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IN TIME OF WAR PREPARE FOR PEACE

by

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I am very glad to be here today, not because I think I can say anything that you do not already know, but because I think it of the utmost importance that, in peace time persons in the civilian branch of the government should, as best they can, cooperate with those of you who are in the armed forces.

Eternal peace is a noble dream and one which, of course, every intelligent man wants to see realized as soon as possible. Many dreams -- such as that men could fly -- have been realized. It is, therefore, folly to sneer at dreams. But it is even more unwise to confuse dreams or hopes -- even if they may be realizable in the future -- with present realities.

I am definitely not war-mongering. All sane men hate war and fervently pray that our country will never engage again in armed conflict. But, as old Thomas Hobbes said in 1651, "Warre consisteth not in Battell only, or the act of fighting; but in a tract of time wherein the Will to contend by Battell is sufficiently known. . . As the nature of Foule weather lyeth not in a shower or two of rain, but in an inclination thereto of many dayes together, so the nature of War, consisteth not in actual fighting, but in the known disposition thereto, during all the time there is no assurance to the contrary. All other time is Peace." In that sense, we seldom know a time of absolute peace. We have an admixture of the two, with the peace ingredient usually, and fortunately, the dominant.

Altogether too much of civilian thinking ignores the fact of war, actual or potential. In a world in which wars are almost constantly going on somewhere, economists still nonsensically write as if wars were "abnormalities" or "interferences" with the "normal" course of world events. To think in those terms is the equivalent of thinking of a universe in which everybody always has perfect health and no one ever dies; a physician who would think in those terms would be a fool. And yet many economists and other civilians indulge in just that kind of thinking.

That was not always true. Adam Smith in his "Wealth of Nations," published in 1776, devoted a chapter to military defense as an integral part of the subject of political economy.

Since the institutions of a country may be overturned by defeat in war, with the result that the essential nature of its economy may become drastically different, and since military expenditures are a necessary part of the budget of any sane government in the sort of world in which we live, any intelligent study of our economy must take into account the activities of the military branch of the government.

Conversely, it would seem to me -- who knows very little about it -- that military men should be vastly concerned with the kind of economy they are asked to defend and with the fiscal, economic, and political aspects of the government of which they are a part.

And so, before I begin my brief discussion of the subject about which you have asked me to talk, I want to say that I, for one, have very little patience with the attitude towards our armed forces depicted in Kipling's "Tommy Atkins." The men in the army and navy are among the most devoted of our public servants. I sincerely hope that the kind of meeting we are having today will lead to closer relations between the civilian and armed forces in government, and that you who are in the armed forces will more freely tell the rest of us what you think of our activities, after learning, through closer contact with us, just what we are doing and why. For you and we are both engaged in preserving the American profit system and American democracy.

Economists, I am told, like to discuss the economics of war, because such a discussion often enables them to simplify their studies by stripping off certain of the complicated problems of money and finance which are brute facts of daily life in peacetime. Such discussion, however, rarely gets down to the blueprint stage. Those, on the other hand, who are faced with the task of drafting actual plans, are often inclined to give too much attention to the mere mechanism of administration and not enough to the purposes which the machine is designed to achieve. Under peacetime conditions, our economic and administrative organizations can well be left to develop largely as actual needs arise. But, to meet the requirements of war, we need a more carefully planned machine -- one that will be ready to function, so to speak, after a few 'phone calls.

While I readily concede, therefore, the need for careful war planning, not only of the methods to be pursued but of the number and nature of organizations which will be required, I intend to say very little about the latter -- for two reasons: First, I think it is essential, before deciding what new agencies will be required or what existing agencies can be adapted to war needs, to have a clear conception of what functions war finance will be required to perform besides the raising of money for guns and ammunition. Second, I believe that once we have clearly in mind the elements of control necessary to shift suddenly from a peacetime economy to one of war, the types, requirements and composition of the various agencies will become fairly well indicated by the nature of the job to be done. As Abraham Lincoln said, in another context, "If we could first know where we are, and whither we are tending, we could better judge what to do and how to do it."

