TAXATION AND REVENUE: CURRENT TAX PROBLEMS

12 September 1957

CONTENTS

Publication No. L58-16

INDUSTRIAL COLLEGE OF THE ARMED FORCES

Washington, D. C.

Dr. Seymour E. Harris, Chairman of Department of Economics and Lucius N. Littauer Professor of Political Economy, Harvard University, Cambridge, Massachusetts, was born in New York City, September 1897. He received A.B. and Ph.D degrees from Harvard, 1920 and 1926 respectively. He has been lecturer, instructor, and professor at Princeton and Harvard Universities; editor of Review of Economics and Statistics since 1943, editor, Quarterly Journal of Economics since 1946, and member of the Executive Committee of the American Economic Association. Member of many boards and committees of the Federal Government, among them the WPB, NRSB, and Agriculture Mobilization Policy Board; Director, Office of Export-Import Price Control, OPA. Author of many books and articles on economics, including: Saving American Capitalism, How Shall we Pay for Education, Twenty Years of Federal Reserve Policy, International and Interregional Economics, Stevenson's New America, and he has in preparation for publication, Economic Policy of the 1950's. This is his first lecture at the Industrial College.

TAXATION AND REVENUE: CURRENT TAX PROBLEMS

12 September 1957

COLONEL LACKAS: General Hollis, Gentlemen. As you probably realize, in the selection of speakers every effort is made to obtain men of distinction in Government, education, and industry. This morning we have a distinguished scholar, a man who has held high positions in the education field. In addition, he has served the Government on various boards and committees. He is also the author of a considerable number of books in the fields of economics and public policy; and he has had time to be the editor of several scholarly journals.

We are indeed fortunate in having as our speaker this morning on the subject "Taxation and Revenue: Current Tax Problems" a man who has specialized in this area and who has had considerable experience in talking about these kinds of problems. Therefore it gives me great pleasure to present to this class of 1958 the Chairman of the Economics Department of Harvard University, Dr. Seymour Harris.

DR. HARRIS: Mr. Chairman, General Hollis, and Gentlemen: It's a great privilege to be here. Now I think I've been to every war college in the country except the Naval College. They must know that I was in the Army, and they never invite me.

Don't be too much impressed by all the books I've written. One of my colleagues once introduced me to an audience in Washington and said: "You all know Seymour Harris. You have all read his books or written one for him." One of my friends who reads Russian told me that after the war there was an article in Pravda which commented on the American economists who thought that not only could capitalism be saved, but who said it could be improved. They said: "Among these economists that we have in mind are three economists from Harvard. One is Professor Alvin Hansen, the second is Professor Harris, and the third is Professor Seymour."

I've been warned that if I talk more than forty-five minutes, I shall be unpopular; so I'm going to try awfully hard to stay within those forty-five minutes. If I leave anything out you'll know why. What I've been asked to do is to deliver in forty-five minutes what we generally take a year for in most colleges. So that you mustn't expect too much. But I'll try to cover any points that I omitted later on.

Now, the first problem, it seems to me, is, Why do we have to have taxes? Well, of course the answer is obvious. You have to have certain services. But when you establish a tax system, what do you look for?

Adam Smith, for example, writing in 1776, said a good deal about the fact that it's very important to have taxes because you have to have revenue and this is one way to get revenue. He also said that we want a tax system that is just; that doesn't hit one group more seriously than another group.

Secretary Humphrey, testifying before the Senate Finance Committee this summer, said that as far as he could see, there is only one objective of tax policy and that is to raise revenue; that nothing else matters. This is a rather extreme position. I don't think it's one that's generally accepted, at least by economists.

I would say that, if we are trying to introduce the most effective tax system, what we try to do is this: Obviously we have to have revenue, and that is a very important objective, but we try also to be fair among different groups.

Of course, this is not so much a question of economics as a question of ideology. What one man considers fair is unfair to somebody else. If you happen to be an advanced Democrat, you may say, "We want a highly progressive tax system, a tax system that takes a larger part of the income of the wealthy groups than of the poor and impoverished people." On the other hand, if you happen to be a rightist Republican, you are more likely to feel that the only thing that matters is to have a tax system that does not interfere with incentive; and therefore you would not put a heavy burden on those who do most of the saving, namely, the relatively high-income group.

This is, as I say, partly an ideological problem. It's also partly an economic problem, because, obviously, one thing you do take into account is the effect of taxes on output. In England, for example, in the last ten years there's been a good deal of talk about the fact that the tax rate is so heavy even on workers that many workers prefer not to work overtime, because if they do, they feel the government takes such a large part of the additional shilling that there's no incentive to work. And obviously, if you're a rich man and have to pay, say, 80 or 90 percent of this marginal income, you may also be wondering whether it's worthwhile taking the risk and working so hard. So incentives, of course, are really an economic problem.

Now, in recent years there's been a tendency to emphasize more and more a related and perhaps a more important aspect of tax policy, and that is what we call the fiscal effect of taxes. By that what we really mean is, What does the tax system do to the economy? We mean that because we know more and more that the tax system does affect the economy in all kinds of ways. We have learned that by having a proper tax system, we can increase output, and we can stop a decline. If we have the wrong kind of tax system, we tend to depress output when we might have had a higher output.

