L60-29
cop. 1

PUBLIC FINANCE

Dr. Seymour E. Harris

NOTICE

This lecture has not been edited by the speaker. It has been reproduced directly from the reporter's notes for the students and faculty for reference and study purposes.

No direct quotations are to be made either in written reports or in oral presentations based on this unedited copy.

Reviewed by: Colonel Tom W. Sills, USA

Date: 29 September 1959

INDUSTRIAL COLLEGE OF THE ARMED FORCES

WASHINGTON, D. C.

1959-1960

PUBLIC FINANCE

22 September 1959

CONTENTS

	Page
INTRODUCTION--Colonel Raymond J. Harvey, USA, Member of the Faculty, ICAF.	1
SPEAKER--Dr. Seymour E. Harris, Chairman, Department of Economics, Harvard University.	2
GENERAL DISCUSSION.	30

NOTICE

This lecture has not been edited by the speaker. It has been reproduced directly from the reporter's notes for the students and faculty for reference and study purposes.

No direct quotations are to be made either in written reports or in oral presentations based on this unedited copy.

Reviewed by Colonel Tom W. Sills, USA, 29 September 1959.

Reporter: Ralph W. Bennett

Publication No. L60-29

INDUSTRIAL COLLEGE OF THE ARMED FORCES

Washington, D. C.

PUBLIC FINANCE

22 September 1959

COLONEL HARVEY: General Mundy, Gentlemen: In our Economics Course up to this point we have reviewed the monetary system, the relations of supply and demand, the Federal Reserve and commercial banking organization, and international economic policies and world trade. Because of ever-expanding governmental activities, and particularly the continuing heavy defense expenditures, the manner in which the Government raises and expends its funds has a vital impact on our entire economic system. So this morning we shall turn our attention to the problems of taxation and revenue, budget and fiscal policy, and related aspects of public finance.

Our speaker today is particularly qualified to discuss the complex and all-important subject of Government fiscal policy. As you have noted in his biography, he is a distinguished educator, the author of numerous books and articles in the fields of economics and public policy, and has served the Government on various committees and boards.

His continuing interest in the Industrial College is attested to by the fact that this is his third appearance here and that, to use his own words, "It is only by super-effort that I can make it, but I shall be glad to be there."

The subject of his lecture this morning is "Public Finance." I am pleased to present Dr. Seymour E. Harris, the Chairman of the Economics Department of Harvard University.

DR. HARRIS: General, Mr. Chairman, Gentlemen: That sounded awful--this business about a super-effort. I should explain that. Actually I am supposed to be on leave since 30 June and therefore I was inclined not to do any lecturing this year. That's why I put that particular phrase in.

I ought also to tell a story which I think I have used here before, and I hope at least Mr. Kress would forgive me; namely, this business of writing books. I have written a great many books, but I can only tell you that one of my colleagues once introduced me to the Federal Reserve and he said: "You all know Seymour Harris. You have all read his books or written them for him."

Now, I might take another minute and tell you that I think the Army is getting awfully soft, because the first time I lectured to an Army class was way back in 1925 and 1926 up at the Watertown Ordnance School. At that time I used to lecture from 1:30 till 5 straight. And one day one of these--in fact, more than one day--officers--it was a major, I believe, at that time--of infantry, fell asleep in the middle of the class. He did this quite conscientiously for quite a number of weeks. So when we were asked to grade these people, we were asked to grade the man

for effort, et cetera, et cetera. When it came to effort, I gave this man a "C." A few weeks later he came around to see me and said he was offered a commission as a result of it. This was a great surprise, because he was really about the best man in the class despite the fact that he slept throughout the whole lecture. Well, I have been warned not to speak for more than 45 minutes, and I shall try to adhere to this request.

I might say I have certain ideological views which affect my economics and vice versa; but Mr. Kress told me that you're going to have Dr. Jacobson here, and he will more than neutralize anything that I have to say on it. So you'll get all views.

Let me first give you some idea of what public finance is. Of course it's the extent to which the Government operates in the economy. And, of course, as we all know, the Government has become a much more important factor in our economy. I'll just give you a few statistics to indicate what the situation has been and what it is now.

Going back to 1929, at that time the gross national product was $100 billion. All governments were spending or buying goods and services equal to $8 billion, or about 8 percent. And of these $8 billion the Federal Government was spending only a little more than 1 billion and the State and local governments a little more than $7 million. So you see, the State and local governments were about six times as important as the Federal Government; and altogether they were only

taking 8 percent of the total product. And defense was taking a very small sum compared to the rest--considerably less than a billion dollars.

By 1958 the gross national product was $437 billion. The Government was purchasing $91 billion of goods and services. That's more than 20 percent. Of these 91 the Federal Government was 52 and State and local governments 40. So, you see, the Federal Government had become much more important than the State and local governments. And also by 1958 defense was taking $44 billion.

Now, that doesn't give you a full idea of what the Government does, because you have to take into account a certain amount of spending that doesn't get into these figures. The way we have our national account--and I understand this has been explained to you at the last lecture--we have Government purchases of goods and services, which, as I say, in 1958 were $91 billion; but the total tax receipts were $114 billion, not 91. The reason for that is that there are a great many expenditures that are merely transfer payments, as, for example, under old age insurance, unemployment compensation; and these don't get into this picture of purchases of goods and services. So when you look at the whole tax burden, it's not $91 billion but $114 billion. And that's because your transfer payments are so important.

You must not forget also that there are certain expenditures in the budget that are not really counted. They're not part of the

budgetary expenditures, or they are not part of the budget that the President presents, for example. Take this great interstate highway system that is being built, largely with Federal money right now. This is a 13-year program and it's going to cost $40 billion. This is not in the budget. It's built up to a special trust fund and largely financed through gasoline taxes, but does not enter as either expenditure or tax in the budget. You see, your budget is really larger than it seems to be.

