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Vernon G. Sorrell

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## CONSEQUENCES OF OUR FEDERAL DEBT

*Vernon G. Sorrell*

[This article was prepared early last fall and would have appeared in the November issue had not certain conditions arisen to crowd it out at the last moment. It is printed now with the conviction that it has lost none of its pertinence or readability, despite the tragic events of December 7, 1941.—Editor's note.]

**R**ECENTLY a friend asked me what would be my "guess" as to the ultimate effect of our federal debt. This friend is an economist of some note in one of our state universities, and one who has given considerable thought and study to this question. My "guess," given rather off-handedly, was that high prices were very probable and that there was a distinct possibility that our debt would be abolished much as Germany's was in 1923, that is, by inflation<sup>o</sup> of the currency. In general my friend agreed with me.

This essay will deal with the possibilities of avoiding such consequences, with some discussion of the probable effects on our economic system of such measures as we may be forced to take.

By inflation we mean in everyday language—"barnyard language," as General Hugh Johnson called it—high and skyrocketing prices. In more technical language we mean an increase in the general price level induced by an increase in the quantity, or in the velocity of circulation, or both, of the circulating media. This means that high prices result because means of payment are increasing faster than the transactions themselves. Conversely, it naturally follows that if economic expansion took place in the future at a greatly accelerated rate, prices would not rise, but might even fall. However, the increase in recent years of our circulating media has been so rapid, this increase now augmented further by defense spending, that it seems only a remote

possibility that economic expansion will keep pace with or exceed currency expansion.

Even though remote, there is a possibility which offers a faint spark of hope, namely, that we may avoid many of the consequences of runaway prices. In this connection the Civil War experience has some significance. At that time the currency was greatly expanded, and while prices rose considerably during the war, they tapered off afterwards and declined down to the turn of the century. Why? It was because of the great economic expansion that took place during that period when the expanded currency was absorbed by the greatly increased economic activity. However, one has to be truly an optimist to see a parallel situation at the present time.

The economic consequences of our huge public and fiscal policies generally should be of concern to all. The future of our system of free enterprise, and of democracy itself, will depend in considerable measure on how well or how badly this problem is handled.

In broad outline, there appear to be two paths that will, or may, be taken. First, there is what we may call the "orthodox" method — balancing the budget, providing for interest payments, and eventually paying off the debt through a surplus of tax receipts over expenditures. A variation of this procedure might be the maintenance of a perpetual debt, which would be a new departure in American practice but still "orthodox."

The other path — and it is hardly conceivable that rational beings would choose it deliberately — is that which leads to repudiation in some form. The usual form of repudiation is, of course, inflation, a paramount danger in spite of the fact that we have been well forewarned.

## I

First, let us indicate some of the possibilities of what I have called the "orthodox" methods of control. (1) We should use the "heroic" method of raising vastly more revenue by taxation. The advantage of taxation as an inflation-avoidance device lies in the fact that it represents only a transfer of purchasing power from the individual to the government; no increase in the circulating media is brought about in the process, hence it is not inflationary. To make changes in the tax system in order to raise more revenue is often a complicated process involving not only many technical matters but also questions of tax

policy. The following changes are favored: (a) As far as practicable, new revenue should be had by increasing existing tax rates rather than by introducing new taxes; for example, an increase in the rates in the lower and middle brackets of the personal net income tax and a further lowering of the exemptions are preferable to the levying of entirely new taxes. (b) If new taxes are necessary, a manufacturers' sales tax is favored both on the grounds of administration and revenue-producing potentialities. (c) Our system of excise taxes might well be extended to cover a wider field, with probable increases in the rates of existing taxes.

In making these tax proposals my position is, frankly, that the major purpose is to raise revenue, and questions of justice in distribution of the tax burden, while recognized, are temporarily of secondary importance. The recent proposal by a group of economists for a special flexible defense tax on income is commendable. The main purpose of this tax is to place another obstacle to inflation by raising or lowering the rates in accordance with price changes, which changes would be made as often as once a month. It is doubtful that such a proposal in itself would be sufficient to forestall inflation, but as an important element in a program involving other fiscal and banking policies, much can be said for it. The sponsors of the proposal insist that other sound policies must not be obviated in any way.

(2) A decided effort should be made to sell government obligations to the public rather than to banks. The major reason for this is the same as that for higher rates of taxation; it represents a transfer of purchasing power with no increase in the circulating media, that is, no increase in bank deposits, and thus is non-inflationary in character. Of course, it is far more convenient and less costly to the Treasury department to sell bonds to banks, and up to now banks have been very willing purchasers, but the anti-inflationary effects of selling direct to the public would be worth the cost of selling campaigns. The present program of selling baby bonds is commendable, but it should be much extended. A desirable, but perhaps hardly attainable, goal would be to sell all future issues to the general public. A policy of "forced savings," as suggested by the English economist Keynes, has much to commend it.

