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FINANCING NATIONAL SECURITY

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FINANCING NATIONAL SECURITY

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MR. MUNCY: We know that inflation reduces the amount of national security that may be procured with a given defense appropriation. This morning we shall consider the efforts of the Federal Government to control inflation and thereby strengthen the economy and stabilize it during a war emergency. Fortunately, we have the documented records of World War II and the present national emergency as a basis for this study.

Our speaker this morning is well-qualified by experience and long study to analyze the records for us and to point out the lessons which the Nation should have learned. During World War II he served as a government price executive in charge of rubber, chemicals, and drugs. Later he served as an economist to the Congressional Subcommittee on Monetary, Credit, and Fiscal Policies, of which Senator Paul Douglas was chairman. Prior to entering the government service he had 17 years as professor of economics.

It is a distinct pleasure for me to introduce Dr. Lester V. Chandler, Professor of Economics at Princeton University, who will speak on "Financing National Security."

Dr. Chandler, we welcome you back to the Industrial College.

DR. CHANDLER: First, I want to express my appreciation of being invited back here. It was very pleasant last time, and I am sure I shall enjoy it this time. Now, in something less than half an hour I shall try to solve all the financial problems of the Government, with the success that you can predict in advance, I am sure.

The topic as announced is "Financing National Security." I shall construe this to include only the problem of raising the money to cover the Government's expenditures, as well as the other activities of the Government; and shall have very little to say about the Government's expenditures as such. In other words, I shall take the expenditure rate as being given and concentrate on the question of how to raise the money to cover those expenditures.

There are, however, two aspects of government expenditures that I should like you to keep in mind as a background for this discussion. Both of these have to do with the fact that government expenditures tend to be expansionary and, under certain circumstances, inflationary.

In the first place, government expenditures constitute demand for the national output. When you have a period of high and rising government demand for output, this in itself tends to create demand for labor, demand for goods and services, and to work in the direction of higher prices.

And this isn't the end of the story, because government expenditures not only constitute a demand for output, but they also feed private money incomes. Practically all the money the Government spends goes into the market for goods and services and enters into incomes--wages, rents, profits, and so on--thereby tending at the very same time that government demand is rising to raise the spending and saving power of the private sectors of the community.

Thus it is necessary to evaluate the alternative methods of financing. Let us turn to these.

Our problems in this field arise not because there is only one way to raise money to cover the expenditures, but because we have so many alternatives. If we had only one way, policy questions would not arise. But there are many different ways of doing it. For example, there is the question of the extent to which we rely on taxes as against borrowing. Within the tax category, the relative reliance on different kinds of taxes; and within the borrowing category, our relative reliance on the different kinds of borrowing.

The choices in this field of financing are extremely important, because different methods of financing affect the behavior of the economy so differently and may in fact have a great influence upon the success of the national security program itself. I should like to single out for comment four of these effects of financing methods that ought, I think, to be borne in mind.

The first is the effect on the over-all rate of output and employment. There are some kinds of financing that interfere with getting the maximum output in the economy, and with getting maximum employment. There are others that do not interfere with, and may in fact tend to promote, an increase in output and employment.

The second is the effect on the diversion of resources and output from civilian purposes to military purposes and in keeping them diverted to military purposes during the duration of the program. Of course you are aware that one of your problems, especially as you try to build up the military effort, is to get the labor and other resources away from the civilian goods industries and toward the military.

And third is the effect on inflationary pressures and on price levels. I refer to both overt and suppressed inflation. Finally, there is the effect of the financing methods on the allocation of the economic burdens among the various economic groups. Who bears the burden? Here again the financing methods are important.

These are, then, the kinds of instruments that we ought to keep in mind in arriving at a financing program.

Now, what kind of financial policy do these considerations indicate in a period of mobilization or war? Let me state my conclusions first. It seems to me that as a general principle we should cover the expenditures by taxes except insofar as a positive case can be made for running a deficit and resorting to borrowing. In my opinion the most common mistake, and the greatest mistake, in financing during most mobilization and war periods has been inadequate taxation and excessive deficit spending and borrowing.

Now, how do I arrive at this kind of decision? Well, one of the major reasons is that, so far as we know at the present time, there is absolutely no substitute for taxation as a means of preventing rising government expenditures from producing inflationary pressures. Taxation is the only way that we have to keep private money incomes, after taxes, from going up. That, of course, is because government expenditures add to private money incomes. Unless you take out at least as much through taxation as you add through government expenditures, you are going to have a rise in private disposable income, and, of course, in private spending and saving power.

Some will say that this doesn't make any difference in a war or mobilization effort, because you can prevent inflation from arising through the use of price ceilings and wage ceilings, perhaps augmented by the use of rationing and allocation of materials. This, however, is looking at it too narrowly, because it may be that you can hold down prices during the mobilization period, that you can prevent actual consumption expenditures from going up; but, if you are running a deficit and the Government is constantly contributing money to private money incomes after taxes, you are going to run up the ability of people to save, and their accumulations of savings, if this goes on for a considerable period, will probably cause some inflationary problems after the effort is over if, in fact, it does not cause an explosion under the price and wage ceilings before the effort is over.

I think we ought not to take too much solace from the World War II experience. In another case we might have an effort that would last considerably longer, and the price and wage ceilings might not prove to be so durable as they were on that occasion.

Thus, taxation is the only way that you can prevent people from having increased spending and saving power in the face of large and rising government expenditures.