Now, of course, one reason for this great expansion of governmental activity is the position of the Nation vis-a-vis these foreign nations, that is, our security problem. This is probably the largest single factor. But another point is, of course, the great depression has resulted in the Government taking much larger responsibilities than it did in the past. The Government, for example, even today spends $6 billion to keep the price of agricultural products up primarily. It spends $6 billion to support the agricultural population. And there are many other programs that I need not go into here.

Now, the next problem is the problem of what is a sound tax and revenue system. Well, there are all kinds of criteria of what a good tax and revenue system might be. For example, everybody

feels a good tax system should be one that's equitable among different groups and different people. That is, the burden should not be excessive on the poor. From that viewpoint many believe that a tax system should be progressive, as our system is. By progressive system, as you all know, we mean simply that a larger proportion of the income of a wealthy man is taken by the Government than of a poor man. If a poor man, for example, has an income of $1,000, you take, say, 10 percent of it. If a man has an income of $100,000, you take 80 percent. That's the general idea of progressivity.

Our tax system is progressive now largely because the Federal Government accounts for a large part of total revenues; and the Federal Government depends to the extent of about 80 percent on income and corporation taxes, and these are at progressive rates, particularly the income tax. The corporation tax is progressive in the sense that most of the people who get the income are relatively wealthy, and so they're taxed and others aren't.

But our State and local tax system is on the whole what we call regressive. It takes a larger proportion of the income of the poor than of the rich. But since this is a relatively smaller part of the total tax picture, the net effect for our whole system is a system that is progressive, that takes a larger part of the income of the relatively well to do.

Now, that doesn't give you the full picture either, because another issue here is that although the tax system looks very progressive--for example, a man with an income of a couple of million dollars will pay 91 percent of his last million dollars, say, or his last hundred thousand dollars, or whatever you have--actually we have studies that show that very few people, even the very wealthy, pay more than about 40 percent of their total income despite the fact that on paper it looks as though they would have to pay 80 percent if they have an income of, say, a million dollars or more.

The reason for this is that there are all kinds of legal ways of evading your taxes--through capital gains, where you only have to pay 25 percent, through depreciation allowances on oil, and so forth. So though our tax system looks like one that's a great burden to the relatively wealthy and might have serious effects on incentives, actually there are so many loopholes in our tax system that the effects on incentive are not very serious. And if you don't believe that, all you have to do is to look at what's happening to corporation profits or what's happening to gross national product. Our gross national product has gone up three and a half times since 1929, and it's gone up a couple of times even when you allow for the change of prices. So we have had a very prosperous and a growing economy, especially since 1940.

Now, of course, one of our great issues and the question of what kind of a tax system we have and how much does it take away depends

partly upon the decisions of the public about how they want to spend the income that they get. I think in a general way the public doesn't like to pay taxes. And so they tend to underexploit services that the Government might render. They would rather have their cash and spend it the way they like to spend it rather than have the Government spend this money on health or security or education or anything else. And therefore, to some extent--at least it is my view--we underspend for education, for health, and other services of that kind. My own guess is that we underspend on security as well. But I'm sure that you are much more expert on this than I am.

The present Administration--you can gather as I go along that I am probably a Democrat rather than a Republican; so you have to some extent write down what is implied in anything I say. I try to be apolitical, but I don't always succeed. The President's 1954 tax reduction bill, which was the big tax reduction bill we have had in recent years, on the whole tended to favor the high-income groups. The explanation of this is that the President and his advisers believe that taxes are too high; that the taxes can have an adverse effect on incentives; that in order to have a prosperous economy you have to have more investment; and if you have more investment, then, of course, you will have more wages, more employment; and this will in the end help the poor as well as the rich. There's a great conflict here between

the Democrats and the Republicans, because the general Republican view is that if we have a tax reduction program, we should especially favor investment. That means getting down the high rates that affect the amount of saving and the amount available for saving of the high-income groups. And the 1954 tax bill was based on this theory. Most of the gains went to the relatively high-income groups.

The Democrats, on the other hand, thought of this as the "trickle-down" theory of taxation, namely, that you give the breaks to the rich and the poor will ultimately gain through the trickle-down of these windfalls to the relatively wealthy.

Now, the next issue is the problem of taxation and fiscal policy. I am following an outline that was really suggested by Dr. Kress; and if you don't like this particular presentation, at least the order of it and the subjects covered, you should blame Dr. Kress and not the speaker. I think it's a perfectly reasonable order, I might say, and I was very glad to follow it, because I didn't find it difficult and it seemed to me that in 45 minutes it covers the problem quite well. I once gave a course in public finance that took a whole year for three hours a week and covered the same ground. So this is a distillate of a distillate.

Now, taxation and fiscal policy. What do we mean? Fiscal policy is something new in economics. We always used to talk about public finance. Now we tend to talk much more about fiscal policy. What

we mean by fiscal policy is the use of the taxing and spending power of the Government and debt management in such a way as to effect the greatest good for our economy. In other words, we levy taxes in such a way and in such amount and we spend in such amount and in such a way and we manage our debt in such a way that we have the maximum beneficial effect on our economy or the minimum damage to our economy. That's the theory of fiscal policy.

Under fiscal policy the major principle is simply this; that if the private economy spends less, and therefore helps bring on a depression, it's the job of the Federal Government, or any other government, to come along and offset this decline in spending on the part of the private economy to keep our economy prosperous. It's based on the theory that in order to have a prosperous economy, you must not only have a highly productive and advanced technological economy, but you must also be sure that if you can produce more and more goods, there is somebody around to buy these goods. Therefore you have to influence demand and purchasing power.

Now, the way you influence purchasing power is partly through monetary policy, creating enough money. In modern times, in recent times, the emphasis has been put increasingly upon fiscal policy; and that means that when the economy is spending too little, the Government fills the gap through spending more, particularly through deficit

financing. And if the economy is spending too much and we're having inflation and so forth, it's the job of the Government to cut down on spending. The Government is supposed to do that by taking in more than it spends and paying off part of the national debt. This is a very simple theory and it sounds beautiful. The arithmetic is very simple, but actually in practice it raises all kinds of difficulties.

