A CRITIQUE OF THE DIFFERENT METHODS OF HANDLING THE NATIONAL DEBT

by

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CHAPTER I

INTRODUCTION

The total direct and guaranteed debt of the United States government stands at $256 billion.[1] This large national liability poses problems to which the public expects its elected officials to find adequate answers.

Will a huge national debt affect adversely the financing of another emergency? Should we pay it off as fast as possible? Should we increase it to maintain an economy of abundance and full employment? Can we use it as an instrument to regulate and manage the oscillations of the business cycle? If we choose to use it as a tool for regulating prices or employment or both what methods of manipulation would be desirable? These questions are not easily answered by any thoughtful person.

Most of the recommendations concerning debt management fall under three general headings. The first, and perhaps the best-known to the average newspaper reader is the orthodox school, which recommends immediate and maximum debt reduction, with the ultimate aim of eliminating it altogether.

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[1] Daily Statement of the United States Treasury, March 1, 1950, p. 12.

The method of debt reduction would be through building up budget surpluses, by decreasing government expenditures and planning to pay off a stated amount of the principal annually.

Second, there is the "full employment" school, which feels that a large debt is no strain on the economy at all. The debt must be used as a tool to combat the threat of unemployment, and should be managed solely with regard to that purpose. In times of less-than-full employment, government expenditures must exceed receipts, and borrowing must be resorted to in order to make up the deficit. When expenditures have stimulated production to the point of full employment, the increased national income will yield increasing revenues, and the need for government expenditures will decrease. If the revenues increase greatly in proportion to the expenditures, the budget surplus can be utilized to pay off some of the debt.

Third, there is the "price-stabilizing" group. This group recommends management of the debt for the purpose of maintaining a relatively stable price level. The method would be to change the form of the debt as presently held, and then to use it as an instrument of control over the volume of credit, implementing the powers of the Federal Reserve System.

The purpose of this thesis is to examine the recommendations of each school of thought and to discuss the relative merits of each.

CHAPTER II

THE ORTHODOX SCHOOL

Perhaps it will be most interesting to consider first the school of thought most familiar to the readers of the newspapers and the current popular journals - the viewpoint supported by orthodox economists.[1] Viewing the existence of the debt as a heavy burden on the economy, they urge immediate and maximum reduction with the ultimate purpose of eliminating it altogether. Balancing the budget through decreasing government expenditures enough to allow for a retirement of part of the principal each year is the method they recommend.

The position of this school rests upon the following assumptions: (1) a long-run tendency of a free economy to come to an equilibrium at full employment, (2) the productivity of private spending, (3) the unproductiveness of public spending, and (4) the similarity between private debt and government debt. Since any purchasing power transferred to the government must come at the expense of agriculture

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[1] For quotations and references to classical and neo-classical economists on the debt, see Seymour E. Harris, The National Debt and the New Economics, New York: McGraw-Hill, 1947, Pt. II, Chap. 4.

and industry, they think that any rise in the public debt, as well as any rise in taxes, is harmful, and any decrease in either must be beneficial.

Since 1933, this group has become more and more alarmed at the inflationary aspects of the debt and the budget deficits through which it is incurred. Inflation is defined by Stewart and Tucker[1] as a condition occurring whenever the circulating medium of a country is expanded to such a point that the total money value of the goods and services offered for sale increases faster than the total quantity of such goods and services. The commercial banks at present hold a large proportion of the debt.[2] When the Federal Reserve System wishes to curtail expansion of member bank deposits by raising the reserve requirements, these securities can be sold on the open market to meet the new requirements and expansion may continue. Any new issues which are purchased by the banks are bought by the creation of bank deposits, and thereby the supply of the circulating medium is increased. Therefore, both past and future deficit financing have inflationary potentials, presumably granting that

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[1]Paul W. Stewart and Rufus S. Tucker, The National Debt and Government Credit, New York: Twentieth Century Fund, 1937, p. 119.

[2]At the end of November, 1949, the commercial banks owned $66.9 billion out of $257 billion total of Federal securities outstanding - 26%. Treasury Bulletin, Feb., 1950, p. 34.

velocity of circulation and the number of transactions remain the same.

Inflation, once begun, is difficult to stop. As speculative commitments are made on the basis of rising prices, influential special interests will oppose any checks on a boom.[1]

The orthodox group claims that a further inflationary factor in the existence of the debt lies in the commitment by the Federal Reserve System to support the government bond market.

> At the time the United States entered the war in December, 1941, the Board of Governors issued a statement to the effect that the Federal Reserve System was prepared to use its powers to assure at all times an ample supply of funds for financing the war effort and to exert its influence toward maintaining conditions in the United States government security market satisfactory from the standpoint of the government's requirements.[2]

Under this commitment, the Federal Reserve System undertook to support by market purchase the prices of issued securities. Thus, prices as well as market interest rates were maintained.

While admitting the necessity for this support during the war, the orthodox group sees the continued support of

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[1]Stewart and Tucker, op. cit., pp. 109-128.

[2]Thirtieth Annual Report of the Board of Governors of the Federal Reserve System, Washington, D. C.: U. S. Government Printing Office, 1943, p. 1.

a low interest rate as an addition to inflationary pressures. Whenever the Federal Reserve System, in accordance with its commitment, steps in and buys Federal securities on the open market to maintain the price, it puts more money into circulation.[1]

The continuing presence of a large public debt reduces public confidence in government credit, according to the orthodox group. Loans made to finance an emergency program should be paid off before the next emergency in order that the next emergency may find the credit resources of the government strong. This not only calls for repayment, but presumably very rapid repayment.