It is my opinion that if high prices come, they will be the result of a superabundance of bank deposits. Consequently, to check the rise of

government-created bank deposits is to check, although perhaps not to prevent, inflation.

(3) A vigorous policy of credit control by our monetary authorities should be set in motion at once. The recent joint recommendations on this point by the Board of Governors of the Federal Reserve System, the president of the Federal Reserve banks, and the Federal Advisory Council to the Congress are highly commendable, and if any criticism is to be offered it is perhaps that the recommendations do not go far enough. To carry out the policy as contemplated, the Board will require more authority than it has under existing law.

As regards changes in the banking law, this group makes recommendations as follows: (a) raise the statutory reserve requirements for member banks by 100%; (b) empower the Federal Open Market Committee to make further increases in reserve requirements up to double the statutory amount; (c) empower this same committee to make necessary adjustments in the reserve requirements of the three classes of member banks, that is, central reserve city banks, reserve city banks, and county banks; (d) make reserve requirements applicable to all banks receiving deposits regardless of whether or not they are member banks; and (e) exempt required reserves from the assessments of the Federal Deposit Insurance Corporation.

It will be noted that these changes have for their major purpose the elimination of much of the present excess reserves of banks, an immediately potential source of enormous bank credit expansion. It might well be argued that such a step is only a restrictive device which does not get at the causes of these excess reserves. But we have an immediate problem. The excess reserves are a tangible weakness that we should and could do something about at once. I strongly favor the recommendations on this point.

Other recommendations of this group deal with checking further increases in excess reserves. These proposals would (a) abolish the right of the President (still existing) to issue three billion dollars in greenbacks; (b) make it possible for foreign-bought silver to become part of our monetary structure; (c) remove the power of issuing silver certificates against the seignorage on purchases of silver; (d) "insulate" further acquisitions of gold from the credit system; and (e) allow to lapse the power of further devaluing the dollar.

Few if any of the executive powers which this group now wishes to abolish had the "blessing" of many students of money and credit when they were given to the President at the beginning of the New Deal period. Few would mourn their loss. It is interesting to note that more newspaper space and editorial comment have centered about this phase of the report than about other (to my mind) more important phases. No doubt, this is because of the political issues involved. Executive power given up might be interpreted as political weakness, which perhaps explains the lukewarm reception the administration has given to the report.

Two further recommendations are made by this group, namely, (a) that existing bank deposits should be drawn on more and more heavily to finance the government, rather than through the sale of obligations to banks, and (b) that we should rely more heavily on taxation than on borrowing, especially as national income increases and as we approach a condition of full utilization of our productive capacity. These two commendable points have been discussed previously and will not be commented on further.

It was suggested earlier that the joint recommendations of the three groups of banking authorities might have gone further. I should like now to suggest other controls and policies that might be expected. This should not be taken as a criticism of the report; rather, these suggestions are, even in my own mind, of a speculative nature—devices that might be tried if prices get too much out of hand. These suggestions, it will be noted, are "orthodox" in monetary theory, and the main question is whether or not they would be effective under present conditions.

First, the gold content of the dollar might be increased; or what would be the same thing, the price of gold could be reduced, say, perhaps to the old statutory price of \$20.67. Or better yet, the price might be reduced by degrees over a period of time, a reversal of the process which ended in the present price of \$35 an ounce back in 1934. This would automatically reduce the value of our present gold holding, and reduce the incentive for further acquisition. This policy, however, should be weighed carefully in the light of our aid-to-Britain program.

Second, the rediscount rates of the federal reserve banks might well be progressively increased. The effectiveness of such a policy would lie almost wholly, under present conditions, in forcefully bringing to the attention of bankers, business men, and the public generally the serious-

ness of the present situation. I believe it would have this effect and would in turn serve as a check upon expanding bank credit. Direct effects would be practically nil, of course, as almost no rediscounting by member banks with the federal reserve is being done, or has been done for a number of years. However, raising the bank rate would be directly effective if excess reserves of member banks were decreased by raising member-bank reserve requirements.

Third, the Open Market Committee of the Federal Reserve has a weapon, perhaps somewhat minor, that can be used more vigorously, and that is the selling of securities in the open market. The effectiveness of this policy depends on the amount of securities that could be sold, a potential total of something over two and a quarter billions at present.