For example, we might argue that now, in 1959, we're in an inflation economy, that there is great danger of inflation, and therefore the Government ought to meet this problem head on by spending less and taking more money in taxes. So when people lose money through taxation, there would be less money available for them to spend in the markets of this country.

But it's almost impossible to get a rise of taxes right now. The public doesn't want to be taxed any more. And any Congressman who proposes an increase in taxes is likely to lose his job. And so the Congressman is not very enthusiastic about a rise in taxes. He says: "This is all right for this theory of the new economics; but these guys that write this economics don't have to face the voter every two years."

This is, of course, one problem. The other approach, of course, is to cut down spending. But, as has been noted so many times, your security takes about 80 percent of the budget. Now, if your security takes 80 percent of your budget and you're in the midst of a contest with the Communists, how can you cut down on your security expenditures?

So it's a very difficult thing, because your economy is expanding too rapidly and your resources are all taken care of and you tend to pour more and more money into the limited field where you can't produce very much more, and if you spend so much more, prices will rise with limited resources and limited flow of goods and services, you can't cut down the demand or the spending by a proper tax or public spending policy, then you've got to accept some inflation as the price for security.

So in a general way what I'm trying to say is that the objective of fiscal policy is a very good objective, but it isn't always very easy to achieve. And therefore, even though the Government might like to contain inflation by these various fiscal policies, in practice it's not easy. And when you have a recession, it's somewhat easier for the Government to do something that bothers than it is, unless you have a great depression like the thirties--actually our major recessions since the war have been handled reasonably well by Government; so you could say the fiscal policy has been quite helpful in these more recent recessions.

I could, for example, give you some idea how fiscal policy works, though I would myself claim that the present Administration is not nearly as much wedded to the theory of fiscal policy as, for example, the Democrats on the average are or as I am. I am more wedded to these theories than the Democrats are. The Democrats are much more

wedded to these theories than the Republicans are on the average. I mean, on the average, the average Democrat and Republic, because there are many Republicans who are much more wedded to these theories than some Democrats are.

Nobody can be wedded less to this theory than Senator Byrd, for example. I almost every year will go down and testify before the Senate Finance Committee, and I've noticed every time I would come down--I don't come down because Senator Byrd is so happy to have me come down, because he really isn't. He looks very unhappy every time I appear. But there are some Democratic Senators who are always sort of peeved with Senator Byrd for inviting me down. And I noticed the last time I was down, which was just about a year ago, in 1958, the Senator was very cordial to me, which sort of surprised me. He smiled and he said how glad he was to have this distinguished professor from Cambridge down here and all that sort of stuff. And he looked and smiled half the time during the evidence and didn't scowl, and when I got through, he delivered another oration about how helpful I'd been and this puzzled me greatly. I thought perhaps Senator Byrd had been influenced by my great teachings and what not.

So I know his secretary. She's a charming woman and has been with him for many years and knows him very well, I said to her one day: "Well, now, Miss So-and-so, why was the Senator so sweet to me

today?" She smiled for a minute and she said: "Well, I'll tell you why, The Senator thought"--you know, right in the middle of the session and I was recommending a tax cut and an increase in public spending, and I said: "After all, this is not the kind of medicine that he really approves of and why was he so sweet?" "Well," she said, "I'll tell you, but don't tell him that I told you. The reason is that he expected you to ask for a $15 billion tax cut and you only asked for a $3 billion tax cut."

Well, now, if you look, for example, in 1958 and 1959--you see, we had the recession in 1957 and 1958, middle of 1957 and the middle of 1958--and then in the middle of 1958 we began to have a recovery from the middle of 1958 to the middle of 1959. The President--and you may have noticed, he made this remark just a few days ago--said that he was very glad that he didn't take the advice--he didn't mention Harris, of course--I don't know whether he knows that Harris is alive, though I did have one conference with him actually--but he said "I didn't take the advice of these people who felt that unless we did something really radical, we would be in more trouble." He said: "Actually, you see, we had a good recovery without the Government interfering very much. This goes to show that the economy is very resilient and responds to depression in a very effective way."

Well, now, we had a recovery in 1958 and 1959, which was a good recovery--from the middle of 1958 to the present. Then when you try

to see now what brought about this recovery, why did we get this--actually it looks now as though in 1959 we're going to have a rise in the gross national product of about 8 percent, which is a very large rise--how did this happen and how do you explain it?

Well, my explanation is--and I am sure many of you will disagree with me on this--but my explanation is that it was this wonderful $13 billion deficit that the Government had in the fiscal year ending 30 June 1959, which they abhorred. This was the thing that really gave the economy the lift. And they didn't have to do very much to achieve this $13 billion deficit, because we have a tax system which was built up particularly in World War II and to some extent in the 1930's --we have a tax system that automatically responds to a depression. So that if your income falls, without any legislation on the part of the Government, you get a substantial cut in taxes; and about half of these $13 billion deficit is explained by the fact that we had something like a $6 or $7 billion drop in our tax receipts. It came automatically without any action on the part of the Government in response to a fall of income. This helped a great deal.

Then on top of that--you see, because of our total decline of gross national product from the time that we began to decline over a period of about nine months, was only about $17 billion. This is much more serious than it seems, because actually in a period of that kind, in

order not to get an increase of unemployment, you have to have a rise of gross national product of something like $20 billion. So instead of getting the normal rise of 20 billion--well , not 20; perhaps 15 for nine months--$15 billion rise that you would expect, and if you don't get the $15 billion rise, you get a rise of unemployment, because our economy is becoming much more productive; and as it becomes more productive, you squeeze workers out. In order to put these people back on the labor market, you've got to produce more goods. And you also have a million new people coming on the labor market. So, you see, you have a $15 billion shortage, short fall, because of the fact that the economy has not grown as it normally would; and then on top of that you've gotthis decline of $17 billion. That's $32 billion of decline.