For example, take the present situation. At the present time inflation concerns us. I'll say a word about inflation with taxes a little later on. But, obviously, we have had a considerable inflation. In the last two years prices have gone up more than six percent.

Now, this is almost a record for peacetime, especially when the Federal Government's budget is balanced. It's rather surprising that such a large price increase occurred when the Federal budget is balanced, because generally prices increase when the Government spends more money than it collects in taxes. Therefore more money is created for the Government, this money is spent in competition with existing money, and prices tend to rise. That is partly because of the fact that against this rise in the supply of money there is not a corresponding increase of output of goods and services.

When output is high, when operation is at a relatively full capacity, an increase in the supply of money brings about a rise of prices. As a matter of fact, in the last year and a half the Government has increased the supply of money very little, as little as we have ever had in such a prosperous period; but, nevertheless, we've had a serious rise of prices. The explanation of this in part is that the existing supplies of money have become more active. People tend to spend a dollar quicker than they used to. The average dollar circulates more rapidly. This also can bring about an increase in prices.

That's one reason the administration has failed to stop the rise of prices--becauses, although they have been pretty successful in stopping the rise in the supply of money, they have not been successful in increasing the amount of spending.

Now, if you get the general line of my argument, then, of course, what I'm trying to say is that if this modern fiscal theory is correct, what we really ought to have now is a rise of taxes. The arithmetic is simple, because if people are spending too much money, and we do not seem to be able to stop this rise by monetary policy, that is by reducing the supply of money or keeping it from rising so much, then what is to be done? The answer is take some of this money away from people. How is money taken from people? Through taxation.

So as an economist I would say that probably the correct policy today would be an increase in tax rates. In that way you would have the most effective fiscal policy in dealing with this problem of inflation.

But as a political economist I am not so sure that this is correct, because, as you all know, both the Democratic and the Republican parties, both seeking votes, are just vying with each other to see who can come up first with a reduction of taxes, not a rise of taxes, because the average American thinks in terms of the tax he has to pay and doesn't see the relationship between the taxes he pays and the inflation.

Now, the average American is very much discouraged over the rise of prices, the inflation, and is against any party that is held responsible for this rise in the cost of living. Therefore you would think the average American would also be in favor of a rise in taxes so long as the inflation continues. But that's not true, because the average American is either ignorant of the relationship of these two problems or else, even if the average American sees these two problems in general, he's sick of taxes and the one thing he wants to do is to reduce taxes.

I think the major explanation is that the average American doesn't like taxes and doesn't like inflation. So there is a conflict here, which is fairly serious. I think as a political economist what I would certainly suggest would be to take into account the political difficulties; that the one thing we should not have is a decline of taxes. But I think to push for a rise of taxes in the present situation, given the views of the average voter, is being unrealistic. And therefore we ought to compromise perhaps on keeping tax rates at their present level until the inflation stops.

Now, if we get a recession, then I would think that there would be a good deal to be said for a cut in taxes, because then by cutting taxes, people would have more money to spend and this would be an antidepression measure. But as long as inflation is a great threat, a cut in taxes is a mistake. And by a cut in taxes I mean a cut in tax rates.

Now, suppose we had a depression or a recession in 1958. Then the objective would be to deal with the depression, and one way of dealing with a depression is to reduce taxes. This is a very easy policy to achieve, because people want lower taxes and the economist says lower taxes are the proper attack.

In 1954, you may recall, there was a recession, which was partly brought on by a dear money policy; and the Government immediately introduced one of the most elaborate tax reduction programs in the history of this country. This tax reduction program is costing the Federal Government about $9 billion a year today. This is a very large tax reduction. But this is a very popular policy. The administration had promised a tax cut, and this was their opportunity to achieve it. So we had a cut in taxes in 1954, which helped end the recession. It played a very important part in bringing about the end of the recession.

Now, you might say that a reduction at that time of $7.5 billion is not a big factor with a gross national product of $400 billion. But one mustn't forget that there are secondary effects. These tax cuts especially favor the businessman and therefore encourage him to invest more. So you have secondary effects. The net result was that the total amount of spending rose a great deal as a result of this particular tax policy.

Let me just say a word about the relationship between taxes and spending. You may recall that in 1954 the Government not only cut taxes, but they also cut spending. If they had not cut spending, they might not have been able to cut taxes. You may recall that there was a large cut in defense spending, of the proportion of more than $10 billion a year. This is a major cut.

Now, was this a wise policy? Well, there you run into difficulty. Obviously, one objective of economic life is to have a stable monetary unit. We don't want inflation, because inflation interferes with production, makes people more speculative-minded. And inflation brings about injustices.

Inflation and deflation bring inequities and therefore cause political disturbances and difficulties. If you look around the world and see a great amount of inflation, you have one of the important causes of difficulty. Deflation with falling prices is also troublesome. The deflation, for example, of the early 1930's had much to do with the rise of prices.

Now, in Germany after the war you had a rise of prices of a *billion* times. That's large compared to our price rise. In Hungary after World War II we had the largest rise of prices in the history of the world--10 to the 17th power. That's quite a rise of prices. You can see that would contribute to discontent and political difficulties. So we don't want inflation and we don't want deflation if we possibly can prevent them.