The second reason for using taxation, primarily if not completely, is that it facilitates the diversion of resources from civilian uses to military uses, by cutting down the private demand for output.

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Here again the advocates of direct controls could say: "You don't need this technique, because you can use limitation orders on civilian production. You can even issue directives to business to deliver to the military" and so on. But I think most of you with procurement experience will agree that you may issue all the directives that you like in a period when the civilian demand for output is very strong indeed, and yet many producers will drag their feet and not produce as enthusiastically for the mobilization program as they would if they faced a decreased demand for their civilian product. And it is only taxation that can really do a good job here of decreasing the civilian demand for military production.

The third reason is that taxation makes it possible for you to make a more equitable allocation of the economic burdens of the security program. Almost any other kind of financing is likely to create some inflationary pressure. I know of no tax system that could give you a worse allocation of the burden of financing a war than inflationary financing, which tends in fact to constitute taxation upon those with fixed money incomes and fixed dollar assets, a point which I am sure all officers in the armed forces appreciate very well.

These are the reasons why taxation should, I believe, be the mainstay of the financing program.

We might turn to a consideration of the conditions which might justify failing to tax enough to cover all government expenditures and which would justify deficit financing and borrowing.

I would say the one broad justification would be if taxation heavy enough to cover all government expenditures would tend to lower output and employment. It is easy to imagine a situation where, even with the large government expenditures, including those for the security program, you would still have unemployment if you had taxation heavy enough to cover all government expenditures.

In that kind of situation a deficit may help to expand total employment, so that you can in fact get more guns and more butter too. But this is an argument that ought to be used only when the assumptions are fulfilled, namely, that there will be unused labor and productive resources if you tax enough to cover the expenditures.

The other subhead under this would be where rates of taxation high enough to cover all government expenditures would have intolerable adverse effects on incentives to produce and to operate businesses efficiently. This, I think, is a very logical consideration in financing policy. What will be the effect on incentive to work, to produce efficiently, and to deliver the materials?

In time of all-out war, when half or more of the national output is being taken for the security program, it may well be that tax rates high enough to cover all the expenditures would have adverse effects upon the willingness of people to work. But I should like to make a couple of comments on this argument.

In the first place, the incentive argument, I believe, has been abused more than almost any other. Every time anybody suggests a tax increase to help finance a program, someone else alleges that it has intolerably deleterious effects on incentive. They usually try to establish the fact by repetitious statements rather than by any objective study of the facts. I think the time has come for us not to allow these allegations to come to be accepted as facts unless there can be some positive evidence that they have some validity.

In the second place, I would point out that the effect of taxation on incentives does not depend alone upon the total amount of tax collections. It depends also on the types of taxes used and even on the specific provisions of the tax laws.

The moral of this is that a number of people have allowed this argument to interfere with and to prevent adequate taxation, when a serious study of the effects of the tax laws on the incentive problem might have enabled us to collect more revenue and not have any more deleterious effects on incentives than the previous lower-tax program.

Let me give you just one example. They said if we had higher taxes on workers, it might prevent people from working longer hours or more efficiently, and so on. It might well be that a provision in the tax law that would levy a 25-percent tax on overtime pay and on all bonuses for extra production would not interfere with overtime pay and extra effort, but permit the Government to collect considerably more revenue by raising the other tax rates. There are other instances that might be mentioned here.

One further effect I should like to mention is that a failure to levy adequate taxes may also have deleterious effects on the rate of output and on defense. If the other methods of financing are inflationary, they can definitely interfere with production, at least after a certain point.

Suppose that in fact you get increases in the cost of living because of failure to tax adequately. In that case you may have long-drawn-out labor disputes which will cause a great deal of lost time and less production than you would otherwise get. Businesses may become more interested in speculative activities than in real productive activities. You may have hoarding of inventory despite the most rigorous inventory control.

This is all about open inflation. In suppressed inflation you may also have an extremely deleterious effect on the incentive to work, as many countries found out toward the end of World War II and in the postwar period, where they were following a deficit financing program which poured lots of income into the hands of the people. The people couldn't spend very much for consumption, because of the scarcity of consumer goods and price controls. So they were forced to save and did save very large amounts of money. The result was that, as time went on, these people accumulated large amounts of money. They didn't see any prospect in the near future of being able to buy goods. So many of them took the attitude, "What is the point of working to accumulate further money when I already have more than I can ever spend in the foreseeable future?"

In evaluating the incentive problem, I think one ought not to let it interfere with adequate taxation without a pretty clear study of the actual effects of taxes on incentive and of the deleterious effects of other methods of financing on incentives.

So much for the tax problem at the moment. My point has been that in the absence of a positive showing to the contrary, we ought to rely upon taxes to cover the whole of these expenditures, with due regard not only to the equity of the taxes but also to their effect on incentives.

Now, what about financing any deficits that may appear? Here I should like to make the point that the deficit may be looked upon as measuring the net contribution of the Government to private money incomes after taxes. Government expenditures contribute to private money incomes. Taxation takes back some of it. The deficit measures the net contribution of the Government to private money incomes. So deficits do tend to be expansionary in effect.

Another point I want to note here is that borrowing is in effect an issue of valuable assets to the public. To the extent the Government collects taxes, people get only the tax receipt to evidence their contribution to the security program. But the extent the Government borrows, it must issue to the private sector valuable assets, which makes them richer in terms of money, if not otherwise. It is the size of the deficit that determines how much richer the Government must make people per period of time.