Now, a $13 billion deficit will probably give you an increase of gross national product of something like twice as much because of the secondary effects of these additional sums of money available to the public, partly through an increase of Government spending, not Federal Government mind you, because the State and local governments did most of the additional spending; and the reduction of tax receipts. This is the major factor that brought about the recovery.

One other factor doesn't appear in these figures and that is the fact that we now have a social security program, and under the social security program we automatically tend to have less money coming in

in a depression, because people have smaller payrolls and therefore smaller payroll taxes; and you get more payments of unemployment compensation, old age insurance, and all that sort of thing.

Now, this is more than anything else the factor that brought about the recovery. And therefore, despite the Government's reluctance to use fiscal policy, that is, any real legislation, the automatic effects of our present economic structure resulted and made the largest contribution to this rather good recovery we had.

Now, the only argument I would use in my own defense of my own position, say, in the middle of 1958, in the spring of 1958, the only argument I would use is that if we had used the medicine that I had recommended, and many others had also, we would have had a much quicker recovery. You see, this recession cost us something like perhaps $40 or $50 billion, because we got output below what otherwise it would have been. If we had had the kind of policy that I had suggested, we would have had a quicker recovery and lost less than the $40 or $50 billion. That's my only answer to the President's position on this business.

You mustn't forget also that fiscal policy is not going to be very effective in the economy unless taxes and Government operations that account for substantial part of our national spending and output, and

when Government takes more than 20 percent, fiscal policy can be of great importance. Now, in 1929, when it took only 8 percent, it couldn't be nearly as important; and if you go back to the 19th century, when it took just a few percent, obviously fiscal policy would not have been discovered even in those days.

Now, the next issue is the problem of the balanced budget and deficit financing. I in a way have discussed that already. I just want to raise one or two other points here.

I think here you have a distinct clash between the position of the Administration and the position of most economists, because I think the position of most economists is more or less the line that I just gave you, namely, that it's the job of the Government to fit into the pattern of private spending; and when private spending is too small, it's the job of the Government to increase the total amount of spending.

Now, in 1954 we had a tax cut. This was in the middle of the recession. And this helped a great deal to shorten that recession and bring about a recovery. The Administration took a great deal of credit for this, and the economists all over the country were saying how smart the Administration was for having brought about a tax cut. But you mustn't forget--and I am sure the military people must remember this--that in 1954 we also had a $10 billion cut in the security program. Now, this $10 billion cut in our security expenditures had a depressing effect on the economy and helped bring on the recession. So that if you give

the Administration credit for having offset this by a tax cut, you must also give them a discredit of having cut down spending, which brought about a recession and, perhaps even more important--and this is a purely personal viewpoint--the Administration is to be critized for having drastically cut our security program at a time when our international situation was rapidly deteriorating.

And they still haven't made up for those cuts in 1954, because even now we're not even half way between where we were in 1953 and where, that is, in total expenditures, and where we finally got in 1955 and 1956 as the result of the 1954 cut in the security program. And when you allow for the change in prices and all that sort of thing, you can say that our security program as a maximum, when it reached its lowest point, had been cut by almost one-third. And so I think from the viewpoint of fiscal policy this was wrong; but, more important, from the viewpoint of our security position it was wrong.

At that time, in 1954, the President was edging on to what you might call this new economics, that some of us call the Keynesian economics. At one point the President delivered an oration which you might have believed was actually written by the late Lord Keynes. But he only held on to this position for a short while; and if you read the statements of Secretary Humphrey, Secretary Anderson, or the President in the last few years, you can see that they have gone back to a theory of economics that sounds a good deal like Mr. Hoover's economics; and

that theory is--and they said this many times--that we will not allow or give a tax cut unless we have a large surplus in the Treasury.

What does that mean? That simply means that if you have a surplus in the Treasury, say, in 1959 or 1960 possibly, then you will get a tax cut. But that's just exactly when you shouldn't have a tax cut, if you understand what I've been saying about fiscal policy. The time you should not have a tax cut is when you are terribly prosperous and inflationary. So that what Mr. Humphrey and Mr. Anderson and the President have been saying is: "Let's have a tax cut and therefore increase the amount of inflation when we have a surplus in the budget." But you only have a surplus in the budget when you're very prosperous; and my argument is that the time to cut taxes is when you're in trouble. You may even have a deficit on the Treasury account. That's the time when you should really cut your taxes and not, as these three gentlemen say now, at the time when you have prosperity. I hope you don't mind my criticizing your Commander-in-Chief.

Now, the issue of Government spending and full employment. We don't really know whether we can have full employment in the economy without Government spending. This is something that nobody can really prove one way or the other. We do know certain things. We do know that when you are in trouble and you're not spending enough, Government spending, especially out of deficit, might make a large contribution.

We also know that in the 1930 deficit financing by the New Deal did some good, but they never brought us back to a position of full employment or prosperity, because even by 1939 we had something like 10 million people unemployed. And what got us back to a position of full employment? The war did. The large expenditures for military and similar purchases out of the military budget went up to about $100 billion in 1944. So that we've had relatively few years since 1940 when we haven't had a very large military budget and a very large Government spending budget.

But there is one thing that is rather interesting and that is that if you take a look at, for example, 1944 and 1945, we had large military spending. In 1946, of course, the war was over, and the Federal Government spending dropped from $75 to $21 billion. This was a tremendous upheaval, you see the Federal Government spending going down from $75 to $21 billion. This is the sort of thing that would happen if we took Mr. Khrushchev's proposal and got rid of all the Army and Navy and the military schools and everything else and completely disarmed. We would have a somewhat similar problem.