But there's a conflict sometimes between objectives. The whole problem is conplicated. If you look at the problem of recovery in 1954, there should be no cut in expenditures. If the problem is incentive to produce, there should be a cut in taxes, because the businessman says his taxes are too high. If you look at the problem of deflation, you probably should not cut the expenditures, because you want to spend more money in order to keep spending up and stop a decline.

But there's another issue here. There's the issue of defense. There's another important objective of the American Government--to keep the defense at an adequate level. I would say on that basis--and this is the opinion of an amateur and you all know much more about this than I do--that the $10 billion cut in defense was a mistake; that the defense problem was even more serious than the problem of stability of the currency.

This is a matter of judgment. You may disagree with me. But as a matter of judgment I would say the Government went too far in dealing with the incentive problem and cutting Government expenditures and concentrating its cut very largely on the military.

I think the recent cut in military spending is also a mistake, because I think that it reflects an over-weighing of the short-run economic issue. As a matter of fact, the cut was quite important on a long-run viewpoint too. After all, is it worth saving $10 billion a year if this makes the Russians so much more anxious or willing to take a risk? And they're more willing to take a risk if the American defense is inadequate.

Now, let me say a word about the relationship between Federal, State, and local taxes. Of course, at the present time we discuss primarily Federal taxes, but you mustn't forget that in many ways State and local taxes are much more important. They're more important in this sense: They're more important in the sense that they're growing much more rapidly than Federal taxes. Since 1946, State and local taxes have increased by 200 percent. They are now roughly at the level of about $40 billion a year, and most experts expect that in 10 years State and local taxes will be at the level of $60 billion a year. The Federal Government is now spending $70 billion a year.

The reason for this is that there are a great many services that the State and local governments are responsible for--roadbuilding; education. The public schools, for example, most experts expect, will require $20 billion a year within ten years, as compared with roughly $10 billion now. That's going to be financed primarily by State and local governments. Then there are the suburbia, one of the most serious problems. We have scarcely launched a program, and the burden on State and local governments will be great.

As you know, there's been much talk about some cooperation and integration between the Federal and State and local governments. The President of the United States has set up a committee of his own assistants and the governors have set up a committee and they're consulting on this issue at the present time.

The Federal Government feels quite strongly that the State and local governments should take over more responsibilities and leave less to the Federal Government. The State and local governments, however, say: "We'll be glad to take on these responsibilities, but you've got to see that we get the cash." There's no use having responsibilities if they cannot be financed.

Well, how to solve that problem? The Federal Government in 1954 said that they would very much like to do this: "We're giving the people a tax cut of seven and a half billion dollars," Mr. Eisenhower said. "In these circumstances why don't we allow the State and local governments to do more? There are seven and a half billion dollars of taxes available to them now. They can use these taxes, and go ahead; depend less on the Federal Government."

But this is nonsense, because, you see, actually this money is not available to the State and local governments. It is not available to the State and local governments because every State and every locality watches very carefully the taxes that it levies in competition with its industrial rivals. If for example, the State of Massachusetts had said: "Well, now, isn't this wonderful. We can raise a couple of hundred million dollars"--as a matter of fact, if Massachusetts took its share of this Federal tax cut, it would have enough additional revenue to double its tax revenue--it wouldn't dare do it, because Massachusetts would lose industry to Connecticut and New York State. Massachusetts has the highest corporation tax in the country and one of the highest income taxes in the country. Just imagine what would happen if they had exercised their right to increase taxes. The National Association of

Manufacturers and other groups would immediately have gone after Massachusetts and every businessman in the country would know that Massachusetts is not the place to establish a plant. And with textile plants closing down and moving out, where would Massachusetts be or Rhode Island and any of the other states if they tried to deal with the problem in this way?

So if the Federal Government and the State and local governments want to deal with this problem in an honest and fair way, then what the Federal Government should do if they want the State and local governments to assume more responsibility is to collect the money for these State and local governments and turn it back to them. This is what the President probably should have done with part of this cut of $7.5 billion. Then they would have gotten around this problem of interstate competition.

Well, let me just deal with two other problems in the time that is available to me. One of them I have already touched on, but I want to dwell a little further on it in relation to taxes and spending. That is the problem of inflation. That is one of the most serious problems and this is an area where the whole tax and spending program of the Government becomes very important.

As I said before, one of the features of the present inflation is the fact that we have it despite Government budgetary surpluses. Ordinarily inflation is supposed to be associated with what the Government does. Inflation is always the Government's fault. The Eisenhower administration can honestly say: "You can't blame us, because, after all, we are spending less money than we collect and using some of it to pay off the national debt."

Then why do you have inflation? Well, we have inflation in part because the Government has not done a very good job of controlling inflation. And that's partly because of the fact that it depended too much upon monetary policy, as I have just suggested.

