that can be made to show the importance of sound finance even in achieving the narrow objective of victory.

Of course, the principal objective of sound finance is to make the country better after victory is obtained. But this is not much good unless you get the victory. The point which I have just made indicates that sound finance helps to secure the victory itself.

I shall now speak very briefly about compulsory borrowing--only with respect to individuals--that is, the sale of government securities to individuals by compulsory means. This is generally done during the war by collecting taxes which are refundable in the postwar period. This generally means that total taxes--refundable and nonrefundable--are levied at higher rates than would otherwise be the case. The refundable taxes are saving for the postwar period when the refunds will be made.

When you line up the economic effects of compulsory borrowing, you find that they are generally between those of taxation and borrowing; for example, compulsory borrowing does not cut down private spending as much as straight taxation. A fellow says, "I don't have to save much. I have a kitty in what the Government is going to return to me." But it does block private expenditures more than voluntary borrowing because he doesn't know when he is going to get his kitty.

With respect to production incentives, men will work much harder to get balances, which are payable after the war, on the Government's books than to get tax receipts; but, they will work still harder for money which they later voluntarily lend to the Government. So that compulsory borrowing in its economic effects is sort of halfway between voluntary borrowing and taxation.

Is compulsory borrowing a good idea? You can't answer the question generally; it depends on what the alternative would be. If we are in an inflationary situation and you can get substantial compulsory borrowing placed on top of all the taxes you can get, then compulsory borrowing is good. But if the effect is merely that you get the compulsory borrowing instead of taxes which you could have got without it, then it is bad. It has to be viewed in the light of alternatives.

I turn next to the place of direct controls in war finance. One of the reasons for direct controls, allocations, and rationing is that people who do not have any place to spend their money submit more easily to taxes and are much more willing to lend their money to the Government. Direct controls psychologically precede fiscal measures--that is taxation and borrowing. This point was made during the last war in a very interesting memorandum by Arthur Upgren and Richard Bissell, but it has been made many other times since and possibly before.

You might say that if you take the people's money by taxation or borrowing, you cut down their purchasing power; then they can't purchase goods on the market as they did before. Psychologically, it doesn't seem to work that way. It seems to work better if you get the products off the market by direct controls. Taxation and borrowing then act to some extent as scavengers; they gather up the money which is left over.

I don't think any direct controls in the United States during the last war were consciously imposed for this general fiscal purpose--that is, for the purpose of helping combat inflation and transfer purchasing power to the Government. They were put in to cover special situations, shortages of this, that, and the other thing. But they had powerful fiscal effects and would again in another similar situation.

Next, I should like to speak about what you might call "general" direct controls. Two of these were talked about in the last war but were never applied. They might be necessary in a future war. One of these is a graduated spending tax; the other is expenditure rationing. I shall describe them pretty briefly.

The graduated spending tax would be a progressive tax on the amount of spending that individuals do. It would be in addition to high taxes on income, but the spending tax, unlike an income tax, would not require a ceiling of 100 percent. Expenditures over $10,000 per head could, for example, be taxed 500 percent. The idea is to hold down expenditures, but to hold them down by a general device. If a fellow really wants to spend $11,000 so that he will pay an additional $5,000 taxes, then he can do it. Such a tax is sort of a flexible spending ration.

Expenditure rationing would provide that--with some exceptions such as medical expenditure, etc.--money could be spent only when accompanied by an equal amount of coupons. That is, when you want to spend five dollars, you must have five dollars in money and five dollars worth of money-spending coupons. This would mean that people could spend only the amount of money they had coupons for. Assuming perfect enforcement, you could fix total spending at any level you wanted. As incomes would be greater than the amount of spending allowed, the people would have a great deal of additional money. They could spend some of it on things outside the national area but they would have to save most of it for the postwar period.

In many respects expenditure rationing is the neatest of all measures proposed for war finance. Both it and a spending tax would present administrative difficulties which we won't go into here. But I would like to point out that each of them to be successful requires faith in the subsequent value of money--its value after coupons are no longer necessary or after the spending tax has been repealed. Otherwise, people will not put forth the necessary effort to earn money which they can only spend after the war and we would be in the same fix Germany was in.