This group seemingly assumes that the interest charge on a debt must be paid annually out of taxes, and therefore this group feels that the interest charge we have now is a burden on the producers of the nation, and a reward to those who do not necessarily earn from productive effort. In this way, the tax payments used to pay interest on the debt are a burden on the economy.

> The taxpayers, broadly speaking, are the industrial workers, farmers, professional people, individual entrepreneurs, corporate investors, business concerns - those who work, save and incur risk in order to produce. Taxes, whether for interest on the debt

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[1]Committee on Public Debt Policy, Our National Debt, New York: Harcourt, Brace, 1949, pp. 76-96.

> or any other purpose, are a drain on their earnings and a deterrent to their enterprise.[1]

This school is in agreement with all the schools that the amount of debt retirement should be related to the prosperity of the country. Heavy retirement of debt in prosperous times would be a check to overexpansion and inflationary tendencies. In times of depression, a smaller retirement would relieve tax burdens and thus aid prosperity.[2]

This group lays great emphasis upon a balanced budget which includes a program for debt retirement. The budget should be balanced through drastically reducing expenditures and eliminating, in so far as possible, bureaucratic inefficiencies. Expenditures should be reduced to such an extent that no further taxes will be imposed upon production and savings. In fact, their ideal would be a cut in government expenditures so large that not only large amounts of the debt principal could be repaid annually but also substantial tax reductions could be put into effect.[3]

The redistribution of the debt by transferring bank-held securities to private hands is recommended by this school.

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[1] The Guaranty Survey, New York: Guaranty Trust Company of New York, Vol. XXXIX, No. 8 (November 30, 1949), p. 2.

[2] Committee on Public Debt Policy, Our National Debt, New York: Harcourt, Brace, 1949, pp. 156-157.

[3] The Cleveland Trust Company Business Bulletin, Vol. 30, No. 12 (Dec. 15, 1949), p. 2.

Also, the issuance of more long-term bonds to reduce the amount of debt due and payable within a period of one year (hereafter referred to as floating debt) would reduce the necessity for refunding such large amounts from year to year and in that way increase the possibilities of financing another emergency.[1]

They would do away with the support policy of the Federal Reserve System and would return to the pre-war market system for government bonds. This would give interest rates enough freedom of movement for them to perform the function that this group assumes they should and could, i.e., to maintain a balance between the supply of savings and the demand for investment funds.[2]

The central idea behind the recommendations of the orthodox group is its concept of the proper purpose of fiscal policy. The Guaranty-Trust Company sums it up as follows:

> The proper purpose of fiscal policy is not to contribute to the growth of the economy but to provide for the necessary expenses of government. Fiscal policy can contribute to true economic growth only in a negative way and to a limited extent.[3]

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[1]Committee on Public Debt Policy, op. cit., pp. 157-159.

[2]Ibid., p. 97.

[3]The Guaranty Survey, Vol. XXXIX, No. 10 (Jan. 27, 1950), p. 2.

Briefly summed up, the recommendations of the orthodox group for management of the public debt are:

1. Immediate and maximum repayment of the debt.
2. Reduction of government expenditures to such an extent as to provide budget surpluses.
3. Maintenance of tax rates at their present level with the ultimate aim of substantially lowering them.
4. Abandonment of the support policy for government bond prices.
5. Redistribution of all bank-held debt to private ownership.
6. Issuance of long-term securities against the floating debt.

CHAPTER III

A CRITIQUE OF THE ORTHODOX SCHOOL

The orthodox school advocates immediate and maximum debt reduction through decreased government expenditures. Its proponents have the advantage of being able to point to an historical precedent. The Harding and Coolidge administrations, through the policies of the Secretary of the Treasury, Andrew Mellon, embarked on a program of debt reduction and tax reduction during a period of prosperity. The program worked for the "boom" period of the business cycle. For nine years, from 1920 to 1929, the debt was retired at a rate of over one billion dollars a year. It was reduced out of current receipts of the government, using economy in government expenditures, a sinking fund for debt repayment, and returns on loans made to foreign powers. Taxes, particularly on the higher income brackets, were drastically reduced, and the era was one of expansion, full employment, and general prosperity. In times of business confidence, optimism, and expansion, retirement of the debt and decreasing taxation were accomplished without any harmful results that were immediately evident.

But then came 1929 - and the program seemed no longer

politically possible. The national debt increased by $598 million in 1930, by $2.6 billion in 1931, and by almost $3 billion in 1932.[1] Receipts fell even faster than expenditures, and a balanced budget became a dream for the future and a plank in the platform of the opposition party. Unemployment climbed to an unknown figure, estimated at not less than 13 million people.[2] Income payments fell 54% between 1929 and 1933.[3] Debt reduction was abandoned in the effort to save the economy from seeming disaster.

Therefore, it is perhaps safe to conclude that large-scale retirement of the debt has come to be politically practical only in the boom period of the business cycle. Any long-run plan of debt retirement must include some kind of provision for depression policy. If any lesson can be drawn from the historical experience of 1920-1933, it would seem to be that the debt not only will not be reduced (and perhaps cannot be reduced), but it is very apt to be increased during a downswing of the business cycle. In that event, it is surely reasonable to try to evolve a workable plan for managing the debt over the entire business cycle. If, in evolving

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[1] Annual Report of the Secretary of the Treasury on the State of the Finances, June 30, 1949, p. 480.

[2] Labor Information Bulletin, Bureau of Labor Statistics, Vol. I, No. 1 (Sept., 1934), p. 1.

[3] Survey of Current Business, U. S. Department of Commerce, Vol. 28, No. 8 (Aug., 1948), p. 19.

such a plan, the debt could also be used as an instrument for regulating the cycle, so much the better.