I am sure many of you will say, "Well, isn't the real cause of inflation these wage increases?" There's no doubt about it that wage increases contribute to the inflation. Now, why do wage increases contribute to the inflation? Because if you have a full-employment economy, and you have the people spending more money than is given you by the flow of goods at the current price level, then obviously prices begin to rise. But if you have relatively full employment, the worker is in a good bargaining position, because there are always plenty of alternative jobs. And the businessman, with rising prices, is in a position where he can pass a large part of these costs on to the tax collector. And in a full-employment economy, with everybody wanting more and more goods, he can also pass these costs on to the consumer. So in a sense you have a conspiracy between the employer and the worker, and they're all conspiring against the rest of us--teachers, Army and Navy people--who have relatively fixed incomes, and anybody who's living on a pension. This becomes a very serious problem.

Now, don't ask me how you're going to stop this. It's a very difficult problem to deal with.

I think one thing you can say is that perhaps if somehow or other we could make it a little bit more difficult for the employer to pass the wage increase on in higher prices, it might help. This might be done partly by antitrust administration. It might be done partly by not so freely allowing increases in wages to be deducted from gross income reported for taxes. If that were done, it would put some restraint on wage increases that are not justified by a rise in the productivity, because in that case the employee would be more likely to oppose a wage increase which could also bring on inflation. There's no doubt about that. It is one possibility.

Now, of course, obviously, another approach, aside from the rise in taxes that I mentioned before, is for the Government to spend less money. This is possible within some limits. But here again you run up against another relevant objective of this Government. The Government wants to provide services, and military security is one of these services.

The Government might also feel that it wants to do more for education or health or roadbuilding. All these require the use of resources. This spending competes with private spending, and this tends to bring about higher prices than otherwise would prevail.

So we have to reconcile the objectives of giving good service, the kinds of service that only the Government can give, against the danger of inflation. This again becomes partly an ideological issue and is not merely economic.

Now, I can think of a number of other things that you could possibly do to cut down on the inflation. I think, for example, this tendency to put more responsibility on State and local governments may be a mistake, because, you see, the State and local governments depend primarily for revenue on the kinds of taxes that tend to be passed on to the consumer--the sales tax, the excise tax, the license tax, and so on. This is where they get most of their money. These taxes are passed on to the consumer and therefore are inflationary. If you look at a cost of living index number, for example, you will find that the largest increases in prices are exactly in those commodities on which the State and local governments have increased their taxes greatly in recent years.

Another field where we might do some good and cut down the rise of prices would be, for example, to deal with the problem of farm price support. Our present policy is stupid. We support the price of farm products and bribe the farmer into producing less, so that the price of all these things goes up.

Now, I'm not arguing against some help to the farmer, because I think the farmer over the years has taken the brunt of these economic adjustments. I would be generally in favor of some support for the farmer. But I think that it would be much more sensible to do it in another way--to say to the farmer: "We will guarantee you such-and-such an income. You produce as much as you want to." Then products would come on the market and prices would fall. In the price of a cotton shirt, for example, half generally is the price of cotton. If you could get the price of cotton down by 25 or 50 percent, this could have a considerable effect on the price of textile products. And so it is with all other farm products, including food products.

So I say that it's much better for the Government to spend its money by guaranteeing income and let the effect of farm policy be increased output and lower prices. This would have a favorable effect on the price levels.

In medicine we have one of the largest rises in prices in recent years. Now, why is that? That is because we have had this tremendous growth of health insurance. Virtually every American has some form of health insurance. This puts a great deal of pressure upon this particular market. We spend much more money on medicine; yet we do not get a corresponding rise in the supply of doctors, hospitals, nurses, and medical supplies of various kinds; and, obviously, this is inflationary. If we are to have a policy, a new program of financing medicine through insurance, then we ought to combine that with a policy for getting more resources into medicine. This can be done with a limited amount of Government stimulus of private programs of medical insurance.

Now, that gives you a few ideas about how tax and spending policies are related to inflation and how these different objectives clash. We have to worry about the stability of the currency. We have to worry about incentives; about the services that governments have to provide. These objectives are frequently in conflict and we have to make decisions among these various objectives. The decisions that are made will be determined partly by economic considerations, that is, the effect on output; but they will also be determined partly by ideological considerations, that is, what your view of a good society is. And there an economist cannot be of very much use. This is a society of individual decisions. An economist can only tell you what the effect is going to be on the economy.

I was asked by Dr. Kress to say something about public credit. I will devote the last ten minutes to that problem. Is the public credit bad? How important is the public credit?

Well, obviously, the public credit is a very important matter, because what we mean by public credit is, Can the Government borrow money? Can the Government borrow money under favorable terms? Obviously, if the Government is unable to borrow money, we're in a bad way, because the Government wouldn't be able to give the services that we require.

We can, of course, collect money through taxes. But the Government, after all, has to borrow and is borrowing all the time. Even if it has a surplus, as it has had the last two years, it still has to go out and borrow $20 or $30 billion a year, because every year a large amount of debt matures and the Government has to pay it off by borrowing an equal sum. This is one of the really tough problems that the Secretary of the Treasury has to deal with.