The method of borrowing can have an influence upon the form of these assets that people accumulate during a period of deficit spending. I am going to deal first here with the voluntary lending program. Our past experience in this country has been to rely almost completely on voluntary lending, where people have a choice whether they lend to the Government or don't lend to the Government. I will have something to say about other programs in a moment.

To the extent that the Government relies on borrowing it has three choices--to borrow from nonbank lenders, to borrow from commercial banks, and to borrow from the Federal Reserve. Economists almost always advise the Government to borrow to the maximum extent from nonbank lenders, so that it will be borrowing money that is already in existence. It will give the people in return government securities, which are not money. This is a kind of borrowing where people get valuable assets in the form of securities, but not in the form of additional money.

They usually advise the Government not to borrow from the banking system, not to borrow from commercial banks, because if they do, it will constitute a direct increase in the money supply. In effect the commercial banks buy securities from the Government and create money for the Government in exchange. In effect the commercial banks put government securities on the asset side and create new deposits for the Treasury. When the Treasury spends those deposits into the hands of the public, the public has new money, additional money, which tends to be inflationary unless the commercial banks must decrease their loans to others enough to offset the increase of their loans to the Government.

And, most expansionary of all is government borrowing from the Federal Reserve. The Treasury sells securities to the Federal Reserve, and the Federal Reserve creates deposits for the Treasury, which the Treasury pays out, to increase the public's money supply and also increase the commercial banks' reserve, so that they could expand their credit on the basis of that.

Now, what about this voluntary borrowing or lending program? We have, as I said, relied on it principally in the past. But it has not been very effective, I think we must say, in all honesty. Why? In the first place, people have usually not responded by actually reducing their rate of consumption and saving in order to buy government securities. Despite all the patriotic appeals, despite the high-pressure selling methods, and so on, people have not done as you might wish they would do--cut their consumption expenditures to save more to lend to the Treasury.

The result has been, in the first place, that the Government has been forced into large borrowing from the banking system; this involves an increase in the money supply. So that at the end of the defense period people end up holding a lot more money than they did before; that is, people have more savings because of the deficit spending program. Many of these savings are in the form of money, because the Government has been forced to borrow from the commercial and central banks.

Furthermore, when they use only the voluntary lending program, it means that the Government usually has to issue highly liquid securities. People don't have to buy the securities. They can simply hold their savings in money form if they want to. In order to get the people, and even the banks, to buy these securities, the Government has to promise them that they can turn the securities into money very easily at the end of the war period, so that people will say, "These are practically money; we might as well buy them." That is very nice from the point of view of selling the securities, but it means that at the end of the war period the people have a large volume of securities which can be thrown into the money stream easily and add to inflationary pressures.

What about changing this method? There have been several suggestions for departing from reliance upon voluntary lending, in order to get away from the evils that I have mentioned. There are a great many of these proposals. I will mention only a couple of them.

One of them is the idea of over-all expenditure rationing of consumers. I would like to discuss this in a situation where the Government is running a large deficit and adding to the money incomes of the people. The general idea of this would be to say to each person or family, "You may spend so much for consumption. You may not spend any more." For example, a family would get an over-all rationing certificate which might allow it to spend 1,000 dollars per person or 750 dollars per person, but they couldn't spend more than that, which would mean that they would have to save large amounts of money.

This has a certain amount of attraction, at least when you first look at it. It is a way of holding down consumption spending during this period. But by the same token it is a way of forcing the people to save very large amounts of money; so that, when the period is over, you may still have, because of the deficit-spending program, an inflationary problem because of the large accumulations of savings during the period. So this proposal is, in my opinion, no substitute for adequate taxation, because it does not cut down the ability to accumulate savings.

There is still another idea which I might mention here, and that is a program of compulsory lending to the Government, not to rely on voluntary loans to the Government, but compel loans to the Government according to a formula. Incidentally, if any of you gentlemen ever get in a position to advocate something like that, please don't call it compulsory lending. It will be much more acceptable if you refer to it as a refundable tax program. The British did this; and the reaction of the general public was one of gratitude--"Thanks for giving me my money back."

The general idea would be that you tie this in with the income tax program, collecting a certain amount of money from the people, supposedly sufficient to cover all expenditures, but provide that a certain amount of that money be a loan to the Government, to be returned at a later date, according to some formula.

This has at least potentially, some advantages. In the first place, if there is a burden in lending to the Government, it might allocate that burden more equitably among the various members of the community. In the second place, it may be a way of forcing down consumption during the war period. If you force people to lend enough to the Government, it may be a way of forcing down their consumption spending during the period.

Most important of all, it may be a way of making people take claims that are less liquid than those you have to issue under a voluntary program. Since people must lend to the Government, the Government may say that the claims that it issues are payable only under conditions that will not contribute to a postdefense-period inflation. So this could be a way of forcing people to borrow securities and making them less liquid, thereby controlling their inflationary effect.

However, even this program has several shortcomings compared to adequate taxation. In the first place, the people are richer even if they are forced to lend to the Government. They have more savings. And, even if they can't get their hands on those savings, the fact that they are richer may lead them to save less out of their income in the postwar period. Just imagine yourself, for example, coming to the end of a period in which you had saved an extremely large amount of money. You may even decide to spend all your current income, because you have so much in these frozen savings accounts.