Clearly, there can be no one single war plan. All wars are not alike. The next war in which we engage may or may not require the same extensive activity as did the last. There should not therefore be a war plan, but many war plans, each being dependent on the character and magnitude of the war to be waged, on whether it is likely to be short or long in duration, and whether it is to be fought primarily on land or sea. Accordingly, there must be several plans, with a recognition, too, that, as a war develops, it may shift its character.

But, whatever the nature of the war, I take it that its purpose will be to preserve our capitalistic or profit economy inside our democracy. Wherefore, all war plans should be so devised as to continue, as far as possible, even in war time, on a free enterprise or capitalistic basis. That means that the effort should be to see to it that the economic machinery will continue to be directed, basically, by the mechanism of prices; that, so far as possible, it will not be directed by government orders. Of course, some direct governmental controls will be necessary, as they were in our last war. But the amount of such direct governmental management of the economy should be no greater than the nature of any particular war (or a particular phase of a particular war) makes indispensable.

The methods of war finance adopted should, then, be required, first, to perform the job with the least disturbance to the ordinary financial life of the community compatible with the supreme aim of winning the war; and second, to perform the job with a minimum of undesirable after-effects. In practical terms, that means that the war burden should be apportioned in as equitable a manner as possible, in order that no group in the community should be permitted to gain at the expense of others. The war should not yield an economic victory for some particular domestic groups.

It is often said that in time of peace we should prepare for war. I suggest this also: In time of war, we should prepare for peace.

The basic fact of war finance is, simply, that the cost of conducting a major war absorbs a considerable proportion of the nation's income, or, more correctly, a considerable portion of the output of the nation's labor force, natural resources, and capital equipment. The essence of war, in the economic sense, is that a portion of productive resources is utilized during war-time in different ways than it is utilized in peace-time; namely, to produce war supplies instead of civilian goods. It is the task of war finance to make possible and to facilitate this shift in the productive effort of the nation. The scope of war finance, therefore, cannot be restricted to the sphere of money or finance proper. We must always be aware that we are dealing, basically, with a problem of shifts in the uses of resources.

Consumption (and I refer, of course, to the consumption by civilians of the everyday articles of peace-time living, especially articles of the inessential variety) must be curtailed below what it would otherwise be with the same level of industrial activity; and production must be stimulated and directed on some adequate basis, in order that any plan of finance decided upon shall be equal to the task of providing the Government with the vast masses of goods and services it will require. In short, assuming any level of national income, during time of war the civilian population must consume less than it would on the same level in peace-time, so that what we save in civilian consumption we can expend in war effort. This, in simplest terms, is the formula of war finance.

If we assume that we are not to employ the direct (totalitarian) method of war finance -- complete industrial conscription and rationing of consumption -- as generally not compatible with the system of capitalistic enterprise, we are left with four main methods of war finance. These are

(1) Taxation,
(2) Forced loans,
(3) Voluntary loans, and
(4) The issue of currency, including both paper money and bank deposit money.

All theoretical discussions of war finance very soon come back to an evaluation of the relative efficiency, desirability and after-effects of those four methods. The discussion has such a long history and is spread over so large a literature that I can scarcely attempt here to touch upon all the essentials of this quadrivium of war finance. In a practical sense, however, it is largely a question as to what combination of these methods will best serve our purpose.

It must be remembered, too, that each method may be expected to perform more than the single function of supplying funds for the purchase of war supplies. Taxes, for instance, are useful not only in raising revenue but as a means of curtailing consumption of non-essentials -- which is an important factor in our formula of war finance. Similarly, forced loans or deferred payment schemes are not only revenue raisers but powerful agents in bringing about shifts in the uses of productive resources.

It makes an essential difference in the evaluation of the different methods, whether our reasoning is applied to an economy with full employment of productive resources or to one with underemployment of the factors of production -- reflected most clearly in the unemployment of part of the labor force. Until the stage of full employment of resources is reached, we should give preference to those methods of war finance which induce a net increase in production, not merely a shift in production. In that period, as I see it, we should not, therefore, seek to cover the cost of armament by new taxes or forced loans, but mainly by borrowing, primarily from the banks and from the idle reserves of individuals. Under such conditions, it is even conceivable that we might finance part of the cost of armaments by issuing additional currency without inducing more than a moderate rise in the level of prices -- a most important consideration as I shall presently indicate.