Now, those of you who have been watching the prices of assets--common stocks, Government bonds and so forth--know very well that we had a rather phenomenal change in the bond market in the last few years, particularly in the last year. For a period of about 20 or 25 years the price of bonds tended to rise. That's the same thing as saying that the rate of interest declined, because if you buy a $1,000 bond and you get four percent that's $40, that's four percent. Suppose this bond rises to a price of $2,000. Then the $2,000 bond, on which you receive $40, yields only two percent. This is just exactly what happened between 1930 and 1951. The average return on bonds declined from about four percent to two percent.

How is that possible? Especially how is it possible in view of the fact that the Government increased its debt from, say, \$20 billion to \$250 billion, which means they sold much more of this commodity, debt. Generally with plenty, the price falls, not rises. Why did the price of these bonds rise?

One reason was that the Government at the same time manufactured a great deal of money, which was used to buy these bonds. The Government manipulated the market. This was the Democratic policy. The Republicians didn't like it, and one of their primary aims was to reverse this policy. In 1953 they began reversing it. They began reversing it by showing an unwillingness to support the bond market. In other words, they said that anybody who buys bonds should sell them in a free market. In their view there should be no attempt on the part of the Government to keep up the prices of these bonds by manufacturing money to buy them.

Well, once you remove that peg--and it was only removed in a limited way--this, of course, would tend to have the effect of reducing the price of bonds; and that's the same thing as a rise in the rate of interest. If the price now drops from \$200 to \$100, the return would rise from two percent to four percent, the return still being \$40. This, of course, has happened--not to that extent but there's been one of the most serious declines in the price of bonds in 1956-57 that this country has ever experienced, certainly in the last generation, a most significant decline.

Now, that looks like a deterioration of the public credit position of the Government. The Government is now experiencing more difficulty in borrowing money. The effect of these policies has been that the cost of the national debt has gone up roughly from \$6 to \$7.5 billion a year. And if all our Government bonds had to be redeemed at the current rate of interest, as they will be eventually because every year a large portion of them become due, if this rate of interest remains at the present level, the national debt, instead of costing us about \$6 billion a year, would cost \$10 or \$11 billion a year.

The Government is worried about this. They're not quite sure what they want to do, because if they let this go on, their credit suffers, the rate of interest rises; and they're going to have more difficulties on that score. On the other hand, if they say, "Let's stop it," then they have to manufacture more money, and they add to the inflation. So this is a pretty tough decision for any Secretary of the Treasury; and I must say I'd just as soon not be Secretary of the Treasury right now.

That's the problem as it looks at the present time. And, what's more, the State and local governments are suffering even more than the Federal Government. You would be surprised at the difficulties school districts are having in borrowing. Their costs of money have gone up much more than the Federal cost.

Now, why should that be so? In the first place, these State and local governments are borrowing much money, partly to build schools and highways. Another reason is, the State and local governments have been in an especially favorable position because their securities are tax exempt and therefore they can borrow at lower rates. A rich man, for example, who has to pay 80 or 90 percent on his marginal income can buy a State or localGovernment bond and pay no taxes on it. And so if he gets three percent without having to pay taxes, that's the same as if he were earning 15 percent on an asset on which he would have to pay 80 percent tax. So this means that these people buy these securities in large numbers.

But, after all, there are only a limited number of people who have to pay 80 or 90 percent on their marginal incomes; and if governments keep on issuing these securities more and more, they finally have to appeal to the people with lower incomes, say $15, 000 incomes, to buy them. And the advantage of buying them at a $15, 000 income is not nearly so great as with an income of $100, 000. And therefore the tax-exempt privilege becomes less and less important, and therefore these State and local governments have to issue their securities at higher and higher rates of interest.

Now, let me say something in a more general way about the state of the public credit. I would expect that everybody is worried about the national debt. Most people think it is too high. Well, I'm one who doesn't believe that. Of course, the national debt can be high enough so that there could be trouble, where there is danger. There's no doubt about that. But let us look at the picture in a broad way.

If we go back, for example, to the early depression, when the national debt was very small, about $20 billion, we paid about $. 5 billion a year interest. Now we pay $7 billion interest. That's an increase of $6. 5 billion that we have to pay to finance our debt. How serious is this?

It isn't very serious, really, because we must not forget that then we had a gross national product of about $60 billion and now we have a gross national product considerably over $400 billion. We have had a rise of output of $350 billion, and a rise in the cost of financing the debt of $6-$7 billion. This rise is not going to wreck the country.

And I must say, as much as I admire General Bradley--I think he was a most distinguished soldier and citizen--I was troubled once or twice when as Chief of Staff he began worrying that the Nation was going to be bankrupt because of the national debt, and therefore that the military ought to be a little bit more careful about asking for cash to take care of our security. If I were the Chief of Staff, I would be inclined to say: "Try to get as much money as you can for defense. Let somebody else worry about what the national debt is going to do to the economy."

I would point out to you that since 1946 the burden of the national debt in relation to national income has fallen by more than one-half. In other words, the interest payments in relation to the gross national product are only about half as large as they were ten years ago. That's largely because we've had a rise of output, which brings the gross national product up; and we've had a rise of prices, which also brings the gross national product up in dollar terms. Well, that's a problem, I am sure, that I ignored more than any other in these last two minutes.

Let me end up simply by saying that I know I've covered this in a very superficial and hurried way.

COLONEL LACKAS: Gentlemen, Professor Harris is prepared to answer your questions.