I shall now turn to some of the narrower techniques of war finance. The Government borrows money during a war and pays interest on it. A number of questions arise as to what interest it should pay. The first question of which I shall speak briefly is that of "stable rates vs. fluctuating rates." In World War I the United States paid a higher interest rate on each successive war loan. If people once get the idea that each loan is going to pay a little more than the last one, they will not subscribe to "this" one; they will wait for the next one. When the "next" one comes, the thing to do is to wait for yet another one. An atmosphere of rising interest rates is a very unfavorable atmosphere in which to sell securities. In order to sell securities effectively, you must convince the people that now is the time to buy them.

When World War II broke out the Federal Reserve Board issued a very emphatic statement saying that interest rates were going to be stable this time; that there would be no point in postponing the purchase of securities. The statement was successful in creating the proper atmosphere. That is, no one felt he was going to be given a better deal by waiting. And the spirit of the statement was carried out; no one did gain by waiting.

The next question is, "What should determine the level of interest rates paid during a war? During a total war interest rates are not an important instrument of economic control. Their level should be determined by the main criteria. The first criterion is that it should be a rate which makes people generally happy during the war period; the second is that it should be a rate which will be viable in the postwar period when the interest rate again becomes an important instrument of economic control.

The next problem with respect to interest rates is the problem of the so-called "pattern of rates," or the relation between short-term and long-term rates. Short-term and long-term rates were about the same in World War I and earlier wars. We entered World War II with short-term rates much lower than long-term rates and this continued to be the case with some modification throughout the war. This resulted in many technical problems I do not have time to discuss. I shall only say that since the end of the war short-term rates have risen a great deal more than long-term rates, so the pattern is not so much of a problem now.

The rate on 90-day Treasury bills just before World War II was substantially zero. During World War II it was three-eighths of 1 percent; now it is over 1.5 percent. The rate for borrowing on long term was 2.5 percent before the war, and 2.5 percent during the war. Now it is about 2.75 percent. So you can see that the gap has been greatly narrowed.

The next point on which I shall say just a few words is that of the ways of selling bonds. One way is the continuous grind method that is evidenced by the pay-roll-savings plan and the bond-a-month plan of the Treasury. Contrasted with them we have the technique of periodic "drives." There's something to be said in favor of both methods. I think there's a great deal more to be said, academically and fundamentally, for the continuous techniques. These were tried exclusively for about one year during World War II, but after that the main reliance was put on periodic drives. I think the same thing would happen again because of the psychological appeal of the drive technique.

Finally, as our time is running out, I shall say a few words about the garrison state.

The first thing I have to say about the garrison state is that maintaining a garrison state tries our patience on the domestic front in the same say that the war in Korea tries it on the military front. I imagine most people feel that in a war with a totalitarian government they should put forth a greater effort and get the thing over with. But, just as a military situation can't always be handled with a meat axe, so neither can the domestic financial situation. Patience pays in financing a garrison state.

What are the basic techniques necessary for financing a garrison state?

In the first place, you can place much less reliance on direct controls in a garrison state than is true in an all-out war. All direct controls (even in total war) tend to lose their efficacy as they are protracted over time. No one knows how long a garrison state will last. You must be prepared to hold out a long time. You also can expect less help from patriotism in enforcing direct controls, even in the short run.

In the next place, while I think that little reliance should be placed on the interest rate as a means of control in an all-out war, in a garrison state we must place considerable reliance on reducing the availability of credit to the private economy with a consequent increase in interest rates.

In general, all techniques used in financing a garrison state should be techniques that, if necessary, can be continued for a long time--ones that don't wear off easily. Compulsory borrowing is not a suitable technique in a garrison state. In a war you expect that there will soon be a period to pay back. But if we raise money now by compulsory borrowing, when will be the pay-back period? It is too indefinite.

So, to end on a sour note, in a garrison state our major reliance must be on taxation. There is no substitute for taxation.

COLONEL HARDENBERGH: Gentlemen, Dr. Murphy is now ready for your questions.

QUESTION: Dr. Murphy, using your 100-units example seems to make these things clear. Would you explain the mechanism of that portion of our gross national product that is turned over to other countries outside the United States? Some of it is for the purchase of material from this country; some of it is for cultural development in those countries. How does that effect the picture in this country?