The situation is quite different, however, once the level of practically fully productive capacity is reached. Then, armament expenditure should be financed largely through taxes or through loans placed outside of the banking system, if we are to avoid a rise in the price level. A rise in prices in such a situation obviously would not lead to a further increase in production. The cost of living would most likely rise at a faster rate than the level of wages and salaries. Such a movement would, it is true, forcibly reduce the real volume of consumption and thus set free additional factors of production for the production of armaments. The social iniquities arising from such methods, however, are too well known to require additional comment.

In order to apply some of these generalized theories to our own economy and to discuss the problem in more concrete terms, it is necessary, of course, to fix our ideas in terms of the amounts involved -- the order of magnitude of probable armament expenditures and the sources from which such funds may be derived. I wish to emphasize that such figures as I am about to use are, at best, rough approximations and are to be, in the main, illustrative.

I shall assume that we would have to spend at least $15 billion a year more on armaments -- including all goods and services needed by the army and navy in prosecuting the war -- than what we are spending now. That is about the amount we spent for a full year in the World War (including loans to our then allies). While the price level now is only about half as high as it was then, armaments have become so much more costly that I understand the expenditure of one billion dollars now means no more, from a military point of view, than did the same amount in 1917 and 1918.

Solely for the sake of discussion, let us assume that, when war came, our national income would be what it was in 1937 -- somewhat over $70 billion. Our participation in any extensive war would almost surely eliminate, within a relatively short time much of the unemployment now existing. On the other hand, we must take into consideration the reduction in efficiency that necessarily will follow from the replacement of several million experienced workmen by the presently unemployed, by over and under-age males and by women workers. On that basis the maximum national income reasonably to be expected in war time may perhaps be estimated at approximately $80 billion, in terms of present prices. As calculations of national income do not include the goods used to make up for depreciation of plant and equipment in business, the value of our current output of goods and services would, under the foregoing assumptions, be somewhere near $90 billion. On that basis, the problem of war finance, then, is (1) to raise an additional $15 billion per year and (2) to reduce civilian consumption and capital expenditures by the same amount -- so that $15 billion worth of the output of productive resources will be shifted from civilian to military uses.

Of these two problems, obviously the basic one concerns the ways and means of reducing civilian expenditures by the cost of armaments, and of reducing them, as far as possible, in step, in time and in kind, with the rise of armament expenditures. We must, accordingly, look to types of civilian expenditure for consumer goods or capital goods which can be reduced without impairing the efficiency of the factors of production and -- in accordance with the principles we have laid down in the beginning -- with the least disturbance to our economic mechanism and with a minimum of undesirable after-effects.

We must begin with a preliminary question: How would the population normally -- in peace time -- spend a national income of $80 billion. According to calculations made by the National Resources Planning Board, consumers' expenditures on non-durable goods would, in peace time, amount to about $45 billion on the basis of a national income of $80 billion. Such expenses go mainly for food, clothing, household operation, and personal care. Since the bulk of these expenditures is made by people of moderate income, I do not think that the allowable and intelligent margin of curtailment is very large, especially if we are to keep the labor force at maximum efficiency and do not want to retrograde too much socially.

It seems permissible, however, to assume that not less than about $3 billion could b cut out of $45 billion of consumers' expenditures on non-durable goods. Even after that reduction, consumers' total expenditure on non-durable goods will be about as large, both in money and in real terms, as their comparable expenditure would be at the present time, when national income aggregates about $70 billion. In other words, on the foregoing assumption, the average civilian might be equally well off in war time with respect to his current consumption as he is today in peace time.

Our great reserve, indeed, lies not in a possible tightening of the belts of individual consumers -- though our midriffs are fairly bulky by international comparison -- but in reducing the expenditures which are usually made both by consumers and by business for durable goods. Or, rather, it lies in the large stock of durable goods which we have accumulated over the years and which we can afford to use, for some time, without making up for accruing depreciation that may be restored after the war is ended.