QUESTION: You said that a good many economists are concerned about a recession or deflation. Would you care to give us your comment about the possibility of one?

DR. HARRIS: I'd be glad to, but don't go out and buy stocks on this basis or sell them. When anybody comes down and asks me for investment advice, I frequently say that my own investment record has not been very good.

Historically I would say this: That we have never in American history had a period of rising interest rates for such a long period that hasn't been followed by some business reaction. Now, I'm not going to say that we're going to have a recession. I would say that if we don't have a recession, this would be the first time in American history that this has happened in that kind of situation.

I would also say that I don't think that any recession we would have would be of the proportions of 1929 or even 1937, because a $100 billion of Government spending supports the economy floor. Then labor is well organized to keep wages from falling. We have a farm support program. We have a social security program. And what's more, the economists and the Government are much more aware of these problems and how to deal with them than they were 25 years ago. So in short, if you want my guess, my guess would be that we would probably have some kind of recession--in fact, there are some signs of it already--but I don't think it should be very serious; though it would be serious enough to bring some action on the part of the Government.

QUESTION: You mentioned the problem which the States have in raising revenue and keeping themselves competitive with other States which have similar business attraction problems. In the light of that, would you favor Federal grants-in-aid, if that is to be one method of solution, on the basis of the States who most need the additional revenue, or on the basis of the population of the States?

DR. HARRIS: Population, of course, is one index of need; but you wouldn't just put it on a per capita basis. This again is partly an ideological issue. My own feeling is that on the grants-in-aid we ought to take into account to some extent the economic capacity of the State.

Now, take schools for example. We have a Federal school program. Mississippi has about one quarter of the capacity to finance schools as compared with, say, a State like New York. That suggests to me that if you had a Federal program, say, a school construction program, there ought to be a difference in the amount per capita of money we give to Mississippi as compared to what we give New York.

Now, what's more, we will find that Mississippi makes a much greater effort in supporting her schools than New York. That is, a larger part of her income is going to schools than is going to the schools in New York, that is, of the income of the people.

So my reservations about grants-in-aid are the following: They tend to encourage a particular pattern of spending. What happens is that the Government has, say, a highway program. The States tend to allocate a large part of their resources on roads because they want to get in on this subsidy.

Now, one of the reasons we are having serious educational problems in State and local governments is that the Federal Government is providing virtually no money for schools except for the major defense areas. So the pattern of spending changes with more spent on highways, more on old age assistance and other kinds of assistance, and less spent on schools.

It's strange that in the recent construction program that the Federal Government sponsored, which the Republicans are sponsoring and the Democrats as well, the Democrats had a bill which on the whole tended less in the direction of favoring the poor States than the Republicans, that's rather a reversal of form, because generally it's the Democrats who want to help the poor. This time it was the Republicans who wanted to help the poor.

QUESTION: I would like to go back to your statement of the problem again. We have evidence that production is declining, that steel production is below capacity, prices of nonferrous metals are declining, and prices of houses are declining. Is it possible that we may have a new type of recession where we have inflated prices but at the same time an actual recession?

DR. HARRIS: That's a good question. This is one of the problems that troubles Congress a good deal. There was much talk in the Senate Finance hearings on that very problem, with say, unemployment, or at least production below full production in many industries. Housing is one and automobiles another and iron and steel is another; and yet we experience rising prices? The explanation of this is not too easy.

You see, it isn't quite as simple as some people think. You go into a really serious, extreme inflation, like, say, the German experience after World War I, and you have a somewhat similar situation, where a good deal of employment persisted because the Germans couldn't get the raw materials and whatnot. Production was at a very low level and yet they had this tremendous rise of prices. So our own experience is in a small degree similar to the German experience; you might say, after World War I.

That's why some of these Senators during these hearings embarrassed the Republican members of the administration when they came in and testified by saying to them: "Why are you so worried about cutting down the supply of money? This is not really a classical inflation. As a matter of fact, there are no shortages." They said. "There are excesses." Senator Kerr kept on this line for two days with Secretary Humphrey, trying to get Secretary Humphrey to admit that actually this is not a period of shortages, that this is a period of excesses, and therefore the administration should abandon money policies which cut down the supply of money.

QUESTION: Would you care to comment on whether the money policy of the Government has had a significant effect on stimulating corporations to finance their expansion out of their own earnings?

DR. HARRIS: Of course, this is another highly controversial point. You see, what the Democratic Senators were saying--and this was one of their objections to the dear money policy--was that the large corporation was becoming more and more important. They finance themselves very largely with internal funds. They do not pay out a large part of their profits in dividends but use this money to expand. They have special advantages therefrom. All of these corporations have access to the banks and the insurance companies. They borrow from banks and insurance companies.

Now, the charge that the Democratic Senators made was that this is just exactly what you would expect of a Republican administration--a dear money policy--that this cuts down the supply of money and favors the big business.

Here you have these big corporations with plenty of resources of their own that they can use for expansion if they want to. And not only that, but they have special access to the banks. And not only that, but they are generally in a position where they can take dear money, pay five percent instead of four percent, or five percent instead of three percent; and they don't have to worry about the increase in the cost of money because they can pass this on to the consumer, because they are in a good position to do that. They're largely monopolistic. This was the Democratic position.