The orthodox school calls for a drastic cut in federal expenditures to provide for debt reduction and even tax relief. Let us look at the situation in the Spring of 1950. In the budget estimate for the fiscal year ending June 30, 1951,[1] expenditures for national defense, international affairs and finance, veterans' services and benefits, and interest on the public debt constituted 70.6% of the total. The only way to reduce expenditures enough to allow for considerable debt repayment, not to mention tax relief, would be to cut severely the appropriations for one or more of these major items.

The Committee for Economic Development presents a program for a budget surplus in 1951 of over $5 billion, of which they advise applying $3 billion to debt reduction.[2] The major item on which they feel reductions could be made was veterans' expenditures. The C. E. D. budget is calculated on an assumption of 96% of the labor force employed. Given this assumption, unemployment allowances and educational aid expenses might become low enough to allow for con-

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[1] The Budget of the United States Government, Washington, D. C.: U. S. Government Printing Office, 1950, p. M18.

[2] Committee for Economic Development, Tax and Expenditure Policy for 1950 (New York, 1950), pp. 14-26.

siderable economy in this. However, the average number of participants in the veterans' education and training program is estimated at 400,000 above the level anticipated a year ago.[1]

The veterans, with their immediate families, will soon comprise 40% of the population, and any serious attempts to cut the unemployment compensation or educational benefits of the group to a point which would permit large repayments of the federal debt would entail grave political consequences for the party in power. Proposals are pending in Congress to increase greatly the special programs for veterans.[2]

The largest item of federal expenditures for 1951 is that of national defense. The outstanding items are $4 billion for pay and support of active duty personnel, $3 billion for operation and maintenance of equipment and facilities, and $2 billion for aircraft procurement.[3] The Administration feels that the tenseness of the international situation calls for a fighting force of 1,507,000 men and an expenditure of $2.1 billion for approximately 2800 airplanes.[4] Secretary Mellon and President Coolidge were faced with a very different political climate. The end of World War I found us at

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[1] The Budget of the United States Government, op. cit., p. M38.

[2] Ibid., p. M36.

[3] Ibid., p. M28.

[4] Ibid., p. M31.

comparative peace with our former allies, and found the sentiments of the voting population of the United States isolationist and pacifistic. An army of 110,000 men was considered then quite adequate to protect the peace and prosperity of the land. Now military authorities estimate the need for an army of 630,000 and a total active military force of 1,507,000.

The estimated expenditures for European aid are dropping steadily, decreasing by almost $1 billion a year.[1] If the world continues its present momentum toward economic recovery and political stability, these expenditures will continue to drop. However, to quote the President,

> The continuing and grave uncertainties which remain in the world situation make it imperative that we be prepared to adjust our efforts to accord with developments.[2]

The interest charge on the public debt could be reduced and quite sharply, by a method to be taken up later in this thesis; but with the debt as it presently stands, to return the interest rate on government securities to the control of a free market might very easily result in the increase of the total interest charge, not a decrease. The support of the government bond market by the Federal Reserve System has been deemed necessary to keep the interest rate as low as it is at present. Approximately $63 billion dollars of the debt will

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[1] Ibid., p. M21.

[2] Ibid., p. M20.

become payable within a year[1] and have to be refunded. If removal of the support policy should increase the interest on government securities, this floating debt would have to be refunded at higher rates, and interest payments on the debt would increase significantly.

To apply budget surpluses to debt reduction, the tax structure should be stable enough to allow continuing surpluses to occur in prosperous times. However, the budget surplus of 1948 of $8.4 billion was promptly followed by a tax reduction bill passed by the 80th Congress in April, 1948. In the fiscal year of 1949, the nation incurred a budget deficit of $1.8 billion.[2]

The orthodox school says that the debt must be paid off. This idea flows first from the reasoning of business men - that expenditures must be lower than receipts to keep the firm from bankruptcy.

> A prudent individual will pay down his debts when his affairs are prosperous. One would suppose that a prudent government would do the same.[3]

Actually, the federal debt differs from the debt of a business man in three ways. (1) A business man owes money to

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[1] Daily Statement of the United States Treasury, March 1, 1950, pp. 5-10.

[2] Annual Report of the Secretary of the Treasury, 1949, op. cit., p. 16.

[3] The Cleveland Trust Company Business Bulletin, February 15, 1950, p. 2.

some legal person other than himself. If the debt of the United States were owed primarily to citizens of foreign countries or their governments, it would be similar to the debt of the business man; but the debt of this government is owed to its own citizens and is paid by taxing them. Interest payments and repayment of the principal are merely transfer payments within the economy. (2) A business man must pay his debt out of the revenue from sales, which are not limitless. The limit of the taxing power of the federal government is not yet tested. (3) A business man cannot create the money to pay off his debt. The federal government, with its constitutional power of coinage, can always print the money to retire all of its debt at any time it so desires.

The viewpoint of this group - that public investment is "unproductive" while private investment is productive - will not withstand careful analysis. Public investment, if wisely made, will create commodities and services which have utility. The development of a public park, swimming pool, playground, or concert hall makes possible a flow of real income no less than the creation of a radio factory. Public investment in the national forest by protecting soil erosion and floods may increase the efficiency of labor and conserve the total wealth of the nation.