Among durable consumers' goods, probably the greatest reduction in civilian purchases without a decrease in efficiency and without much hardship can be effected in the purchase and up-keep of passenger automobiles. The National Resources

Planning Board estimates that at a national income of $80 billion, expenditures for the purchase of new automobiles and for the operation of old ones would aggregate about $5¼ billion in peace-time. It is probably not too much to assume that out of this amount about $2¼ billion could be set free for armaments. (That, of course, would not mean a reduction by $2½ billion in the sales of the automobile and oil industries; it would only mean that the automobile industry would produce trucks, combat cars, tanks, and possibly airplane motors, instead of passenger automobiles, and that the oil industry would sell more of its products to the army and navy and less to civilians.) Similarly, we might set free about $2 billion through a reduction of expenditures on other durable consumer goods -- (mainly household machinery and furnishings) and another half billion dollars by curtailing expenditures on home construction.

Thus, perhaps about $5 billion might be derived from curtailing expenditures for durable consumers' goods. In addition, replacement expenditures of business (to make up for depreciation and the like) might be curtailed by about $2 billion for several years. These, together with about $3 billion from current civilian consumption of non-durable goods would give us a total of about $10 billion from the reduction of current civilian expenditures, mainly on durable goods.

We further have available a large proportion of the amounts usually saved by individuals, estimated by the National Resources Planning Board at over $10 billion when the national income aggregates $80 billion. In war time, expenditures of such savings for the expansion of civilian plant and equipment must, of course, be heavily curtailed. Consequently, it should be easily possible to use an amount in the order of magnitude of about $5 billion of individuals' normal savings for the financing of war expenditures:

We thus could set free for the production of armaments $15 billion with relative ease, and up to $20 billion without serious hardship or impairment of the efficiency of the factors of production. It is probably only in the case that armament expenditure should materially exceed $20 billion per year, at present price levels, that a serious curtailment of the current consumption of civilians will be necessary.

How relatively easy our problem is, until we go beyond $20 billion of war expenditures, can be seen by comparison with the situation among the present belligerents in Europe:

$20 billion spent on armaments would represent no more than one-fourth of the total output of our productive resources, whereas Great Britain, France, and Germany are already spending about one-half of their national income on armaments and may have to increase this proportion substantially before they are through.

The London Times for February 27, 1940 states: "It is now realized that the needs of our armed forces will make such claims upon our resources that civilian consumption will have to be drastically reduced; that although we may hope greatly to increase the total amount of production, both agricultural and industrial, yet so much of this must be diverted to war purposes, either directly or indirectly by being exported to pay for necessary supplies from abroad, that the balance available for consumption cannot be maintained at the old level; and that this curtailed supply will have to meet a vastly increased demand caused by the much greater distribution of purchasing power through Government expenditure. . . The immediate task is to bring about a reduction of consumption on the part of all except those already on the borderline of privation in the fairest way with the least dislocation."

But, in this country, as I have suggested, we should not face really basic difficulties in curtailing civilian expenditure on consumption and capital goods by an amount sufficient to finance up to $20 billion of armament expenditures per year.

There remains, however, the other part of the problem -- the raising of the necessary funds -- which may, in turn, be divided into (a) the financing of current expenditure for armament and (b) financing the expansion of "war plant", i.e., structures and equipment not available in peace time and not easily adaptable to civilian uses but necessary for the production of the vast amounts of armaments needed.

Financing current armament expenditure is essentially a fiscal problem. I will not, therefore, attempt a detailed discussion of it. Even if I were qualified, it would be somewhat presumptuous for me to do so. We may be guided, however, in our general exploration of the present subject by several broad principles.

The first is that, through financial measures, we should reduce purchasing power, wherever possible, at those points where curtailment of civilian expenditure is desired to set free land, labor and capital for the production of armaments. This principle leads to heavy excise taxes on durable consumers' goods, particularly on such items as automobiles, gasoline and household equipment and luxury articles. Taxes of this nature would not produce much revenue; in fact, the more efficient they are in reducing the consumption of non-essentials, the smaller their yield. Taxes of this type must be supplemented, however, by other means which effectively curtail civilian expenditure: Examples of such supplementary measures are increases in rates for mortgage loans and stiffening of the terms for installment credit.

The most important of the supplementary measures to reduce unnecessary civilian expenditures, however, have to do with capital expenditures by business and by local governments, both for replacement and for expansion. The problem is not a difficult one, insofar as capital expenditures are financed by new issues of securities or by long term loans from banks and other financial institutions. The experience of the Capital Issues Committee during the World War indicates the comparative facility by which new issues of capital can be controlled. To make the control effective, it obviously is necessary to extend the control, under present capital market conditions, to private placements of securities and to long term loans now being made by commercial banks, life insurance companies, investment companies, and other financial institutions. Technical difficulties in this field are admittedly large, but, I am fairly confident, not truly serious.