## II

The second part of this paper will deal with "unorthodox" methods of controlling credit which are conditioned and perhaps made necessary by defense preparations. The problem is greater than that of financial control, but the approach will be made from that angle. The problems of a preparedness economy would be great and highly complicated even if the public debt were small, but they are even greater when the public debt is enormous.

The aim of a preparedness program, as I see it, is not only to produce combat materials and trained military personnel, but also to maintain civilian consumption and morale. Certain German writers have a word for it — *Wehrwirtschaft*, the "economics of the military state," a concept which, however, means more than what we mean by a preparedness economy. It means more than preparation for war, or the economics of a nation at war, or demobilization after a war; it embraces as well total "peacetime" activities. In other words, a modern state is conceived of as being a military state and the whole purpose of such a state is that of perpetual armed defense. In such a state there is no such thing as "war economics" as distinguished from "peace economics."

Our aims are not as bellicose, I trust, as those of the German economic writers. I assume that our aim is not a permanent military state, and so we can talk sense about the economy of preparedness or of war, on one hand, and the economy of peace on the other. Our broad problem at present, as I see it, is to make the transition to a condition of

military preparedness with as few maladjustments and dislocations as possible, with a view to returning eventually to an economy of peace.

This means, of course, the exercise of governmental controls of varying kinds and degrees. The traditional automatic controls of such things as free consumer choices, freedom of occupations, freedom of markets, even the profit motive itself, will not suffice without at least some modifications, directly or indirectly. Of course, the whole problem is highly complex, and one should not be dogmatic on specific points. The major reason for a departure from the automatic controls of free enterprise seems to lie in the fact that they work too slowly for the purpose at hand. A job is set to be done, and individual initiative, as potent as it is for economic production, cannot be wholly relied upon even in a nation that has grown strong and powerful under such incentive.

The question then becomes: What kind of control and to what degree should it be exercised? No hard and fast rules can be laid down. But with a conviction that as much of private initiative as possible should be retained, I offer certain broad comments and generalizations.

The further we carry our preparedness effort the more we will experience price rises in specific products because of bottlenecks in transportation or industry, competitive bidding by various government agencies and civilian consumers, or other factors not so easily discernible. These increases will probably take place first in certain strategic materials, but it is unlikely that sporadic price advances will be confined to such products. When these increases take place—as has already happened in the case of lumber, for example — the issue of “price fixing” at once will be thrown into the forefront. At first government policy may be that of adjuration and threats directed at the sellers of the products; and when and if this policy fails — which it no doubt will — then direct fixing may be expected to be employed.

Price fixing as a general rule should not be undertaken. Even in a period of great preparedness effort the automatic functioning of prices may operate effectively as a stimulator of production and a conserver of essential materials. By way of example, let us consider the recent rise of lumber prices, which was due, apparently, to the competitive bidding by various agencies of the government. A rising lumber price on the one hand encourages greater lumber production, and on the

other hand leads to more economical use of lumber and the consideration of substitute building materials. Or let us take an example in the field of food consumption. Suppose the price of butter skyrockets. The cause for the high price would be, no doubt, a shortage in the supply, and high prices will encourage more dairymen to enter the butter producing business which will increase the supply and prices will tend to fall. Butter would be used more economically, substitutes would be used more and more — which would also tend to pull the price down. It would seem highly desirable that prices should remain as flexible as possible, competition should be free, and collusion of all kinds should be restricted.

Control of prices should be of a general nature along the lines brought out earlier in this paper.

Fixing of specific prices may be considered from another angle. If the price of lumber, for example, were fixed and the price of labor and capital and other elements of cost were free, a rise in the price of these cost factors could easily wipe out profit margins of the lumber producers who in time would have to fold up and go out of business, with disastrous results to the supply of an essential product. It must be remembered that "costs" to some are "prices" to others, and the logic of the matter would dictate that all cost-prices should be fixed, including wages, interest on capital, rents, leases, etc. As a practical matter specific price fixing will naturally lead to many more such fixations. Carried to its logical extreme, the policy means the fixing of all prices.

Moreover, it would seem that any thoroughgoing system of price fixing should be accompanied by a correlative system of rationing; otherwise, injustices will result in the distribution of the goods in question. It is not at all unlikely that those consumers with ample incomes would buy up and hoard available stocks at the fixed price (unless rationing was applied) to the detriment of those whose incomes would not permit of such practices. And, I take it, a policy of price fixing would have as its major aim the protection of the low income group. Obviously, if all had sufficient incomes to buy all they wished regardless of price there would be no necessity for fixing prices.