The inflationary potential in the debt lies in its ownership, not in its existence. When the commercial banks buy

new securities, they buy them with demand deposits. The demand deposits issued to buy the bonds increase the supply of the circulating medium and, if the velocity of circulation and the number of transactions remains the same, prices will go up, and if the quantity of goods and services does not increase proportionately, an inflationary step has been taken. However, when a non-bank purchaser buys new securities, he reduces his demand deposits or currency by the amount of the bonds. The demand deposits withdrawn reduce the supply of the circulating medium and, if the velocity of circulation and the number of transactions remain the same, prices will go down, and if the quantity of goods and services does not decrease proportionately, a deflationary step has been taken. Consumption is perhaps sometimes decreased by the amount of the bond purchases. Therefore, if the commercial banks could not buy government securities, one of the inflationary pressures would be eased. When non-bank purchasers buy government securities from the commercial banks, the Federal Reserve, or the Treasury, the money supply is decreased. Each issue of government bonds purchased in this manner would be a deflationary step, and the debt already in existence would be a neutral factor.

The inflationary or deflationary effect of the debt is conditional upon what the government does with the funds secured by selling government bonds to non-bank purchasers.

If these funds represent money that otherwise would be held as idle cash balances, and if the government spends them for goods and services, the velocity of circulation would rise and prices might rise as well.

One of the difficulties which might hinder an attempt to put the proposals of the orthodox school into practice is that of educating the American people to accept their definition of the goal of fiscal policy. It might very well be that the majority of the public have come to expect government interference in their affairs in times of unemployment or other emergency. If they look to the government to use any available tools to mitigate the evils of depressions, they may regard fiscal policy as one of those tools.

CHAPTER IV

THE FULL EMPLOYMENT SCHOOL

The viewpoint of the "full employment" school concerning the management of the federal debt cannot be understood unless it is made clear from the beginning that their idea of the raison d'etre for government differs from that of the more orthodox economists. In the eyes of this second group, the primary duty of the government is to maintain full employment, and the federal debt must be managed with the goal of full employment in the foreground. To quote A. P. Lerner,

> The elimination of the threat of economic insecurity is the most important task of society today. Government fiscal policy, its spending and taxing, its borrowing and repayment of loans, its issue of new money and its withdrawal of money, should all be undertaken with an eye only to the results of these actions on the economy and not to any established traditional doctrine about what is sound or unsound.[1]

The full employment school concludes that, at the high incomes necessary to assure high levels of employment, private spending might be inadequate. Because of

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[1] Abba P. Lerner, "Functional Finance and the Federal Debt," Social Research, Vol. X, No. 1 (Feb. 1943), p. 39.

the lowered propensity to consume at higher income levels, the ensuing oversaving leads to unemployment, a fall in the national income, idle capacity, and retarded capital accumulation. Without adequate consumption, the business man refuses to invest, and the economy slows down and may even assume an equilibrium of less-than-full employment. If the outlay of the community should be insufficient to absorb all the goods and services produced, then an increased outlay by the State either can stimulate further outlay by the community or can absorb the excess goods and services. This increased outlay by the State would have to be financed by borrowing from the banking system, as either taxing or borrowing from the general public might further decrease either investment or aggregate demand or both. The increased government outlay, financed in this manner, can increase the national income. If a condition of less-than-full employment exists in the economy, then expenditure by the State will stimulate consumption, enterprise, and employment. Therefore, this school proposed a "socialization of demand," i.e., support of demand through government deficit spending, which, in their view, is the way to prevent a cumulative decline.[1]

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[1]Seymour E. Harris, National Debt and the New Economics, New York: McGraw-Hill, 1947, p. 5.

These proponents of debt accumulation would not rely entirely upon the growth of debt; to strengthen the propensity to spend they would reduce interest rates, reduce consumption taxes and increase social security benefits. The first financial responsibility of the government is to keep the total rate of spending on goods and services at that rate which, at current prices, would buy all the goods which it is possible to produce. More than this amount of spending would produce inflation, but less would result in unemployment.

Therefore, according to this logic, the size of the national debt is of no practical significance. The national debt cannot be a burden on the nation because every cent collected for interest or retirement that is obtained from the citizens as taxpayers is received by the citizens as government bondholders. If it becomes undesirable to raise taxes to pay the interest, money can be borrowed or printed to pay it. As the national debt rises, the sum of private income will increase due to stimulated consumption and employment. This will result in greater revenue yields from taxes on increased incomes and inheritances, and the budget will be balanced.

Stuart Chase, however, sounds a warning note. The tax structure and the debt must be used to keep national income high, or the debt will become unmanageable. He

hazards that the economy can bear a national debt of twice the national income without suffering harm, basing his conclusions on the fact that the British debt reached that figure in 1936.[1] Lerner warns that the budget must not reach a point of imbalance such as to upset the confidence of business men, who might tend to reduce their investments and effectively counter a program of deficit spending by the government. However, he suggests that there are devices to deceive the business men and make them believe that the budget is being balanced, as has been done in Sweden. Then, too, a guarantee of full employment would tend to allay the fears of entrepreneurs.[2]

If inflation should set in, it would be necessary to hold in check, or even to reduce, the volume of demand deposits. This could be accomplished by a federal budgetary surplus used to retire the bonds held by the commercial banking system. If the budgetary surplus were to be used to retire debt held by individuals and institutions other than commercial banks, the funds would flow back into the capital market and would not act against the inflationary pressures.[3] Increased borrowing from individ-

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[1]Stuart Chase, Where's the Money Coming From? New York: Twentieth Century Fund, 1943, p. 107.

[2]Abba P. Lerner, The Economics of Control, New York: MacMillan, 1944, pp. 320-321.

[3]Alvin H. Hansen, Fiscal Policy and Business Cycles, New York: W. W. Norton, 1941, p. 422.

uals would decrease the amount of money in the hands of the public and would curtail consumption.