In the second place, if not well conceived, it may not actually lower consumption. In other words, it may merely force people to lend to the Government the money they would have saved anyway, although, if you carry it far enough, it probably will lower consumption.

In the third place, it creates a terrific political problem at the end of a war or mobilization period. Imagine that the period has gone on for five years and people have accumulated tremendous amounts in these frozen accounts. A Presidential election comes along. I think we can see the candidates vying with each other in their promises of liberality as to the quickness and terms on which they will release the savings. It might well happen that they would release them right in the midst of a serious inflation. One would hope for better judgment, but not be confident of getting it.

Finally, there is the question of the effect on incentives. Some people say that a forced savings program is fine because it doesn't interfere so much with the incentive to work. But the great value of this program, in the sense that it has value, is that it limits the availability of savings to people. This is the way it limits inflation. The more it does limit the availability of these funds, the less may people be willing to work in order to accumulate frozen savings that they will get only at some indefinite time in the future.

I have mentioned here these two things--consumer expenditure rationing and forced or compulsory lending to the Government. I do not mean at all to say that these things are valueless. Each may have its good points. The point I want to make, however, is that neither one of them limits the ability of people to accumulate savings during the war period; so that both of them may permit you to have an inflationary problem after the period is over.

Up until World War II we used to think that if we could prevent inflation during the actual war and mobilization period, that was all there was to it, that the postwar period could take care of itself. But if World War II has taught us nothing else, it is that it is possible to have most of your actual open price inflation after the period is over. That is due primarily, of course, to the great disadvantage of direct controls, which do not prevent the creation of inflationary pressures during the war effort, but which suppress them and force people into accumulation of savings. If you have a deficit spending program, you carry over at least some of your headaches to the postwar period.

There is another idea in this general field, which is related to the consumers' expenditure rationing program. That is to create a tax on consumption. Instead of using a straight rationing scheme and saying to people that they may not spend more than X dollars per head for consumption purposes, you might give people an exemption from tax on consumption purposes up to a certain level, and have highly graduated tax on all expenditures over and above that level.

You face two possibilities here. One is that all you do is to hold down the consumption expenditures during the war period. Here again what is happening is that you force people to accumulate large sums of savings. So that you still can have trouble in the postwar period.

You might accomplish something by using either consumer rationing of the over-all expenditure type; or you might use a graduated tax on consumption spending and force people to save, and then use a compulsory lending program to make them take government securities of a very illiquid type to represent those savings. But you still have the problem of releasing them in the postwar period.

There is just one other point I would like to make, very briefly, and that is the idea of issuing bonds with constant real purchasing power. This is essentially the compensated dollar bond idea. I think most of you have heard a good deal about that. The idea would be that you issue a bond that would have a stated value on its face, but the price at which the bond would be redeemed would be the stated value times some index number of the cost of living. Say the cost of living index rose from 100 to 200. The bond would be payable at the face value times 200 percent.

Well, this has a certain amount of attraction, especially when each one of us thinks himself a potential buyer of securities. It has the attraction of equity, of fairness, to the buyer of the security to protect him against inflation, to give him equitable treatment as compared, for example, with the fellow who doesn't buy the government bond; he goes out and buys real estate instead, so that he would not be robbed by the decrease in the purchasing power of his dollar.

It has the attraction that it may be a way of encouraging savings during the period if people are promised that they will get back as much real purchasing power as they lent, thereby operating both to cause people to keep their consumption down and to buy the bonds and hold them.

There are, however, some very real dangers in starting to issue this kind of bond on a wide-scale basis. The first danger involved in the thing is that you may issue bonds which you simply cannot redeem. Suppose, for instance, that you have a relatively long war period, with large deficit spending, so that tremendous amounts of these things must be issued and you promise they will be redeemed at constant real purchasing power. I can imagine that we might have to issue something like 300 billion or 400 billion dollars worth of these things if we run into a protracted large defense or war effort. This would be 300 or 400 billion of purchasing power at the present level. This would be equal to the entire national output for a year or more, and the query is whether you really could redeem them in those terms.

It might develop that the people in general would say, "We simply will not let that part of the national output go to the holders of these bonds." Then you would have to scale down to a certain degree the purchasing power of the bonds.

The second thing that I would like to emphasize, however, is the possible increase of inflationary pressure that you could get from these things. Many people have said this type of bond would be anti-inflationary, because in the middle of an inflation people would be perfectly willing to continue to hold them and therefore will not dump them on the market and ask for their money.

Well, that is possible. But suppose the people have been deprived of consumer durable goods and other things for a long time during the war period. Then comes the postwar period. They say, "Look. We are hungary for this new car, new washing machine, or whatever it may be. These bonds have a certain amount of purchasing power, which will become neither more nor less. So let us throw them on the market now."

What would happen? Instead of these bonds losing their purchasing power, they would keep their purchasing power. If the people throw them on the market, the Government would have to put up the money to redeem them. That would tend to raise prices. Then other bonds would be brought out and redeemed at still higher prices, which would raise the price level still higher, as well as the money that the Government would have to pay to redeem the bonds. So the thing could be a part of the inflationary engine if you weren't very careful about it.