Now, defense expenditures went down from $76 to $17 billion. This would suggest a tremendous problem of readjustment, and yet from 1945 to 1946 there was actually an increase in the gross national product despite this very large decline in Government spending. You

may immediately say, "Well, this shows that we don't have to depend upon military spending to be a prosperous economy, as all the Marxists claim," although, if you allow for the change of prices, you have some decline of gross national product during this period.

But I don't think you can draw too strong a conclusion from this, because you mustn't forget that we had one break in 1946, 1947, and 1948, and that was that this was a period in which the public was determined to spend an awful lot of money, because they had been denied access to goods during the war by rationing and the unavailability of goods and all that sort of thing, the pressure to save, to buy Liberty bonds, Government bonds, and all that sort of thing. So that though the 1945-1946 experience might suggest that we might have a very prosperous economy without military spending, it hasn't been proved, though on the whole if offers some very helpful evidence that this might conceivably be done.

I was asked the other day, a couple of weeks ago, by a national paper journal, to write an article anticipating the Khrushchev visit, an article on the general issue of what disarmament would do to the American economy. And so I proceeded to write this--it hasn't been published yet, I might say--and what I did was to assume what seemed to me to be a realistic assumption, namely, that we are spending close to $50 billion now on defense; and let's assume that Khrushchev got

reasonable and we could work out something with him and that we cut our military spending to $25 billion. We would save $25 billion. What would happen to the economy?

Well, what would happen to the economy in that case is that it could be disastrous or it could not. It depends on how we handle it. I think if we did nothing, we would have trouble. But, you see, if you cut your military spending by $25 billion, you could have a substantial tax cut; and I would argue that we ought to use half of these $25 billion for a tax cut, which would leave this money in the hands of the taxpayers to spend elsewhere, and the other half could be used to develop our various resource and welfare programs, like urban redevelopment, the building of roads, an increase in social security benefits, more spending on natural resources, which have been rather unexploited in recent years. So I developed a program of this kind.

Now, this in terms of equity might also be a wise program. It would give the relatively well-to-do people, who are the taxpayers, some relief from taxes. At the same time it would satisfy those who feel that Government spending on welfare services is inadequate and that we ought to to some extent, which is the Galbraith thesis, to some extent transfer payments from the private spending for liquor and tobacco and large cars and recreation even and other items of that kind, transfer some of this spending to more elementary or more important needs, like health, education, and what-not. For example, in the next

10 years we're going to increase our total spending for education from something like $16 billion or $18 billion to something like $35 billion. There is some problem of where this money is coming from.

So I think if you have that kind of a program prepared, we could have 50 percent disarmament without any serious effect on the economy. I do think you're going to have certain problems in special areas. For instance, in a State like Connecticut or California or New York or even Massachusetts they get an awful lot of Government contracts and in these places where there are Army bases as well. In these areas you would have to have special programs, to reeducate people, to transfer them into other industries. The tax cuts, of course, would help these States. A State like New York, for example, puts much more money into the Federal Government than it takes out and they would be helped to some extent by this tax cut. But you would have to have some special area development program to deal with these regions that would be helped by the general measures of the Government, but would be hit so hard by the change in this pattern of spending that they would have to have some special treatment.

So that's a preview of what I have to say in this article.

Now a word about the Government debt management, which is part of fiscal policy. In a general way the theory of Government debt management is that the Treasury should cooperate with the monetary authorities in such a way that you would have a wise debt policy that would fit in with the needs of the economy.

Now, what does that mean? This would mean, in a general way--suppose the Federal Reserve is anxious to drop inflation and raise the money rate in order to stop the expansion of the economy. What is the job of debt management of the United States Treasury? The job of the debt management group should be to help this policy by making money dear, so that people won't borrow as much and therefore there'll be less money outstanding. How do you do that? You do that by the Federal Government issuing long-term securities. They dump thes securities on the market. This reduces their price. Reduction of the price of a security is the same thing as a rise in the rate of interest. If Mr. Kress hadn't rationed my time so much, I would have spent a few minutes explaining this more fully, but I can't do it. So the net effect, therefore, is that the correct policy of the Government in such a period is to issue long-term securities.

Did the Government do this? No, they didn't. Why didn't they? Because they said: "We mustn't interfere with the market. If the private market wants all this money, why should we take this money away from them and issue long-term securities?"

Well, this is a viewpoint and this explains in a sense the ideology of the Administration. They feel that they shouldn't interfere with private investment funds. On the other hand, they have some responsibilities for the economy. I would say they should have, but actually they didn't.

In 1958 we had a recession, and in this recession what's the correct policy? In a recession what you try to do is, you have the monetary system manufacture more money so the businessman can borrow more money, put more people to work. Therefore you bring the rate of interest down by manufacturing more money. The money is used to buy up bonds and other assets. This raises their prices. This is a decline in the rate of interest.

In such a period what should the Treasury do? The Treasury in such a period should issue short-term securities, that have the minimum effect on the market, and not issue long-term securities, because if you issue long-term securities, you are in a sense absorbing the additional money that the Federal Reserve is creating on behalf of private employers. If you issue long-term securities, you see, you interfere with your rise of employment and the reduction of unemployment.

What did the Administration do? In the nine months of the recession they issued $10 billion worth of long-term securities--exactly the opposite from what they should have done. And so to that extent they slowed up the recovery.

I was going to say a word about the 1959 problem, the problem of whether the Government should have a higher rate of interest, but I think I'll skip that, because of the shortage of time. I see I have only about four more minutes. I'd like, therefore, at the very end just say

a word about the problem--you see, we talked about fiscal policy. I wasn't sure whether you had had a lecture on money. Yes, you did have a lecture on money recently; so you know something about this.

Of course the real tough problem, as you know, today is the problem of how you integrate all these various policies. You see, what the Government is interested in is--I think they are more interested--I think if you say where they put their greatest emphasis--this also is probably a matter of idiology as well as economics--they put their greatest emphasis on the stability of the dollar. They want a dollar that's stable in value, that doesn't become less and less valuable. This is the line they've taken for many years. They stress this. If you read the literature or go to hearings and listen to the representatives, this is the point that they harp upon more than any other point.