The SEC could be helpful there. I believe that your tentative plans contemplate its assistance at that point. And there is no need here to discuss the detailed techniques of such controls. I know that the SEC and its staff will be ready, at any time, to help you in blue-printing those techniques.

Greater difficulties lie in curtailing the capital expenditures, both for replacement and for expansion, which are financed by business enterprises (and also by many states and municipalities) out of current earnings or accumulated surplus. A stiff excess profits tax, of course, would reduce the magnitude of the problem. So would a heavy special tax, which might well be considered, on the purchase of machinery by enterprises not engaged in the production of armaments, insofar as such purchases exceed a certain fraction of the average of similar expenditures over a reasonable number of years before the war.

The second guiding principle in the financing of current armament expenditures is the practical necessity of preserving, to a very considerable extent, the profit incentive, so long as we rely during war time, for the production of armaments, on the market mechanism. For this reason I would regard as undesirable all tax proposals which would take away a substantial part of all incomes above a very moderate level (such as $5000) or would take away all so-called "war profits" -- unless we definitely and consciously shift the basis of war finance from the guidance of the market mechanism to the dictates of commandeering and rationing.

That does not mean that the rates of direct taxation on personal incomes should not be much higher in war than in peace time; nor that a considerable part of the additional profits of corporations above the pre-war level should not be claimed by the Treasury. Indeed, a stiff excess profits tax is essential, as I have indicated, to curtail unnecessary civilian capital expenditures.

After levying special excise taxes and the excess profits tax, the Treasury would still be left with the task of financing the great bulk of the cost of armament. That cost must be covered mainly -- under our present income tax structure and after introduction of a heavy corporate excess profits tax -- by a levy on people with the more moderate incomes. The reason for this is clear when it is remembered that, with a national income of $80 billion, individuals with an income of more than $10,000 are estimated to receive, in the aggregate, not more than approximately $13 billion. A third general principle, therefore, is that the bulk of armament expenditure must be derived from direct contributions, from all except the poor. As the main burden will have to be borne by those of moderate means, it is essential that the contribution be made in the most equitable manner possible.

I think the plan evolved for Great Britain by J. M. Keynes, the well-known economist, deserves careful attention. The essence of the plan is simple; I omit details not important for American purposes. It is a combination of an income tax and of a forced loan, or, as Mr. Keynes later termed it, a delayed payment of wages. A contribution, fairly high in relation to total income, is levied. But part of the contribution is regarded as a deferred credit to -- a loan by -- the taxpayer, to be evidenced by securities repayable in installments - after the termination of the war.

The proportion of the total contribution credited to the taxpayer, and repayable to him, is in inverse ratio to his income; the higher the income, the lower is the proportion credited and repayable.

Under American conditions, this contribution would take the place of the personal income tax, both normal and surtax, and might be made payable at intervals much shorter than once a year, possibly weekly for wages and salaries and quarterly for other income.

I promised not to go into details, but for the sake of illustration, let us assume that we would start with an average rate of contribution of 2% for family incomes of $1000 to $1500, i.e., a tax of $25 per average family in this bracket (the actual rate would have to be higher than the average for small families and single individuals and lower for large families). This rate might be further raised to about 25% for the average family with an income of $5000 to $10,000 and to about 75% for those with incomes of over $100,000. These rates are somewhat lower than the income tax rates proposed in the Connolly Bill; they are much lower than the rates proposed in the Bone Bill. Such rates might, as a rough estimate, produce more than $10 billion whenever the national income is around $80 billion, about enough, together with excise and excess profits taxes, to supply most of the amount needed for additional armament expenditure, taking into consideration the probable decline in the relief expenditures of the Government. If we treat between 75% and 50% of the total contribution as deferred tax creditt(repayable after the war) for incomes below $5,000, reducing the ratio gradually to about 10% for the highest incomes, we would in this way levy a forced loan of only about $5 billion per year.