Administratively the problems of price fixing and rationing are very complex, and what prices to fix and what amounts to ration would depend mainly on consideration of immediate ends to be achieved. What-

ever seemed expedient under given circumstances would tend to govern administrative action. There is no body of theory concerning legal prices which might be used as a guide. Neo-classical price theory concerns itself primarily with free markets, and while it offers much light upon problems of legal price fixing, obviously it cannot be a guide, as the assumptions are entirely different. On the other hand, socialist theory, in its present state at least, offers much less than neo-classical theory. Under price fixing and rationing, what we have is a mixture of free enterprise and socialism with very little theory to guide. In practice, what has been done in certain periods of our past, and what likely will be done in similar periods in the future, is to base action on expediency — and that means dealing with such things as impairment of transportation facilities, shortages in particular commodity stocks, sudden changes in consumer demand, etc. In all this, political pressures from powerful groups, unfortunately, will play important, if not in some cases at least, dominant roles.

As I see it, the economics of priorities, of which we are hearing much these days, is much the same as price fixing and rationing. A system of priorities is concerned, of course, with the channeling of the products of industry into specific consumer uses. As a modifier of free enterprise it is more mild than price fixing and rationing — but it is a different species of the same genus. It is to be considered as a first step along the road which leads logically to complete legal control of all phases of economic activity.

The further we go into our preparedness program, probably, the more we shall use a mixture of what I have called “orthodox” and “unorthodox” methods. What likely will be done will be to use the method or methods which offer the greatest possibility of achieving immediate ends.

### III

In the latter part of this paper, I cannot resist the temptation to comment on the possible economic system of the future. I justify these comments in a paper on the economic consequences of the public debt on the conviction that it is through disruption of finances that great changes take place. Lenin is supposed to have said once that the best tactical method of overthrowing capitalism is to debauch the currency. Whether or not that system which is called capitalism can be abolished in this manner, it is true that a breakdown in a nation's finances re-

leases forces that may well bring about vast changes in the structure of an economy if not, in some measure, in the foundations themselves.

By foundations we mean, on the one hand (to use a colorless economic term) human wants, and on the other hand, human motivation, and all that these terms imply. By structure is meant the techniques and methods developed by society, formally or informally, through which incentives operate to create the things that satisfy wants. Now it seems obvious as an historical fact that structure has been and is undergoing constant change. It is not so obvious, however, that human nature (to use a none-too-specific term) changes in any such manner. A breakdown in finances obviously would bring changes in the structure, but what changes would be effected in the foundations is none too clear.

Even to predict what specific changes in structure might take place is pure speculation. Nor is it especially clarifying to call the "new order" by some general name such as socialism, state socialism, state capitalism, communism, totalitarianism, or super new dealism. Probably any new order would take a name from the political group which sponsored the changes and carried out the program, or even perhaps from a campaign slogan of an existing political group. The name is relatively unimportant. What would take place, it seems to me, would be a vast increase in the scope of legal controls over all phases of our economic life. Political rather than economic considerations would be a dominant factor.

That such changes will actually take place is not at all unlikely. It is not out of reason to suppose that, *if we preserve our free competitive system*, the present financial policies will lead to another great economic depression probably worse than the one we have come through since 1931. But—and this point is crucial—political and humanitarian considerations will not permit of the dislocations and suffering such a depression would entail. The alternative would be the government's taking care of people on a vast scale, and doing the things necessary to achieve that purpose, such as commandeering food supplies, operating transportation systems, exploiting productive resources, etc. In short, restriction on private business would be greatly extended, as well as the scope of direct governmental engagement in production.

One should not make the mistake of assuming, however, that such positive changes would of necessity be sudden and drastic. When they

come, if they do, they will seem to be best under the circumstances. Economic change is often not spectacular and usually proceeds on what has gone before. The aphorism, "nature makes no leaps," seems to be as applicable to economic and political change as to any other part of nature. The trend in this country for many years has been in the direction of more and more controls, and at present they are increasing apace; so when the time comes in the emergency of a new depression, the groundwork will be well laid for additional controls.

On the political side, such broadening of the scope of legal controls would probably mean the progressive disintegration of democracy unless we redefine our concept of that political system. Historically, democracy has been essentially the counterpart of the economic system of free enterprise. It seems a bit incongruous, therefore, to talk about preserving democracy and at the same time advocate the passing of more laws to restrict individual economic activity. Of course, one should not be dogmatic: free enterprise and democracy do not mean, and never did mean, the total absence of restrictions and controls. It is a matter of degree. The real issue is how far we may go and still retain a desirable quantum of economic freedom.