Consider a little school district that is trying to build a school. They can't pass this on to anybody except try to pass it on to their own taxpayers. And this is really a tough thing to do at present.

Investment, you know, has been on a record level for years. This is another problem about the inflation. You see, the Republican administration tries to stop the inflation by reducing the supply of money. The whole classic theory of reducing the supply of money is to increase the rate of interest. You increase the rate of interest because you want to stop investment or cut it down.

Now, your question really comes down to this: Is this really the way to deal with inflation? If you want to stop inflation, do you really cut down the amount of investment? You mustn't forget that the one thing that cuts cost and therefore tends to bring prices down is increased investment, quicker obsolescence, etc. So that if you cut down investment by reducing the supply of money, you also cut down something that tends to reduce costs and bring prices down. And so you might argue that a dear money policy is not the way to stop an inflation.

QUESTION: You have indicated that you feel that if there should be a future recession, it probably won't be a very severe one. Do you think that in the long run it would be good for the country to have such a recession?

The present administration, you know, has been accused by the Democratic commentators of wanting to bring on a recession on the theory that it would be a good thing. In other words, they're arguing that maybe you're having a bad inflation now; that the more you go up, the more you're going to fall, and therefore the proper thing to do is to keep it from going up too much.

Now, if in order to do that you have to take the risk of a small decline, this is all to the good. With a small decline you can, for example, prevent even a greater decline later. As a matter of fact, you could look through the interesting hearings of the Senate Finance Committee that were held this summer and you would find that there's a good deal of testimony there on that issue--whether it wouldn't be preferable to have a small recession rather than a great inflation.

Of course, no Republican or Democrat would say this, but there are many people who believe that if you had a recession--we have now, say, three million people unemployed--supposing you get this up to five million people unemployed, wouldn't it be a good thing? This is the one thing that could stop these demands for increases in wages. That's another position taken by many people, although no politician, or very few, would dare say this publicly, though economists have said it publicly many times.

QUESTION: You mentioned earlier the collection by the Government of taxes in excess of its needs and passing these taxes on back to the States for their local needs. But wouldn't that put control of the State operations indirectly or probably directly in the hands of the Federal Government?

DR. HARRIS: That's a good question, because these are things that worry people a great deal and this is one argument against Federal intervention. This is true of the present school construction program--the fear that this might be giving the Federal Government control of education. This is not a problem of financing, a yes-or-no matter. Of course, if the prices rise enough, there's no doubt that the Federal Government does take over. This always does happen when there is real trouble, like a war, when the Government's position becomes much more important.

Now, how risky is it? How much danger is there that if the Federal Government collected this money, it could do it in such a way that it would finally take over control of all the functions? Could it, for example, say to the State Education Commissioner: "You've got to teach a course in American history which shows that everything that the Russians do is wrong" or something of that sort or "You must teach a course in American history which shows that Abraham Lincoln and Teddy Roosevelt were heroes and Franklin Roosevelt was a rascal"? This is the sort of thing that people worry about.

We've had a great many educational programs on the part of the United States Government and there have been virtually no charges that the Government has ever really interfered in the administration.

I was asked by a high official in Washington why my State of Massachusetts does the following, and they're very much annoyed that this is true: In the social security program, which the Federal Government provides the cash for from its own taxes, the Federal Government is unable to force the State of Massachusetts to require an educational requirement for anybody who works in the Social Security Administration in Massachusetts. Now, you would think that this is something that the Federal Government would have a right to do, wouldn't you? They are providing the cash. Why is this true in Massachusetts? It's true because the local politicians are determined that everybody should have a crack at a job and education doesn't matter, and some of the people they're interested in finding jobs for don't happen to have the requisite education.

So the danger may be exactly the reverse when the Federal Government gets into this--that it doesn't take over enough control. I think you'll agree that at least they ought to have that amount of control. In their program what they generally require is some civil service standards of hiring and so forth. Unemployment insurance, which I think works very badly in many ways, works badly partly because the Federal Government refuses to set standards; just lets the States do as they please. The result is that we have a program that's not nearly as good as it might be if the Federal Government were setting standards.

QUESTION: I note that you are quite concerned about the adequacy of defense spending. In view of all the social programs that are demanded of the Federal Government, do you feel that we can now increase Federal spending for defense without increasing taxes?

DR. HARRIS: Well, I would say yes. Of course, if the defense program is important enough, I think we might even be able to cut down on some other spending programs. I don't think myself that that would be necessary.

As a matter of fact, the welfare programs of the United States Government relative to the gross national product have fallen greatly since before the war. In other words, the Federal welfare programs have become much less important as compared to what they were before the war in relation to the gross national product or in relation to Federal Revenue. The reason for that is in part that defense is taking up so much additional Government spending.

Now, why is the situation so serious? For example, take the last four or five years. In the last four or five years we have had a rise of gross national product of $50 billion. All the experts say that with good management we're going to have a rise of the gross national product of $150 or $200 billion in the next ten years. Automatically the Federal Government would get $40 billion of additional revenue without changing its tax structure or increasing the tax rates.