E. F. Schumacher insists that no government could confidently embark upon a policy of maintaining full employment by means of deficit spending, unless it were certain that the rate of interest was under its own control and could not be raised against it. Any such rise would mean an increased cost of new borrowing to the government, and a capital depreciation on old bonds to the investor; but if the Government succeeds in developing such a technique, the very difference between the liquidity of cash, short-term paper and long-term bonds would tend to disappear, because a money title that can always be sold for cash at a fixed price is almost as good as cash. If interest is a reward for risk or for the postponement of consumption for a fixed period, stabilizing the rate of interest deprives the rate of interest of its function. Therefore, new notes which carry no interest are just as feasible as new bonds which carry interest.[1]

Robinson agrees with this.

> The policy of maintaining stability of interest rates and prices of government securities makes virtually the whole public debt equivalent

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[1]E. F. Schumacher, "Public Finance - Its Relation to Full Employment," The Economics of Full Employment, Oxford: Institute of Statistics, 1944, pp. 113-115.

> to money. It assures individual holders that they can convert their securities into money without appreciable capital loss.[1]

The proponents of the full employment school are aware that their plan may be untenable in the light of their own goal if the debt is not very widely held. A transfer payment from the consuming section of the economy to the saving sector in the form of interest on the federal debt only adds to the inequality of incomes and tends to create a rentier class. If large sums of the interest wind up in the hands of the already well-to-do, whose propensity to consume is proportionately less than that of the lower income groups, idle money in the form of savings will only be increased.

It is important to the theory of full employment that the government make an attempt to redistribute the income from the wealthy to the poor in sufficient amounts to increase consumption significantly. Taxes should be levied with the aim of redistributing income, provided they are levied in such a way as not to constrict the incentive to invest. The rich will decrease their spending by very little, while the poor will increase their spending by an amount equal to the whole of the reduction

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[1]Roland I. Robinson, "Monetary Aspects of National Debt Policy," Public Finance and Full Employment, p. 74. Postwar Economic Studies No. 3. Washington, D.C.: Board of Governors of the Federal Reserve System, 1945.

in their taxes or by the amount equal to the increase in their bonuses. As Harris says,

> High-level consumption is a *sine qua non* for high levels of demand and employment. At high incomes, and, even more so, at rising incomes there is a tendency to save too much..... Any measures that discourage consumption will also discourage investment, for the latter depends on the former.[1]

However, budget deficits tend to aggravate the maldistribution of incomes and of private wealth, if the income payments consist of a yearly transfer of considerable amounts to a small minority of citizens already wealthy. This fact is a big stumbling block to any policy of reducing the inequalities of incomes.

Lerner also deals with the problem of a decline in the public demand for government bonds. If the public becomes reluctant to keep on lending, it must either hoard the money or spend it. If the public hoards, the government can print the money to meet its interest and other obligations, and the only effect is that the public holds government currency instead of government bonds. If the public spends, the government will not need to borrow to increase the rate of total spending. If spending becomes too great, taxes can be levied to avoid inflation. A "simple, quasi-automatic response" operates

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[1]Harris, *op. cit.*, pp. 204-205.

in every case.[1]

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[1]Lerner, "Functional Finance and the Federal Debt," op. cit., p. 43.

CHAPTER V

CRITIQUE OF THE FULL EMPLOYMENT SCHOOL

The "full employment" school advocates the use of the debt and other fiscal measures to maintain full employment, increasing the debt deliberately in times of depression, and paying it off in times of prosperity.

One of the virtues of the suggestions of the full employment school is that it faces the fact that the federal debt is likely to be an important factor in our economy for a long time to come. They propose a definite, thought-out method of dealing with the debt and using it for purposes held to be for the general good. One may question whether the existence of the debt must be viewed as an asset, but it may be viewed as a usable tool for economic action.

The spending programs advocated by the school seem to be clumsy and unwieldy to use to adjust and repair the economic system. Appropriations must be made far in advance, administrative bureaus must be set up, with the result that the actual spending can begin a considerable period of time after the need for it becomes apparent and can quite conceivably continue for a con-

siderable period of time after the need for it has passed. The federal fiscal machinery is cumbersome and cannot always respond in time to the needs of the economy. Congress, even if it could, does not always act with speed and precision. A sharp decline can cause contagious depression and pessimism, and six months after the turning-point may be too late to stave off depression.

Congress cannot be depended upon to apply the brakes to credit expansion when the proper moment has arrived. The pressures for continuation along the existing road tend to be powerful and persistent.[1] Limiting spending to offset a boom is politically unpopular, and to expect Congress to follow a course that might bring defeat at the polls seems unreasonable.

Furthermore, the full employment school recommends a system to help redistribute the income on a more equitable basis. A large national debt pays interest, and this interest may tend to concentrate in the hands of the few. The citizens who pay the taxes are not necessarily the same as those who get the interest. This is the danger most widely recognized by the economists of the full employment school. Stuart Chase says,

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[1]Harold G. Moulton, The New Philosophy of Public Debt, Washington, D. C.: Brookings Institution, 1943, pp. 79-80.

> It is most desirable that the public debt be held by investors from all classes of the population. If war bonds land up in great blocks in the safes of the well-to-do then.... the problem of idle money immediately arises.[1]

E. F. Schumacher says,

> Ownership of government bonds - like the ownership of any other form of capital, real or financial - is a claim to wealth, not merely a claim to annual income. A steady increase in the national debt means a steady increase in the volume of financial claims held by a small section of the community..... It may ultimately lead to an undesirable rise in the number of rich rentiers.[2]

Seymour Harris feels that this tendency is offset by the high taxes on the wealthy.

> Government securities still seem to be held largely by the higher income groups. Before the war, the receipts of large income groups from interest of all kinds exceeded what they had paid in interest..... Available figures on the distribution of government securities.....suggest that the high income groups more than hold their own. But against this we should allow for the much greater burden of taxes they pay.[3]

The banks make such a profit from their ownership of government securities that Seltzer is led to question the current level of bank earnings.