You might say, "Oh, but we will prevent this from happening by placing very strict limitations on the redemption of these constant purchasing power bonds." That is theoretically possible. But I would point out that as a practical matter, if you place that kind of strict limitation on the cashing of them, you may defeat one of your major purposes, which is to sell a lot of bonds to the people, because a lot of people would say, "I am not interested in having constant purchasing power which I can't get, or whose availability to me depends upon the whim of some politician." So that I would hope that before they embark upon the sale of large amounts of constant purchasing power bonds, there would be a very long study of the dangers involved in such a procedure.

I think I have pretty well exhausted my time. I am rather acutely aware that I have not by any means covered all the problems. Some I have dealt with rather summarily and some I have not touched upon. But perhaps I should leave a few points for the discussion period.

QUESTION: Dr. Chandler, would you care to state the valid arguments against a Federal sales tax?

DR. CHANDLER: I think the principal argument that is used against it is that it is inequitable; that it tends to be regressive in its effect on people, because it can take--at least as it has been administered in the past--no account of the total income of a person, can take no account of the number of dependents and other things that have to be considered.

This is tied to another point, that all taxes are taken out of income anyway, that when you use sales taxes, property taxes, income taxes, or what not, they are all methods of tapping people's income. This being true, the argument runs, why not go to income directly and tax income, because this gives you a chance to take into consideration the number of dependents, the total income, and that kind of thing?

The only argument for the sales tax that I can think of, at least at the moment, is on the basis that it makes possible a lower marginal rate of tax; that is, that the percentage of tax on the additional dollars of income may be lower, simply because it doesn't have the basic exemptions and that kind of thing.

Here is very definitely a case where the equity consideration may conflict with the incentive consideration; where the sales tax, since it applies to all of your income or most of your income, no matter how low the income is, may be at lower rates to give you a given amount of income. So it may have a less deleterious effect on incentive than would an income tax which exempts a considerable amount of income, and therefore you have to tax at a higher rate on incomes beyond that amount.

Just to make my point here: There are certain kinds of taxation which give people an incentive to work more. For example, the British found in some of their colonial areas that their managers had trouble getting primitive people, or not very highly developed people economically, to work. So they taxed these people pretty hard on, say, a per capita basis. That lowers their income so much that they go in and work like the deuce to try to restore the income that has been taken away from them. This is a case where you use a per capita tax, where there is a zero marginal rate, that is, the amount of the tax doesn't depend on income. Therefore you work harder to get every dollar of extra income that you can.

About the only thing I can see in favor of a Federal sales tax would be that it may interfere with incentives less than an income tax that would yield the same revenue. But it does it at the expense of equity to some individuals.

There are techniques, we believe, that can be used to rob the sales tax of some of its inequities. For example, it would be possible to allow a flat deduction per person. Suppose, for example, that you had a 10 percent Federal sales tax on everything. Then in connection with the income tax you could allow people to deduct from the income tax that is due an amount equal to, say, 50 dollars per person in the family, which would be in effect a refund to him of a certain amount of the sales tax.

This technique could be worked out. It has never been worked out so far. But a lot of people are rather sympathetic to it. It brings some equity into the sales tax and still protects a lot of its revenue-producing possibilities.

QUESTION: My question concerns methods rather than effect. In this matter of withholding the tax at the source, that is, where so much of the monthly wage is withheld, rather than letting it get into the hands of the person to whom the salary is due and then let him pay it out, would you comment on that?

DR. CHANDLER: Yes. This happens to be one particular technique of tax collection about which I am highly enthusiastic, both for personal reasons and for economic reasons; the two of them amount to about the same thing.

Until World War II the income tax was not a mass tax. It applied to only a very small percentage of the population. With a 2,500 dollar family exemption, plus 400 dollars for each dependent, it meant that not very many American families paid the tax.

My own guess is that it would not have been feasible to make our personal income tax a mass tax without withholding at the source, or at least without notification from the source to the Treasury; that there are a great many people who would not have bothered to "join" the income tax system except under this kind of pressure; that the ability to enforce the income tax would have been so low that over a period of time it might have degenerated very badly. I hope it wouldn't have fallen into a system such as they have in France, where to pay the income tax is almost to get yourself made into a social outcast. But it is a method of enforcement for lower-income groups--and perhaps for some others--which I think is essential if it is to be a mass tax.

In the second place, I think it is very important from the point of view of timing the increase in tax collections. Suppose, for example you go from a peacetime period into a period of rapid mobilization, when the government expenditures rise fairly rapidly and personal incomes rise fairly rapidly also, and you want quickly to drain off the increased purchasing power from the public. Under the old system, say that in 1952 you get a certain income and then on 15 March 1953 you would declare the 1952 income. This would be paid during the year 1953. You don't get extra tax collections until a long time after the incomes go up. But withholding at the source enables you to start draining off income much earlier when you increase the tax rate. Of course, conversely, with a decrease in the tax rate, people get the benefit of the decreased tax rate, because it takes effect a great deal earlier. So it is very useful from that point of view, it seems to me.

I believe that if you put the thing up to a great many people--and this is where my personal part of it comes in--they would say, "Deduct at source" because it is an automatic budgeting procedure for families; and family budgets are very frequently something less than scientific measures.

QUESTION: Don't you think, Doctor, that if you did away with it, it would have an influence on the people being taxed of realizing the tax they are paying, rather than the way it is now; I doubt if there are many of these laborers who really realize what they are paying? It is a hidden tax, from my point of view. I realize the benefits that you have mentioned, but it seems to me it has a lot of effect on the other side.