Now, why shouldn't some part of these $40 billion be mortgaged for defense if this is necessary? I am absolutely convinced, as I've watched this thing carefully, that a large part of this cut in Federal spending for defense has been a result of the pressure by the budget economizers who believe that it's more important to keep the tax rates down than to have adequate defense.

Present-day taxes are not greatly damaging the economy. We have an average rise of output in real terms of three percent a year, or two and one half percent per capita. This is tremendous. This means we double our income every 30 years. This is what's been happening. So you see that the present tremendous increase in taxes hasn't really had any serious effect on incentive. If it has, why have we had this full employment and rising standards all these years?

So I think we can exaggerate the burden of taxes. I myself would be inclined to spend more money on defense, or at least recommend more spending on defense, even if it involved a somewhat heavier tax burden. As I say, it doesn't need to involve a heavier tax burden, because we can take it out of the growth in the economy. We can, for example, have more nondefense spending, we can have more defense spending, and yet we can still have a cut in tax rates in the next ten years.

QUESTION: You mentioned earlier the rise in inflation of three percent over the last year, I believe. Do you feel that it is possible to have a stable economy over a period of time without either a serious depression or a so-called creeping inflation?

DR. HARRIS: That's a good question and it's a hard one to answer. From 1948 until the outbreak of the Korean War we had stable prices. And from 1953 until 1955 we had really virtually stable prices. There's no doubt about that. But I think this was probably accidental. For example, in the 1953-1955 period we had this big decline in agricultural prices. This was what made possible the stable prices.

I think we realize much more than in the past how we can stabilize our economy. I mean, we have a fairly good idea of what is required as economists. But that's not enough. We have also to convince the politicians. And even that is not enough, because the politicians have to convince the public. The politicians are not going to do what they know is right if the public isn't convinced, because then they're going to lose votes.

Now, you take this present controversy as to what is the best economic policy. What is the conflict? Well, the conflict comes down to a considerable extent to this: On the whole the Democrats take the position that if you try to stablize the economy too hard--which is what they claim the Republicans are trying to do--you don't have that precise control of the economy which will result in a stable price level. If you try too hard to stabilize the price level, you are endangering the economy and perhaps may bring about a fall of prices and a depression. So the Democratic Senators said: "Let's not be so precise. Why not have a one percent rise in the cost of living in a year if it is accompanied by a five percent rise in output?"

So that this is a concrete way in which this argument is reflected. The Democrats and their advisors feel that we have pretty good control, we know what we want to do; but our instruments are not too precise. Therefore if you try to stabilize the economy too earnestly, you are going to bring about a depression. And they say, "Let's have a little increase in the cost of living and have a rise of output. It's better to have a rise of output, a five percent increase in output or a three percent increase in output, and a one percent in prices than have a two or five percent fall in prices and a depression, which might cost $100 billion.

QUESTION: You have indicated that perhaps a better policy relative to farmers would be to guarantee them an income rather than to have price support. Wouldn't this have a tendency to decrease farm output rather than to increase it?

DR. HARRIS: Well, this guarantee of income would be in terms of prices. In other words, I mean that you wouldn't guarantee a farmer a $5,000 income if he went out of business. The theory is that this is related to the amount that he produces. In other words, you would say, for example, "You produce as much wheat as you like. You sell that wheat on the free market at, say, one dollar a bushel--the difference between a dollar and two dollars." And then if they find, for example, that they are getting too much income as a result of this, they will say, "Hereafter we will only guarnatee you a price of $1.80."

QUESTION: I gathered that you would differ with Mr. Humphrey in your definition of a tax and that you would add to the collection of money the control of money; that is, if you add to the tax, you reduce the velocity of money. If I am correct in that, then do you further believe that you could accomplish the same thing through wage and price controls and excess profit controls?

DR. HARRIS: That's an interesting question. I suppose if you were facing it seriously enough, that's what you would have to do. That's what you do in wartime. You tell businessmen that they can't raise their prices. If we had a war, there's no doubt that all these things would be done in a more serious way than they were done in World War II.

As to how far you can go now, I would myself think that it would be unwise to try to control wages and prices at the present time, I don't think the situation is serious enough for that. Remember I said I would be willing perhaps to put a little pressure on the employer in relation to taxes, so that he wouldn't be absolutely sure he could pass them on to Uncle Sam every time he allows a wage increase. This would tend to cut down some on wage demands. It would tend to cut down on inflationary pressures, especially with some of the corporations.

Now, if you had an increase in the price level of, say, 10 percent a year in peacetime, I would be inclined to go further. This would be a matter of judgment. You might not. You might say, "I don't care if prices go up 100 percent. I don't want the Government telling me how to fix prices or wages or anything of the sort." Well, this, of course, would be a question of what the public wanted. I think if the prices went up 10 percent in each year, you would hear the public yelling for price control. Enough politicians would have their ear to the ground to plead for it.

COLONEL LACKAS: Dr. Harris, on behalf of the College and the faculty, I want to thank you for a clear and precise statement on taxation and revenue. You have demonstrated that the economists, in contrast to the politician, can think about these things dispassionately.

(6 Jan 58--4,200)B/ljt