DR. MURPHY: I would say that the effects on the United States of external expenditures are for most purposes substantially the same as those of internal expenditures. For the purpose of economic analysis let us say the product is 100 units and of those 100 units the Government purchases 25. Then of the 100 units of income received from production the Government takes 20 in taxes. That means the Government has a deficit equal to 5 units. The Government has 25 units of goods and service to dispose of; it sends 5 of those units abroad. That may be for payment to American personnel abroad, for shipments of physical goods to those countries for military purchases, or raw materials for economic aid of one type or another. The situation in the United States is not materially different from what it would have been if the Government had kept the goods at home. The essential fact is that there are 100 units of products and 100 units of income. The Government has taken 25, therefore only 75 are available to the people who receive the income. The Government has cut down this income from 100 to 80 by levying taxes and has to induce people to save another 5 units and turn them over to the Government in order to avoid inflation. So it doesn't seem to make any difference where the goods go so far as the over-all analysis is concerned. If the commodities needed for foreign aid were scarce, like copper or steel, there would be special pinches, but no more than if the Government's own use for those commodities at home had increased.

QUESTION: Dr. Murphy, I am a little concerned about the graduated feature of your proposed spending tax. I don't understand how you intend to employ it. It seems to be a penalty on the upper brackets for spending their income. Five hundred percent, or even 100 percent, would destroy the initiative for anyone to increase his earning power. It would appear to be almost pure socialism, by reducing the ability of the people to earn more money to increase their standard of living and pull them down to some poor sustenance level. Would you comment on how you reconcile that with the war effort?

DR. MURPHY: This spending tax as I see it is a temporary war measure. I should like to say that spending taxation has been advocated as permanent in peacetime in lieu of income taxation—Irving Fisher has advocated this. But I am not concerned with that here.

Let us come back again to the point of faith in the postwar purchasing power of money. We invoke this faith to make people work hard to earn money during wartime; money to save, not to spend, so that they can enjoy the good things of life in the postwar period. Spending during wartime might be cut down by absolute limitations. But, instead of imposing an absolute limit as does a ration coupon that says you can get five gallons of gas but that you can't get six at any price, or an extra tire at any price, the spending tax tries to accomplish the same thing flexibly. We figure up in a rough way how much can be spent without pushing up prices and then we try by means of taxes to control the amount that will be spent. It is really more liberal than rationing because it allows some flexibility. Instead of saying five gallons of gas is all you can get, period, it says that six gallons may be obtained at a price, but that price is plenty high. The only way you can get this sixth gallon of gasoline is by somebody else getting only four. Suppose you want this sixth gallon so much that you will pay a tax of 200 percent; there is another fellow who will take four and save his money for the postwar period. The contraction in total expenditures is required by the shortage of goods. The spending tax does not decrease by one unit the amount of goods available to be bought; it merely affects their distribution. It gives you some kind of choice. People who have, shall we say, a short time-prospective—who value the present very highly, relatively, to the future—can, by paying a stiff price, take the goods away from people who place a high value on the future as compared to the present. The limitation of goods is brought about by the physical situation; the spending tax is a means of redistributing the demand for the goods.

QUESTION: Doctor, I thought your point was very well taken on the analogy between the workmen in Germany and the American workmen. During World War II the German workmen didn't have confidence in the postwar medium of exchange, but the American workmen did. Now, I project that same situation into another world war. What leads you to believe that the American workman will have confidence in his dollar following another world war in view of his experience following World War II?

DR. MURPHY: I would say that popular confidence in the dollar is now less than it was during World War II; this war followed immediately upon a long depression during which people learned to play it close to the vest. The idea was "hang on to your money; you are going to need it." Also, there had been a decline in prices during the preceding decade. If World War III should start now, we would be entering into a rather different situation. In the first place I think the individual need for financial independence and thrift has not been as firmly implanted by the experience of the last five years as it had been by that of years previous to World War II. There has also been the experience of rising prices.

However, if we compare this experience with that in foreign countries, with the single exception of Switzerland, our price rises have been much more moderate. The price rises in the United States associated with World War II were slightly less than those associated with World War I despite the fact that World War II was much longer and more destructive than World War I. But, of course, the experience of World War II is much more recent.

Public psychology is not easy to guess, but I doubt if the bulk of the people who saved money in World War II have been sufficiently depressed by the price rises since to wish that they had "shot the wad" during the war. While they would have liked to have their money go further, I think that by and large they got what they were saving for--automobiles, refrigerators, and things of that kind. Such items came on the market, but at somewhat higher prices than people had expected. During the war these items were not available at all.