The Democrats, on the other hand, have tended to emphasize much more the problem of growth; that we ought to have an economy that grows, 4, 5, 6, percent a year. These two objectives are not necessarily inconsistent, but they sometimes are. As a matter of emphasis I would say the Democrats are a party of growth and the Republicans are a party of the stability of the dollar. There's where you have your clash.

Now, here you have, you might say, these twin objectives. One is to have a stable economy and the other is to have a growing economy. Why do you want a growing economy? You want a growing economy

because, in the first place, if you have a growing economy, you have a higher standard of living. The public can have the services they need, not only private but also public, much more easily with a growing economy than with a declining economy or with a stable economy in terms of output.

If you have this growing economy, it's also terribly important that you think about our international position. From 1952 to 1958 we had a growth in the economy that averaged only 2 percent a year. The Democrats are very critical of the Republicans for this. But to be fair, on the other hand, if you add in 1959, which is a good year--the period 1952 to 1958 had two recession years, 1954 and the year between 1957 and 1958--and that pulled the general average down--if you add in 1959, which I think is a fair thing to do, you get an increase of an average of about 3 percent rather than 2; and that isn't too bad. But in the last 10 years we have had an increase on the average of 4 percent. That allows, you see, for the changes in prices.

A 4 percent rise is not bad. But the Russians in recent years have had an increase of 7 percent a year. They even claim 9 percent, but our own experts claim it's only 7. But, you know, the difference between 2 and 7 is tremendous. If this continues, in 10 or 12 years the Russians will be producing as much as we are.

And you musn't forget that when they produce as much as we do, they're much more effective than we are, with their kind of a society,

because, for example, they devote only one quarter of their economy to services--boxing, salesmanship, and all that sort of thing--and we devote half of our economy to services. So with a given output they are in a much more effective position than we are.

Now, then, if that's the situation--and let me point out that if you have a 3 percent growth, from now to 10 years, as against a 5 percent growth, it makes a difference of $150 billion in 10 years, that is, per year. In 1959-1970 we would be producing something like $700 billion--a little more than that--of gross national product if you have a 5 percent growth. If we have a 3 percent growth, it would only be $550 billion. You can see what a difference that makes in terms of our competitive position with the Russians.

Now, from that viewpoint there's a good deal to be said--and this is my personal position and a good many people will disagree with it--for taking the risk of a little inflation, what we call creeping inflation, if this will mean a greater degree of growth. And if you can have a 2 percent inflation a year, this saves you, say, $50 billion every few years because if you try too hard to stabilize the price level, you generally bring about unemployment. This is just exactly what happened in 1957 and 1958. The Federal Reserve was terribly concerned about inflation . They cut down the supply of money. This had an effect on the amount of goods that people could buy, and this helped bring on the recession. It wasn't the only thing, but it was a substantial factor in the recession.

Now, if you don't worry too much about the price level and let a little inflation go on, if it does result in a larger degree of output, this might be a very important thing from the viewpoint of the security of the Nation. And that seems to be one of the really crucial debates that we are in the midst of right now.

I might add that you can see very well that I haven't had very much to do with this Administration in terms of my economics. I was a consultant for the preceding Administration to quite a number of agencies. One learns a great deal from being a consultant.

(Two stories omitted.)

COLONEL HARVEY: Dr. Seymour is ready for your questions.

QUESTION: Doctor, you indicated that we might be able to do with a little creeping inflation, say, 3 percent, if necessary. What effect would this have on the economy and what effect would it have on our prices in the world markets?

DR. HARRIS: On the question of creeping inflation is in the first place a question of just exactly what you mean. I think a creeping inflation of 3 percent would be really quite serious per year. I would hope we could keep it down below 2 percent. I think the ideal might be about 1 percent. If we have a 1 percent inflation and a 5 percent rise in output, you are running a damn good economy. If you have a 5 percent inflation and a 1 percent rise in output, you're running a damn poor economy. That would be my theory.

Now, on the international position--and this is my opinion--there's no doubt about it. We have suffered a deterioration of our international position in the last year or two. You know, the problem has been a dollar shortage, and now it seems as though there are too many dollars around. The foreigners are getting their hands on our dollars. They're getting their hands on our gold. We lost about $3 billion of gold in one year, which is unprecedented.

Now, what's the explanation of this? Many people have argued--in fact, the Chairman of the Board of Governors of the Federal Reserve has argued--that this is partly the result of inflation in the United States. We had an 8 percent inflation from 1956 to 1958, which is quite an inflation for peace times.

Now, in that kind of situation it may well be that this inflation does to some extent make it more expensive to buy American goods; and since prices remain low abroad, we tend to buy more and this affects our balance of payments.

I am not sure myself that this is a major explanation. My explanation of the whole business is that up until very recently the rest of the world was in a weakened competitive position as compared with the United States. Of course they had suffered more as a result of the war than we had, particularly our major competitior, like the British and the Germans and the Japanese. So that, although we have had some difficulties with our international position, I don't think it's primarily inflation.

Now, if we should have a 3 percent inflation per year and the rest of the world didn't, then, of course, this would affect our international position adversely. Then we would have to try to cut that down. But on the basis of the experience since 1946, most of the inflation has been in the rest of the world rather than in the United States; and the problem is, What will the future be?

QUESTION: Dr. Harris, my question also presumes a certain amount of creeping inflation. If we buy 2 percent inflation per year, with a 4 percent growth, who is going to buy Government bonds if they know that in 20 years they're going to be worth less than half what they're worth now? Who's going to buy insurance? Who's going to come up with any kind of mortgage loans? And what if the people who now own the bonds decide to dump all the bonds based on a policy of inflation?