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[1]Stuart Chase, Where's the Money Coming From? New York: Twentieth Century Fund, 1943, p. 105.

[2]E. F. Schumacher, "Public Finance - Its Relation to Full Employment," Economics of Full Employment, Oxford: Institute of Statistics, 1947, p. 103.

[3]Harris, op. cit., pp. 45-46.

> Mainly as a result of their increased holdings of governments, the net profits of member banks in 1944 were two-thirds larger than in 1941 and larger than in any previous year. They rose by another 25% in the first half of 1945 as compared with the like period of 1944. The wartime boom in bank earnings differs from that of other industries in that the supporting conditions will not disappear at the end of the war.[1]

The tendency Seltzer mentions, however, turned in 1948 when, for the first time since 1942, earnings from lending operations exceeded aggregate income from investment in governments and other securities by a margin of $200 million. Net profits fell to 7.6% of capital funds as compared with 8.6% of the year before.[2] This was the result of a deliberate Treasury policy to reduce bank ownership of Federal securities and widen the distribution of the debt. From 1946 to 1949, bank-held debt was reduced by approximately $34 billion.[3]

The viewpoint of many of the protagonists of this school is that the size of the national debt is of almost no significance.[4] The size of the national debt in its

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[1]Lawrence H. Seltzer, "The Changed Environment of Monetary-Banking Policy," American Economic Review, Vol. XXXVI, No. 2 (May 1946), p. 75.

[2]86th Annual Report of the Comptroller of the Currency, Washington, D. C.: Treasury Dept., 1949, p. 3.

[3]Annual Report of the Secretary of the Treasury for 1949, op. cit., p. 17.

[4]Lerner, The Economics of Control, op. cit., p. 302-303; Hansen, Fiscal Policy and Business Cycles, op. cit., p. 175.

present form is significant, because the interest charge is so heavy. Thus the authorities are tempted to hold down interest rates. This practice weakens the monetary tools of policy. Indirectly it weakens the use of bank reserves as a regulatory device. By supporting the prices of government bonds, the Federal Reserve System increases bank reserves by each purchase of securities. Monetary policy tends then to become subservient to a policy of low rates of interest.[1]

If the theories of this school were accepted as a guide to public policy, what would happen if prices began to climb rapidly while unemployment was still fairly heavy? In that situation, the more prices are boosted, the less the spending policy is taking hold on the physical volume of production and on employment.[2] Simons suggests that if the government has full employment as a goal of monetary-fiscal policy, labor unions can successfully press for an excessive increase in wages, confident that debt and spending will be increased to counteract any resulting unemployment.[3] Fellner says that if the

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[1]Albert G. Hart, Money, Debt and Economic Activity, New York: Prentice-Hall, 1948, p. 508.

[2]Ibid., p. 514.

[3]Henry Simons, Economic Policy for a Free Society, Chicago: University of Chicago Press, 1948, p. 203.

government "guaranteed" the level of employment de facto, monopolistic groups would attempt to raise their money earnings against the background of the "guarantee." Labor unions would be in a position to raise money wages without creating unemployment because the government would always absorb the slack. In many industries of strategic significance, which would benefit from public investment expenditure, the same would be true of monopolistic entrepreneur groups. The normal penalty for raising supply prices beyond certain limits would be eliminated.[1]

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[1] William Fellner, Monetary Policies and Full Employment, Berkeley: University of California Press, 1946, pp. 225-226.

CHAPTER VI

THE PRICE-STABILIZING SCHOOL

The "price-stabilizing" group sees the existence of the debt in its present form as having dangerous potentialities for the economy. Like the orthodox group, they see the danger of inflation, but they advocate another method of circumventing it rather than that of outright and immediate reduction.[1]

Under the present fractional reserve system of banking, the money supply may be increased by (1) commercial banks lending to individuals or businesses, or by purchasing outstanding securities, and by (2) commercial banks taking new security issues to finance a government deficit. The money supply is normally increased at present through an increase in the assets of commercial banks. The monetary authorities can affect the money supply by open-market operations of the Federal Reserve Banks. When the Federal Reserve System buys securities on the open-market, it increases the volume of bank re-

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[1] Jerry Voorhis, Out of Debt, Out of Danger, New York: Devin-Adair, 1943, pp. 129-140.

serves and with it the capacity of the commercial banks to lend and to invest. Then the Treasury can also increase the money supply through a sale of securities to the commercial banks.[1]

The public debt has become the chief earning asset of commercial banks. On December 31, 1928, the total loans and investments of all commercial banks amounted to $49.3 billion, of which $5 billion, or 10%, were United States Government obligations.[2] On December 31, 1948, the total loans and investments of all commercial banks amounted to $95.6 billion of which $52.2 billion, or 54% were United States Government obligations.[3] This shift in the quality of earning assets has seriously impaired the control of commercial bank lending by the Federal Reserve System. Traditionally, the central bank has resorted to three methods of credit control: (1) the raising or lowering of the rediscount rate, (2) the raising or lowering of member bank reserve requirements, and (3) open-market operations.

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[1]Alvin H. Hansen, Monetary Theory and Fiscal Policy, New York: McGraw-Hill, 1949, pp. 24-27.

[2]Board of Governors of the Federal Reserve System, Banking and Monetary Statistics, Washington, D. C.: National Capitol Press, 1943, p. 19.

[3]Board of Governors of the Federal Reserve System, 35th Annual Report (Washington, 1948), p. 32.