DR. CHANDLER: This may be true. I am not sure how important it is. But there is one other aspect to the hidden tax, as such, and that is that you may come nearer to a balanced budget if some of the tax is hidden than if it were absolutely out in the open and everybody realized it. There is political pressure to that extent, because the greater income you get, the greater pressure for greater taxes; and with greater taxes you get yourselves into the danger of a situation where you feel you are paying a tremendous number of dollars to the Government.

As a matter of fact, I don't know how many people are innocent of the knowledge that something is being deducted at the source. I know every time I get my pay slip, I am acutely conscious of the amount that is in the deduction column.

QUESTION: Would you expand your remarks about the sales tax as compared to the other types--the excise taxes on tobacco and liquor, and perhaps even the Russian type of state-operated black market?

DR. CHANDLER: I am afraid my knowledge of the Russian situation isn't adequate enough for me to say very much about that.

I am very sympathetic, in general, to selective production or sales taxes. There is one kind of selective tax, to be used in a mobilization period, of which I approve and that is a selective tax on those consumer articles which compete most directly with the military program.

It is possible to select out certain items, such as automobiles, for example, and tax those at an extraordinarily heavy rate, making them so expensive that the effective demand for them will fall off, and thereby tending to free resources to the military effort. It seems to me that this might be a useful supplement to direct orders to manufacturers to divert military production. So there is something to be said for them from that point of view.

So far as levying them for other reasons, I am very skeptical of most of them. In the first place, the definition of a luxury is an extraordinarily difficult thing. What is a luxury? One might say, "Oh, well, those things that people buy only with their extra income."

But when your wife or your daughter is willing to go hungry so she can do some feminine shopping and buy some fancy dresses or silk stockings or something like that, it almost sounds as if luxuries are necessities and necessities are luxuries.

On this matter of definitions you might think of a meal with music as being a luxury. During the war I used to go to a Chinese place on fifteenth street where they had an orchestra. They were subject to a 20-percent tax, whereas another place on Connecticut Avenue, where the meals cost three times as much, didn't have any music and there was no tax on it at all. That strikes me as being simply absurd. If I had been Petrillo, I would have objected to that.

And so with admissions to the opera. I must frankly admit that to me the opera is decidedly a luxury. But there are a good many members of our society with lower incomes than I have, and more musical appreciation, to whom music appears to be practically a necessity.

How do you define these things?

We have always been in the habit of having a tax on liquor and tobacco, pretty much on the basis that these are bad habits and ought to be taxed out of existence anyway. But I don't personally take very kindly to the invidious comparison involved in luxury taxes except in the cases I have indicated, where you definitely want to discourage the production of a particular kind of item because it competes with your military program.

QUESTION: You mentioned that we should tax these things to the maximum extent possible during the war period. I wonder if some saving should not be encouraged during this period in order to offset the imbalance that comes following the war in the consumption and production of materials.

DR. CHANDLER: Yes. I am in favor of a certain amount of saving at any time. I would think that during a war period to leave enough income in the hands of the public so that the normal amount of saving could occur would be a perfectly good policy and would not necessarily be inflationary.

I am sympathetic to the argument that your question implies. I remember that during World War II Mr. Morgenthau and several others pointed to the very high rate of private saving during the war which was made possible by the large spending and the inadequate taxing program, the inference being that this was an awfully good idea. It would mean that people should come out of the war period with reserve purchasing power which they could use to cushion any tendency toward depression.

I think we have learned something there and that is this: During a war period no one can predict with any very high degree of accuracy what the postwar period will be like. Literally hundreds of responsible people were predicting fairly strongly that we would have a depression after World War II. We know now that they were wrong.

I think it is a rather dangerous policy to allow people to accumulate very large amounts of savings, which they hold in liquid form--I mean in a form which enables them to spend whenever they want and at whatever rate they want, on the supposition that there may be a depression after the war.

I would say that a tighter-tax policy during the war would be better--one that would prevent this excessive accumulation of savings, followed by a recognition on the part of the Government that perhaps it should follow a very easy fiscal policy at the end of the war, if that were necessary to tide you over into a good recovery and conversion. It might be possible, for example, to cover expenditures by taxes during the war, but then drop tax rates precipitously at the end of the war, and even have deficit spending at that time to ease the conversion problem. Although I still don't admit the wisdom of a lot of extra accumulated savings, a certain amount may be helpful in the transition.

QUESTION: You spoke about the difficulties in high taxes during the war and the argument that they reduce incentives. My question is, what finite means are there to determine where the break-even point is?

DR. CHANDLER: I have read a lot of books and literature recently on this very question--Are taxes already so high that they are stifling incentive? Some people say that they are obviously too high. Then you look at all kinds of industries and find that, for example, the rate of private investment is the highest of all time, even if allowance is made or the changes in the price level. Practically every business is operating with a considerable degree of efficiency despite the excess-profits tax. In 1953, despite the income tax, people seemed to be more than willing to work overtime, and so on. So it doesn't appear to me that we have really passed this point where you are getting a considerable effect on incentives.

This is one problem I suspect, where sort of a trial-and-error method ought to be used. So far as the labor force is concerned, for example, you could push the tax rates up to a certain point and watch over the country to see what is happening to the hours of labor, the efficiency of work, and so on; and make your modifications from that point on. I don't see that apriori you can really arrive at very much of a decision.