It is not my purpose to compare the merits of a possible "new order" with what we call the system of free enterprise. A few comments will suffice. The result in total economic goods and services in our country under free enterprise is generally well known to all and most of us would pronounce the results reasonably satisfactory, although many of us would like to see the material things of life more widely distributed. The results of a "new order" in Russia, for example, are not so clear, largely because of the difficulties in making objective studies of that economy. In Germany the results, measured in terms of war efforts at least, seem to be excellent; how the situation will be in peace time, we do not know. In Italy, as regards war effort, the results have not been so good, even though fascism was a "going concern" there for many years prior to the war.

Regardless of the "system," one important set of factors is always present. The task of providing goods and services to satisfy human wants is the one big economic problem. Any system has the problem of producing goods and services by utilizing scarce means of production. The problem is present in Soviet Russia as it is in any other country. The difference comes in the methods of solving this problem, and these methods constitute the "system." To state my own position, I am of the

opinion that the job can be done better under slow-moving free enterprise, notwithstanding the imperfections of that system which socialist writers and others have done good service in pointing out.

But this position does not prevent me from observing realistically that we are moving away from free enterprise toward a "new order"—an observation which leads to several comments on the place of economics in such an order, the place of what has come to be called neo-classical economics. Much of it will be outmoded, but by no means all. Price theory, including distribution theory, based as it is on assumptions of free competition and free choice, would have to go. I am not so sure about value theory, if one thinks of it as distinct from price theory. Economic values would be present and would be allocated on some basis or other whether free markets were or were not present. The marginal analysis, especially as a factor in the allocation of productive resources, would be as important as under a competitive system, perhaps more important. An authority would have to know, for example, whether to employ 100 men on a project or 99 men or 101 men, and he would have to have means of finding this out, not in terms of profit, to be sure, but in terms of physical achievement. In this fundamental sense, neo-classical economics would be necessary to a "new order," but of course present-day textbooks would have to be rewritten. On the practical side, the new textbooks would have to be written mainly as guides to the "authorities," rather than mainly as guides to business men, as they are at present. Economists could live in the hope that the "authorities" would take advice better than business men have done!

And now a few comments on motivation. To achieve the results of producing goods and services, enterprisers under a system of free economy engage in economic activity for the purpose of making a profit (or once in a business, to keep from incurring losses). With this motive absent, or at least greatly modified in a "new order," what are the possibilities of substituting some other motive, or perhaps several motives or combinations of motives? This issue is crucial in any consideration of alternative systems, and unfortunately we know little about the matter in a precise or scientific manner. A search of the writings of the "great names" in economics results in a collection of interesting quotations, many of which we have been inclined to accept as axiomatic but which are without scientific proof. The psychologists seem to have been able to offer the economist little on the subject. The study of human motivation seems to be still in the stage of speculation.

The issue of motivation, nevertheless, is crucial to this discussion. Would it not be true to say that in the "new order," as we have envisaged it, motivation would necessarily take the form of mass appeals made in different nations and under different circumstances? In war times the appeals would be made for "national defense," "national security," "national pride," "national honor," "revenge for felt past wrongs," etc. Such appeals are powerful forces in getting goods and services produced in war times as has been amply demonstrated in recent years.

But what about collective motives in peace times? After all, the business of making a living is pretty much a continuous day-by-day matter, and the process can easily become humdrum. Would it not be necessary for the "authorities" to "manufacture" emergencies periodically about which they could make a mass appeal? Perhaps there is some truth in the view that the economic and military success of Germany at present is due to the newness and freshness of the mass appeals that have been made to the German people in the past few years; and by the same token, the lack of military success of the Italians can be explained in terms of the Italian people's having tired of such appeals, for it must be remembered that fascism in Italy is much older than nazism in Germany, and has existed over a much longer peacetime period. Perhaps in Italy the effectiveness of mass appeal, even in wartime, is playing out, whereas in Germany that stage has not been reached.

One might contend that fear of punishment is a necessary and important motive in a collectivist state. Granted that concentration camps and blood purges have been necessary to keep dictators in power, yet such a contention cannot be entertained if the long-run aim is to produce the greatest amount of goods and services with the least sacrifice. The motive must be positive, not negative.

If it seems to the reader that I have wandered rather far from the subject in these last random speculations, I beg this extenuation. My conviction that great changes are in the making and that these changes will, in major part, come in through the "financial door" as it were, is the reason why this paper has taken the turn it has. These changes will probably bear little semblance to the various specific purposes we had in mind as we have developed our financial policies; but in the light of human history even this should not strike us as being too strange or unusual, for, in the words of Bishop Bossuet, uttered several centuries ago, "men do other than they intend."