Now, when the Korean war broke out, we had an opportunity to make what you might call a test run of public psychology. People were tremendously impressed by the possibility of shortages; some were impressed by the possibility of price rises. They ran to buy things and they got them; they got plenty. There has been quite a revulsion of popular psychology. What the psychology would be now I don't know. It's a hard thing in a sophisticated discussion to judge the psychology of people who don't think a great deal about these things; but I believe most of them still have what we might call the money illusion. As one of the persons replying to the questions our Committee sent out recently said, "Most people have the money illusion; thank God for that."

QUESTION: Doctor, one of the reasons for the high taxation on corporations is undoubtedly due to their lavish personal expenditures and their large programs, things that are written off as expenses, to reduce taxation. Do you have any idea of the extent of the impact on the present high corporate taxes? Are there any limits that can be put on corporate earnings to control that to some extent?

DR. MURPHY: It is pretty hard to estimate the quantity. You have a very important point. I think one of the best cartoons that came out of World War II showed a man of the Mr. Winterbottom type in a night club. His companion was a girl of the Peter Arno type. He was explaining to his friend: "She is sort of a secretary. I figure with the present tax setup she costs me only two cents on the dollar." Of course, I don't know whether he was using the type of GNP that would be convertible to the war effort.

It is a bad problem. The most fundamental remedy for it is to keep the marginal rate of the tax down as far as possible. But that is going directly against popular psychology. The public says that excess profits ought to be taxed 100 percent; but that for legitimate profits a tax of 50 percent is much too high. The public doesn't realize how hard it is to distinguish between them.

Some things can be done by law. Advertising, for example, is probably a bad abuse and something can be done about it but it is very difficult. But I think that there is an inhibiting force in the system that keeps the abuses within limits. Most people don't think the excess-profits tax is going to last forever. Director of corporations hate to see expenditure habits built up while this tax is in effect, since it may be very difficult to check afterward. And, then, there is just plain honesty.

QUESTION: I was interested in exploring this popular psychology just at the start of the Korean war. I wonder if the people were afraid of shortages realistically or shortages created by governmental edict.

DR. MURPHY: I think they were afraid of shortages, period. One of the first reactions of the public was to buy sugar. There is scarcely a commodity in greater supply than sugar. They might have been afraid of sugar rationing and there might have been some idea of getting in under the rope, but I think they were primarily concerned with actual shortages.

QUESTION: I believe you have almost hit it. They bought sugar, but from the way I have read the newspapers, there is such a supply of sugar available to the United States today that the Government has restricted the importation of sugar three successive times since Korea in order to keep the price up.

DR. MURPHY: My example seems to be a poor one. Sugar is a queer thing. It was really short in World War I, but people have the popular psychology that sugar is always short. It was rationed in World War II, not because there was an absolute shortage, but because sugar is an easy article to hoard and because there would not have been enough sugar for most people to be able to lay away 100 pounds in the cellar. As long as they wanted sugar to sweeten their coffee even until it was sickening sweet, there was enough. People now remember the sugar rationing of World War II. But, in general, it is my own guess that people expect that war brings shortages and fear this more than the rationing process itself. After all, not many things were rationed in World War II. In some cases the question becomes metaphysical. For example, Did the people rush to buy automobiles after Korea because they thought the Government would need tanks and this would cause a shortage of automobiles, or did they rush to buy them because they thought the Government would prohibit the purchase of them in order to clear plants for making tanks? The two points sort of merge.

QUESTION: Doctor, do you recommend taxation as a source of revenue? There's quite a bit of discussion in newspapers on congressional hearings about having reached the ultimate income tax on corporation taxation. How do you feel about that? Do you have any other forms of revenue that you would recommend?

DR. MURPHY: Taxation is the only important source of government revenue. I have no recommendations of revenue sources other than taxation.

I have no doubt that people are pretty much fed up with tax increases, but this is psychology rather than lack of money. There are two important things to remember. The first is that the Government is taking a large amount in taxes in real terms. The second is that, despite this, more people live better now than they ever did before. They could pay taxes even higher than at present and still maintain a standard of living better than they had been accustomed to at any time until the last five years. But people can take tax increases, psychologically, only at a certain rate. When taxes get increased, increased, and increased, and we are not in an all-out war, people demand a breathing spell to become accustomed to the new rates. But we are far from the absolute limit.

I am not advocating taxes for their own sake. I would like to have taxes as low as possible to serve the purpose, but I believe that the country will prefer higher taxes to either serious inflation or defeat.

COLONEL HARDENBERGH: On behalf of the student body, the faculty, and the college, I thank you for a most interesting lecture and discussion period.

(4 Jan 1952—350)S./VJM