But I would say this: In World War II, for example, if a person had gone into the situation objectively, he would have found that almost all workers were subject to no more than about a 24 percent tax rate. Very few of them were subject to a higher tax rate than that. It seems quite likely that they could have pushed the tax rate up to 30 or 35 percent without interfering very much with the overtime work.

As I indicated earlier, I am pretty sure you could have done that. You could have made the basic tax rate 35, but provided that the worker would have the option of declaring his overtime pay as regular pay and being taxed on it at the regular rate, or declaring it at a 25 percent tax rate, which would give you more revenue and still protect your incentive to work overtime.

COMMENT: I think the British are doing that right now.

DR. CHANDLER: I don't know about that.

QUESTION: You discussed the inflation that we have had since World War II. But right after World War I we went through a deflationary period which was quite severe. Can you tell us something about the different conditions that existed and the different techniques and policies of the Government that made us have an inflation at the end of one war and a deflation at the end of the other?

DR. CHANDLER: I think there are two things that I would underline on that.

The first one is the underlying fact that we had practically no effective direct controls during World War I. There were some price controls, but they didn't cover very many commodities, and they weren't really very effective. There was no rationing and that sort of thing. So people were pretty much free to spend their money as they got it during World War I.

During World War II we had all of these direct controls that made people hold down their consumption. We had the direct controls that kept business from spending for new plants, equipment, and so on. So we ended up World War II with individuals apparently having 133 billion dollars more savings than they had when they went into the war, and with corporations having something like 50 billion dollars of liquid assets which they could not spend during the war. So that we had sort of a pent-up batch of assets at the end of World War II, which made people feel a lot richer.

This tended to create inflationary pressures in two ways. In the first place, even if people didn't spend their accumulated savings in the postwar period, they felt freer to spend their current income and to save less out of current income. In the second place, a lot of them spent all or most of their accumulated savings in the process, or at least used them as down payments on automobiles, washing machines, durable goods, and so forth. You didn't have that thing at the end of World War I.

Then we are not quite sure what might have taken place after World War II if we hadn't had the large international aid program that we carried on for quite a period of time. That was largely absent after World War I. We had some international aid immediately after World War I, but it was not like the situation this time.

I personally would attach some importance to this fact: that the period before World War I was in general a very prosperous period, with a fairly high rate of housebuilding, business investments, and that kind of thing. So in general plants and equipment were in pretty good order and housing was in pretty good order when we went into World War I. For 10 years before we went into World War II we had had very little business investment in this country, probably not much more than enough to offset the depreciation during the period. So that our stock of capital goods in 1941, or at least in 1940, was practically no greater than it was at the end of 1929.

So there was sort of a pent-up demand at the end of World War II, pent up not only because of the limitation on private purchases during World War II, but also because of the lack of private purchases of durable goods during the preceding deflationary period.

I think all these things are relevant there. There are probably some others that I haven't thought of.

QUESTION: A few minutes ago you mentioned the excess-profits tax. Would you elaborate on that a little bit? Would you explain the advantages and the disadvantages of that particular kind of tax?

DR. CHANDLER: This strikes me as being another case where equity conflicts with incentives. I think that one must sympathize with the kind of speech that President Roosevelt made in 1940--that this war was not to be a repetition of World War I, in which we created a whole bunch of new war millionaires; that there are bound to be, despite the best pricing by the armed forces procurement agencies, very loose contracts in some cases, and that there is bound to be a lot of money made, that there will be terrific increases in profits in this period created by the national emergency, and therefore we should not let people get rich at the expense of the national crisis or because of the national crisis. I am inclined to be sympathetic with that.

On the other hand, I think one must realize that if you have an excess-profits tax at extraordinarily high rates, verging on 100 percent, so that if a man saves a dollar by increasing the efficiency of his process, you take 90 cents of it in taxes and he gets 10 cents of it, then maybe he will say, "To heck with the whole business." I think one has to realize that it can have very adverse effects.

Moreover, it can cause a serious waste of resources. Plants can hoard labor, they can waste materials, and so on, and run up their expenses. They don't bear the burden. The United States Treasury bears most of the burden, which is certainly something that we don't want in a period of national emergency.

Furthermore, there is the problem of defining excess profits for tax purposes. What base do you use? Do you use the peacetime profit? If you do, you may get very cockeyed results, because you can't find any base period that everybody will accept as equitable. Somebody says there were extraordinary circumstances and his earnings were lower than usual, because he had stomach ulcers. Or he may say, "I had a bad fire in my plant this year, and you have to adjust on that basis." I use the stomach ulcers illustration because that actually occurred. A man insisted that he felt very badly and his plant was run badly during the period, because he wasn't there.

You can't use a capital base period. You can't use the rate of return on net worth. How do you define net worth? It is an extraordinarily difficult tax to administer.

Personally I feel that there is something to be said for it in a case of at least all-out war. But it is largely on this basis--I must admit I am not talking as an economist now, but I am talking as a very amateur politician--that if you do not have in time of war a fairly strong excess-profits tax, you may find it politically impossible to get those other parts of your stabilization program that are essential. You cannot, for example, impose wage controls on the workers and make them stick if you don't have an excess-profits tax. You cannot levy very heavy taxes on the lower income groups if there is not an excess-profits tax or something that takes its place. You cannot get control over farm products prices if you don't have an excess-profits tax.