However, now that 54% of earning assets are in the form of government securities, a member bank does not need to borrow from the Reserve Bank in order to expand its loans after using up its excess reserves. The securities can be sold on the open market, and the kind of loans as well as the aggregate amount made will be out of reach of the Reserve Bank.[1] The control of the rediscount rate has ceased to be an adequate tool. To quote Eccles,

> So long as the banking system owns such a large amount of Government securities, and there is an immediate market for those securities, banks have little or no use for the rediscount facilities, and therefore the discount rate by itself is ineffective.[2]

The Federal Reserve System has committed itself to support the government bond market. As long as this commitment stands, any attempt of the Federal Reserve to reduce the amount of money in circulation through selling government bonds in the open market might result in a fall in their value and a rise in the interest rate. This would conflict sharply with their commitment to maintain the value of government bonds - a commitment

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[1]Lawrence H. Seltzer, "The Changed Environment of Monetary-Banking Policy," American Economic Review, Vol. XXXVI, No. 2 (May 1946), p. 74.

[2]Marriner S. Eccles, testimony in Hearings Before the Subcommittee on Monetary, Credit, and Fiscal Policies of the Joint Committee on the Economic Report. Washington, D. C.: U. S. Government Printing Office, 1950, p. 225.

which obligates them to buy on the open market when the value begins to fall and the interest rate commences to rise. Thus the credit control power of the Federal Reserve through open-market operations has been seriously impaired.

Any attempt by the Federal Reserve System to use its power to regulate member bank loans through raising member bank reserve requirements meets the same impasse, as long as government securities comprise 54% of their earning assets. If reserve requirements are raised, the commercial banks would be likely to dispose of their government bonds.[1] This would lead to a fall in the value of government bonds and, under its commitment, the Federal Reserve would be forced to buy on the open market. This purchase would increase member bank reserves, and the control would be no control at all, as one movement would cancel the effect of the other. Therefore the method of controlling member bank loans through control of member bank reserves has been seriously impaired.

Thus, the inflationary effect of the existence of the debt lies in the portion of it that is owned by the commercial banks, especially as long as the support policy of the Federal Reserve System is continued.

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[1] Lawrence H. Seltzer, "Postwar Domestic Monetary Problems," American Economic Review, Supp., Vol. XXXIV, No. 1, Pt. 2 (March 1944), p. 286.

Monetary control by the Federal Reserve System has been weakened, and Shaw goes so far as to say,

> Monetary controls have a special virtue. They are peculiarly impersonal, and they use the system of prices to get their results in output and employment. If they are strong, there is less call for the direct economic controls (such as price-fixing and rationing) that repress freedom of economic choice. The survival of private enterprise depends in no small way on the successful evolution of monetary techniques.[1]

There seems to be no reason for the government to pay interest on its short-term notes and certificates. These are so liquid as to be, in effect, demand deposits. When they are redeemed, they are redeemed in noninterest-bearing notes issued through the Federal Reserve - promises to pay issued by the government and not paying interest. If interest is a reward for risk, and if the value of government bonds is supported by the Federal Reserve, then the payment of interest on government securities shortly to be redeemed is not necessary.[2] The Treasury's short-term needs could be met by issuing noninterest-bearing certificates through the Federal Reserve System. The floating debt in the Spring of 1950 stands at $63 billion[3] and if this were refunded by the issuance of non-

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[1]Edward S. Shaw, Money, Income and Monetary Policy, Chicago: Richard D. Irwin, 1950, p. 25.

[2]Schumacher, op. cit., pp. 110-113.

[3]Daily Statement of the United States Treasury, March 1, 1950, pp. 6-9.

interest-bearing certificates rather than interest-bearing securities, a large - and needless, according to this school - interest charge would be removed. To quote Simons,

> There is even less sense in the Treasury's paying interest on demand or time deposits than in permitting banks to do so.[1]

The balance of the debt could be changed to the form of consols or perpetuities. The Treasury is assumed to be in business, not for ten years, not for ninety days, but for a lifetime. England and France have long recognized this. Why, asks this group, should government bonds ever be redeemable? They can be marketable, but they need never be redeemed. An individual who wished to sell his bonds could do so on the open market. If the government wished to retire its bonds, it could buy them on the open market.

A free market for these consols would then be feasible. When $63 billion of floating debt no longer carried an interest charge, the fluctuation of the long-term interest rate on the consols would be no longer of such importance, and the Federal Reserve could afford to relax its commitment.

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[1]Henry Simons, Economic Policy for a Free Society, Chicago: University of Chicago Press, 1948, p. 222.

Then the control of inflationary forces would be enhanced, because the consols would always be traded on the open market and never sold directly by the government to the commercial banks. When the Treasury incurred a deficit and it seemed desirable to the Federal Reserve that the supply of money be increased, the Treasury's needs could be met through noninterest-bearing certificates. When the Treasury incurred a deficit and it seemed desirable to the Federal Reserve that the supply of money in the hands of the public be decreased, the Treasury's needs could be met through the issue of consols. These checks would be simple and clear.[1] To quote Bach,

> For a central government with money-creating power, debt management is properly a monetary-fiscal control function, not a narrow money-raising and repaying function..... If funds are wanted to augment the volume of income and employment, new money should be created. The only appropriate control function of debt operations vis-ā-vis the non-banking public is the sale of securities in boom periods and the repurchase of securities in depressions.[2]

This school offers an objective criterion for the Federal Reserve System to judge what is "desirable." The amount of the circulating medium would be controlled in regard to the price level, as indicated by a price index.

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[1]Simons, op. cit., p. 225.

[2]George L. Bach, "Monetary-Fiscal Policy, Debt Policy, and the Price Level," American Economic Review, Vol. XXXVII, No. 2 (May 1947), p. 237.