The plan as the main source of war finance would seemingly have several advantages. First, it would compensate, in part at least, the poorer classes for their war-time sacrifices by a future additional income and would provide them with a small capital after the war is over -- probably more than the average family's present equity in industrial insurance. Secondly, it would provide an anti-deflationary source of purchasing power available after the termination of the war, through the redemption in installments of the tax certificates. Thirdly, it would increase the ratio of savings to income, where it is now very low, and - what may perhaps be an advantage partly from the economic and partly from the social point of view -- decrease it where it is high. Finally, such a scheme would, desirably, avoid or at least reduce the rise in the rate of interest and in particular the rate on Treasury securities, which would occur if the war were financed mainly through open-market Treasury issues.

We come, then, to the final part of the problem -- financing the new plant and equipment necessary for the production of armaments. In this case it is necessary to distinguish between (1) expansion of the productive capacity for goods which, although bought for military use, are identical with or similar to civilian goods, and (2) expansion of the productive capacity for items of an exclusively military nature which are produced in plants and by machines not available in peace time and not well adaptable to later peace time use.

Financing additions to productive capacity for such items as uniforms, trucks, petroleum products, and to some extent shells, presents but few difficulties. Short term facilities for financing probably would be amply available in commercial banks and certification of government orders should provide a satisfactory collateral for bank credit. In this connection, I would emphasize the importance of the question of prompt payments, especially to the small business man who has only limited access to credit facilities.

Insofar as long term funds are needed (and the need should not be very large), they should be raised, so far as possible, by the usual methods, i.e., either by an offering of securities in the open market, or by a private placement with a financial institution, or by a long term loan from the bank. All such transactions, of course, should be under the supervision of something like the Capital Issues Committee so that unnecessary or exaggerated demands could be controlled.

It may be that, to some extent, the government, directly or indirectly, through such agencies as the RFC, would need to aid in such long term financing of industry. For my own part, I should prefer indirect governmental assistance lest, after the war, the government would be too much in control of private business. The proposal (elsewhere made for peace-time purposes) for the creation of governmentally aided but privately owned and operated regional industrial banks, would be well worth considering.

I suggest that you consider, too, whether funds for such purposes should not be procured by industry primarily through the issuance of stocks rather than bonds. Over-bonded companies are in poor shape to meet industrial recessions, and the transition to a peace-time economy after the war, may be accompanied by a severe recession.

There is an entirely different problem with respect to financing the construction of plants and equipment for the production of specific armaments which are not closely related in production to civilian goods or are ordinarily produced in small quantities only, such as small arms, guns, explosives and warships. The essential difference is that plant and equipment constructed for such war-time production will be practically unusable when the war is ended.

If financed by private enterprise, these productive facilities will be without peace-time outlets for the products for which they were built. They will either have to be written off by the owners or will be forced into producing civilian goods, probably after expensive adaptation to peace-time production, thereby creating the danger of over-supply and demoralization in a wide circle of industries.

It has been suggested that the first of those dangers might be avoided by permitting the owners to write off, more or less, the entire cost as depreciation during war time. This solution is hardly feasible or fair to either the owner or the Treasury, as the duration of the war cannot be calculated in advance and it cannot be foreseen to what extent the additional facilities can be profitably used after the war. Moreover, the plants would exist, in time of peace, in the hands of private owners, and the second danger -- of over-supply -- would still largely remain unabated.

The logic of the situation, it seems to me, points in another direction. Where new plant and equipment is adapted only, or primarily, for the production of such specific armaments,* the government should have the facilities built for its own account, either to be operated by the Government or to be rented to private business -- the decision depending entirely on which form of operation is regarded as technically more efficient. After the war, the Government would either have to scrap those plants or keep them in good order to stand by for the next emergency.

All that I have said, of course, is a mere outline. If it has any validity, then its working out in detail is a matter with which you gentlemen are necessarily greatly concerned. Those of us in the civilian branches of the Government should be -- and, of course, will be -- pleased at any time to cooperate with you, since, to repeat, we are all commonly engaged in the task of preserving our American system, a profit economy inside a democracy.

I suggest that it might be well, indeed, to have occasional "fire-drills" in which we would participate.

* And perhaps also for the production of articles usalbe in peace time in excess, however, of ordinary peace time needs.