I think one of the things you have to realize about an economic stabilization program is that it is essentially a political process, of balancing forces against each other so as to get some sort of arrangement where everybody will accept a certain amount of restrictive deprivation, whether you use the term "control," "tax," or what not, because he knows the other fellow is being restricted and deprived too.

I think our experience at the end of World War I, and the political disintegration of the stabilization system that occurred, shows that, for example, when you knock out the excess-profits tax, it gives everybody an excuse; when you take away the controls on wages, it gives everybody an excuse; and so on down the line. I think that is probably one of the political limitations that you have in a democracy, and that you can't escape it. And yet I think one sometimes feels like holding his nose when he sees how the thing actually operates with high rates.

QUESTION: It seems to me that taxation is an indirect way of keeping down purchasing power and cutting down the reservoir of savings. Why don't we face the issue and actually control the wages? That will keep excess money out of the hands of the people. If they don't have the money, the problem will not exist. In addition, it will save some of the overhead which is required to collect the taxes, and that will keep down the budget cost. It is not only a question of guns against butter. There is the question of first conserving the labor cost. Would you care to comment on that?

DR. CHANDLER: I am glad you brought that up, for two reasons. Your question implies some very definite limitations on the effectiveness of taxes. A new philosophy that is growing in this economy is that in setting wage rates and prices and in administering price control you should always look at income after taxes. I can't think of anything that can defeat the entire stabilization program any quicker than this kind of thing.

That reflects what one writer has called the philosophy of "parity." The farmers have their parity, to let their prices go up every time other prices go up. The workers have their parity formula in the escalator clause, which would raise their wage rates with every increase in the cost of living. The businessmen have their particular form of parity, which they would like to get and which would maintain a certain rate of profit on sales. When you have all these things operating, you obviously are on the escalator.

But, now, suppose people accepted this general philosophy that a certain level of money income should be restored after taxes. Then every increase in tax rates would be taken as a signal for increasing the wage rates, prices, and so on, so as to restore the money income of these people.

Where would that get in any anti-inflationary program? Every tax increase, whose purpose is to take purchasing power away from people, would then be the signal for an increase in the wage rates and prices, which would release more money income. That kind of thing could run into the stratosphere.

So I think it is essential to get away from the idea that what is looked at is the wage rates or profits after taxes. It must be realized that the purpose is to decrease people's purchasing power. In order to get anywhere taxes have to be permitted to decrease their purchasing power.

Now, on your other point, on wage rates, I think you all are aware that there is need for a wage ceiling program--I am not at all convinced of its need in the kind of program we are in now--but either wage controls or price controls are really needed if there is unwillingness to use taxation and monetary restrictions. And personally, insofar as one possibly can, I think that he ought to advocate staying away from direct controls, because it would get you into literally thousands of individual prices and individual wage levels.

But I quite agree with your point that, if you don't control the wage rates, the effect might be not only that you tend to increase the cost per unit of output, but you also tend to add to the money income of a large proportion of our people, which tends to help them to bid things up.

One other point, though--I am not sympathetic to the general idea that the upward rise of wages during and since World War II is owing to the labor unions pushing these rates up.

My reasoning is this: In the first place, why do wages go up, anyway? Well, for the same reason that anything goes up. There is a terrific demand for labor relative to the supply. Therefore employers bid against one another. If they have a good market for their product, they bid against each other for labor. Even where there is a union, you find one employer hiring labor away from another by paying something under the table and saying, "Don't tell anybody about this, because somebody might match my offer." During World War I, when the American labor movement could be dismissed as being almost completely unimportant, except in a few lines, there was a terrific increase in wage rates simply based on the competition of employers bidding against one another.

Now, one thing that the labor union does do in general, when it doesn't have the escalator clause, is that it reopens the contract only once a year. So at least there is a lag of a year in the upward rush of wages. Whereas if you don't have any labor contract, I am not at all sure that you wouldn't have wage rates being bid up month by month. So that, while I don't mean to say that unions have not been fairly aggressive on this, I think it still has to be proven that unions get, in general, higher wages for their people then they would have gotten in the midst of the same economic circumstances. Some people say that wage controls, fiscal policy, and monetary policy can't work, because of this kind of thing. I would like to show you what would happen if you used taxation and monetary policy to hold down the total demand for output, so that the employers did not have such a very great demand for their output, which would enable them to pass on to the consumers and to other buyers all of the wage increases that they pay.

I think those of you who are experts on labor relations will agree with this observation: Although we had some strikes in the postwar period, in most of the cases the employers put up no more than token resistance to rather considerable wage increases. Even when there was a strike, it was very frequently because each side wanted to show the other that he still had the capacity to cause trouble, and maybe next time he had better be a little careful; but that in most of the cases everybody knew there was going to be a wage increase. There may have been disputes over a few cents per hour, but the employers put up no more than token resistance. Why? Because the demand for their output was so great that they knew that whatever the increase was, it wouldn't have to come out of their pockets anyway.

I think myself that, political pressures being what they are, a wage ceiling program is not likely to be successful over a very long period of time unless you have something to hold down the total level of demand, so that everybody doesn't have so much incentive to try to push these wage rates up. I think all these things are supplementary in that sense.

MR. MUNCY: On behalf of the Commandant, staff, and faculty, Dr. Chandler, we are indebted to you for a very stimulating discussion today. Many of the questions are recognized as being very definitely on problems that the students are working on here and you are going to have some more of them this afternoon during the seminar session. I thank you very sincerely.

(10 Mar 1953--750)S/en