DR. HARRIS: That's a good question and it's a tough one to answer too. Let me give you a little background on that, though.

This is, of course, the position that the Federal Reserve has taken--that you've got to stop inflation. And the Treasury, of course, now claims that they can't sell bonds because everybody is getting their money out of the bond market and putting it into the stock market. Why do they put their money into the stock market? The put their money into the stock market because they feel this is a protection

against inflation partly, and partly because they want to capitalize on growth. You can capitalize on growth much more in the stock market than you can in the bond market.

Let me just argue this: One thing is that the public on the whole is remarkably obtuse on this issue. In other words, they allow themselves to be exploited by inflation much more than we are ready to admit.

Now, it may well be that if you have a creeping inflation for a generation, the public will finally wake up and say: "Let's not buy anything that has a fixed yield in dollars." Of course, one answer is that you will get a response in the bond price. This is happening now. You notice that the bond yield now for some of the Government bonds is 5 percent. Well, 5 percent, you see, gives you a good protection against inflation, any kind of creeping inflation, or even more than creeping inflation. So that what happens in this case is that the Goeverment, therefore, has to pay more for its bonds, and that's one response.

Now, another answer is that on the whole this inflation, or the fear of inflation, is partly--and here again I speak for the Democrats, who are perhaps overcritical of the Administration--this is a thing I can't entirely elimate--I am an adviser to the Democratic National Committee; so you can see where my prejudices are--but if you take this present fear of inflation, how does it come about?

Why didn't people, for example, from 1940 to 1948, say, when we had a doubling of the price level, all dispose of their bonds? You would think that in that kind of situation, where you had a 100 percent rise in prices in eight years and in most of this country in a few years, they would have dumped their bonds. But they didn't. Now, why should they suddenly become so concious of inflation?

I think one reason is because Mr. Martin goes all over the country and yells about the fact that we're in danger of inflation; and Mr. Martin is a very smart man. So what do all the investment trusts do? They dump their bonds and they all buy stocks. And a great many other investors, pension funds and what-not, are very much impressed by what Mr. Martin says. And the President himself has made statements of this kind and the Secretary of the Treasury. I think if you want the people to be worried about inflation and tend to bring it about because they are worried about it, then you go around and tell everybody that inflation is on the way and there's nothing you can do about stopping it and all that sort of thing.

So my answer in short to you is that this is a serious problem. I think the solution is partly that the Government will have to pay higher rates of interest. I think it's partly also that the Federal Reserve itself and the banking system hasn't supported the bond market as much as they should, because the bond market is a very important part of our economy. It supplies the cash the Government has to have to wage this

war against the Russians. In that kind of situation the banking system has some responsibility to the bond market, and every time that one of their regular customers comes along and wants some cash, they shouldn't go off and dump Government securities, as they have done in recent years, and as have insurance companies and others.

So I think that by a better support of this market by the Federal Reserve and commercial banks and insurance companies, and also by some increase in the rate of interest as a result of this situation, you will still be able to get the cash you need for the Government. But this is one of the unfortunate aspects of the inflation. But, on the other hand, you have the other advantage, of having a much larger income out of which to pay all these bills.

QUESTION: I probably am oversimplifying this, but the difference between yourself and the Administration seems to me to be that the Administration feels that it ought to run the Government like a business and worry about income and outgo and also in terms of the future; whereas your approach to it is quite different. I wonder in economic terms if you could explain your basic differences in how to run a government from an economic standpoint.

DR. HARRIS: Yes. I think that's a good question. I think this is one of the troubles.

Now, one of the things that impressed me about the Administration has been that time and again they have, --for example, one of the reasons we have been so prosperous in the last, say, six or seven years has been that the Government has done everything possible to get everybody in debt but the Government. There has been a tremendous increase in the housing debt and consumer credit, and they have positively contributed toward this. When the President, for example, gave an $8 to $10 billion tax cut, he immediately said: "Well, now, the State and local governments can go out and collect some money and expand." He announced that they have a $200 billion program of public works. They can now go ahead with them. And the State and local governments increased their debt every year by $3 or $4 billion--a tremendous rise. So that the President apparently believes that it's all right for everybody to get into debt except the Federal Government.

Now, I would take exactly the reverse position. I don't mean to say that getting into debt for housing is bad for the economy, because I don't think it is, though there are some who think it can be carried too far. But what the Administration assumes is that in the same way that as youngsters we were all taught that you must save some of your income, you must not get into debt, and I think that in a general way is a good principle for individuals, although I think its quite clear that we can get into debt much more than we ever thought we could, and with good effect on the individual and with good effect on the economy.

But I think that the Federal Government has a special responsibility here. In the first place, it has the power to create money, which nobody else has. And therefore if the Federal Government has some responsibility for the economy, then the Federal Government has some responsibility not to balance its books every year, in fact, to unbalance its books frequently and have a growing national debt as long as that growing national debt doesn't involve costs that are very much out of line with our rise of income. And so I think the mistake that the Administration makes is to apply the dicta of private finance to public finance, and this is what gets us into trouble.

QUESTION: You didn't have a chance to mention this interest business. Would you give your views on that?

DR. HARRIS: You mean the 1959 problem?

QUESTION: Yes.

DR. HARRIS: Well, the 1959 problem--of course I would say that the Treasury has one of the toughest financing jobs that any Treasury has ever had, particularly in so-called peace times. I can't remember a period when the Treasury has had more trouble than now. I don't mean to say this has been the result of poor workmanship on the part of Secretary Anderson. I think he's had a very difficult situation.

I myself feel that the Administration is partly responsible for this for having given the general public an idea that we are in great danger of inflation and therefore the deflation of the bond market.

So the Administration suggested to the Congress that what they would like to have is an unlimited rate of interest. In other words, they didn't want to be restricted to a 4.25 percent rate of interest on securities of more than five years, which they are by law, in a period when the rate of interest is gradually rising to 5 percent. They said: "How can we borrow money at 4.25 percent for five years or more when the market requires 5 percent?"

Well, this, of course, is true. So if they are not given the unlimited rate, they're in trouble. They can't borrow the necessary supplies of money. But they can borrow it another way. They can borrow short term. If it's not over five years, they can borrow it at any rate. But, of course, when they borrow short term, they generally have to sell to the banks, which means that more money is being created.

Now, this seems like a reasonable position on the part of the Secretary of the Treasury. I was myself asked by a number of Senators what they should do on this. I suppose everything I say here is confidential. I advised the Senators not to accept the President's proposal. And they didn't. I mean, not because I said so. Other people advised them and they had their own views on this thing.

Now, why did I take this position? Why did I defend an anti-Administration position on this? It's not that I don't want the Treasury to get money; that I don't want the Treasury to get the money at any

possible rate. The reason for it is this: In the first place, they don't need the money right away. They can wait until January or February and they can still get it. And they didn't present a very good case. They just came and said they wanted it. They didn't try to show what the relation of this policy would be with the Federal Reserve policy, with wage policy, and all these other policies.

But perhaps the most important reason from my viewpoint is this, and this I think is the thing that Congressmen who opposed this were very much impressed by, and that is that there's a strong feeling that the Federal Reserve is too inflation-conscious. They tend to restrict money too easily and too quickly. And if you say to the Treasury, "Now you can have any rate you like," this will make it so much easier for the Federal Reserve to restrict the supply of money and help bring on a recession. And when you say that the Treasury can't have any rate that it pleases, that is the same thing as saying to the Federal Reserve, "You've got to create enough money so the Treasury doesn't have to pay 5 percent." This is a way of the Congress to some extent taking over control of the Federal Reserve.

Now, you may think that this is bad and unwise; but you mustn't forget that the Constitution says that the power to create money and to determine the value thereof lies with Congress, not with the Federal Reserve.

QUESTION: In our economy, considering the broad requirements for economic growth, that is, the birth rate, the new labor coming into the picture, and the requirement for more goods and services to improve the standard of living of those people that yet are marginal or to strengthen the desire of the people that already have but want a little more, and considering the requirement for financing this economic growth and the required consumer disposable income to keep this machine going, is it arithmetically possible to retire this debt?

DR. HARRIS: I don't think it's necessary to retire the debt myself. That doesn't mean that you're repudiating the debt or anything of that sort. Let's look at the debt, which worries a good many people. This is a downright complicated problem, and I don't want to go into it all.

But we have a debt now of, say, $275 billion. It cost about $7 billion a year to finance it. You go back to the early thirties, when we had a debt that cost about half a billion dollars to finance, maybe $20 billion or something of that sort, and now you have a debt of 275 billion. What has happened since the thirties? Have we had prosperity or depression? You compare the thirties with the present time and there's no question about how much better off we are now. So this growth of the debt in the economy hasn't destroyed us.

In this same period we have had an increase of our gross national product of something like $400 billion a year, and the cost of financing

this debt is $6 or $7 billion additional as compared with the early thirties. That suggests that the growth of the debt has not been so terribly serious.

There are other problems which arise from the debt which I can't go into. I recommend a book to you that raises and discusses all these problems. It's a book by Harris on the national debt. I might say it's out of print now; so I won't get any royalties if you buy it. But you probably can get it in the library.

QUESTION: You spoke quite a bit about inflation of 1, 2, 3, and 9 percent. The median income, I think, in the United States is on the order of $3,500 or $3,900. I'll take a number between $3,000 and $5,000. And 51 percent of the people make up a majority, or 50 plus 1. So it seems to me that there is a psychological pressure in the United States that can't be denied because it is a voting majority, that wants more money and they don't care how they get it. Twenty dollars looks bigger than $5 and we have had this constant pressure. My question is, Is not then a small creeping inflation really normal and it's silly to talk about no inflation or stability; that 1 or 2 or 3 percent is the normality from which we go?

DR. HARRIS: You're the only man so far that's been on my side.

Before I answer that question I'd just like to say that I hope you don't think I'm trying to indoctrinate you. I am very happy that Dr. Jakobsen is coming, who will more than offset my views on this.

I don't feel quite so badly about indoctrinating people of your maturity and experience as I do when I get an undergraduate class.

But, coming to your question, this is true. And you know, the interesting thing is that if you take the last period of 120 years, you would be awfully surprised to know that the average inflation over a period of 120 years has been a little more than 1 percent a year. And that's a surprisingly small amount of inflation. And this has been a creeping inflation over a hundred years, although most of it has come in war times.

You mustn't forget that we have had very serious periods of large declines of prices, like in the last quarter of the 19th century, from 1929 to 1932, 1936 to 1938, and so forth. So that when you talk about the great danger of creeping inflation and the people dumping bonds and so on, you mustn't forget that we have lived with this over a hundred years and done a damn good job. And I think, if you look at the whole history, especially when you leave out war periods, when it's almost impossible to prevent some inflation, even there we are doing a much better job than we ever did before. People tend to overexaggerate these things.

Now, as I gather this thing here, I'm sure that 90 percent of you are much more worried about inflation than I am. You might say that I'm an inflationist. My first book was a doctor's thesis on the paper money that was issued during the French Revolution, and the theory

then was that this was the classic experience of inflation. The price level went up 200 times in a period of four or five years. That's nothing compared to the Hungarian inflation postwar, when prices went up 10 to the 17th root.

But that experience taught me one thing and this was my main conclusion, namely, that the paper money made it possible to finance 14 armies of Napoleon and carry the French Revolution all over the world. So that even inflation sometimes does some good.

COLONEL HARVEY: Gentlemen, for your information, the lecture by Dr. Jakobsen is due in the Economic Stabilization Unit next February.

On behalf of the Commandant and the College, I'd like to thank you for a very able presentation of the problems of public finance.