They feel that booms and depressions are exaggerated because of the effect of the rise and fall in the general price level upon the entrepreneurs. Because they fear a fall in the general price level, they refuse to borrow or expand production; because they hope for a rise in the general price level, they over-expand. Therefore, a more stable price level would help to iron out the extremes of the business cycle.[1] If the price level declines, as expressed by a lower price index, noninterest-bearing certificates could be issued. As the price level rises, consols could be sold to the public.

Friedman points out that such a proposal tends to offset cyclical fluctuations and therefore seems to offer considerable promise of providing a tolerable degree of short-run economic stability. It relies as far as possible on a market mechanism within a competitive order to organize the utilization of economic resources. He says that the aim of the proposal is modest. It does not claim to provide full employment in the absence of successful measures to make prices of final goods and of factors of production flexible; it does not claim to eliminate cyclical fluctuations in output and employment. It does claim to provide a stable framework of monetary action and involves minimum

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[1]Irving Fisher, 100% Money, New York: Adelphi, 1935, pp. 110-116.

reliance on uncertain and untested knowledge.[1]

This scheme of putting the federal debt wholly into two forms is advocated by Simons as a direction for policy - an ultimate objective. The two debt forms he conceives of as too radical for early political consideration. Therefore, there are interim modifications suggested. A third debt form, a completely liquid federal bond, continuously redeemable and callable, eligible only for bank ownership, could be required as a reserve against bank deposits. New reserve requirements of these bonds might be imposed upon existing reserve requirements. A very low rate of interest, less than 1%, would be paid on these.[2]

Seltzer also suggests additional reserve requirements in government bonds which would keep the commercial banks from selling bonds when reserve requirements were tightened. He suggests an interest rate of 1% on these bonds. This would lower the rate of interest as well as the total interest charge.[3]

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[1]Milton Friedman, "A Monetary and Fiscal Framework for Economic Stability," American Economic Review, Vol. XXXVIII, No. 3 (June 1948), pp. 245-263.

[2]Simons, op. cit., pp. 231-232.

[3]Seltzer, "The Changed Environment of Monetary-Banking Policy," op. cit., pp. 76-77.

Abbott, too, suggests a long-term, low coupon bond eligible only for purchase by banks. Tax liability on it could be reduced to offset the low coupon. The banks might be permitted to invest their legal reserves entirely in these bonds.[1]

The Board of Governors of the Federal Reserve System in 1947 requested Congress to grant them authority to require special reserves of member banks in Treasury bills, certificates, and short-term notes. This would make it possible for the Federal Open Market Committee to require banks to immobilize a portion of their greatly expanded holdings of government securities instead of permitting them to treat these holdings as excess reserves.[2]

To sum up, the proposals of the price-stabilizing group are five:

1. Management of the public debt with a view to maintaining a stable price level.
2. Monetization of as much of the floating debt as the Federal Reserve deems feasible according to the price index.[3]

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[1] C. C. Abbott, Management of the Federal Debt, New York: McGraw-Hill, 1946, p. 94.

[2] Board of Governors of the Federal Reserve System, 34th Annual Report, Washington, 1947, pp. 8-9.

[3] Floating debt is defined in this thesis as all debt due or redeemable within one year.

3. Issuance of consols or perpetuities for investment purposes against the balance of the debt.
4. A return to a free market for government securities by releasing the Federal Reserve System from its commitment to support government bond prices.
5. An interim issue of a long-term bond with a very low interest rate to be held by banks as a large part of their reserves.

CHAPTER VII

CRITIQUE OF THE PRICE-STABILIZING SCHOOL

The sharpest criticism that can be made of the proposals of the "price-stabilizing" school is that they may be too radical for early political consideration. The conversion of the debt into two forms, currency and consols, might be too sharp a change from its present composition. That is the reason for the several suggestions put forth utilizing a third debt form to be required as a reserve against bank deposits.[1]

The ratio of member bank capital to member bank total assets is falling at present. In 1948 the average ratio was 6.6%.[2] If the liquidity preference of commercial banks should be high at the time that reserve requirements were raised, private loans might be contracted rather than government securities. If such contraction of private credit should be frightening to entrepreneurs, deflation or even depression might ensue.

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[1] Simons, op. cit., pp. 231-232.

[2] 35th Annual Report of the Board of Governors of the Federal Reserve System, Washington, D. C.: U. S. Government Printing Office, 1949, p. 25.

The return to a free market for government bonds, while it could be of considerable value in the long run, if effected too suddenly could have some serious and deleterious effects. Peter Bernstein, an economist of the Modern Industrial Bank, New York City, argues that a break below par in the market for government bonds would bring about wholesale sales of securities.[1] He cites two instances when this actually occurred. When pegs were dropped in December 24, 1947, heavy panic selling by holders ensued, to the extent that pegging had to be resumed. In the fall of 1948, just the discussion in financial circles that pegs might be dropped altogether led to heavy selling. A fall in the value of government bonds would lead to a rise in the interest rate and subsequent refunding would become a problem.

To this point the price-stabilizing school would reply that borrowing or refunding via consols on a free market must mean higher interest rates as a reward to bond-holders for giving up the liquidity of their present holdings. But this need not increase the interest burden. By retiring short-term and redeemable issues we would have a good proportion of the debt in a noninterest-

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[1]Peter Bernstein, "Federal Reserve Policy and Federal Debt: a Comment," American Economic Review, Vol. XXXIX, No. 6 (Dec. 1949), pp. 1278-1281.

bearing form.[1] Fellner feels that direct financing by the Federal Reserve banks, i.e., direct borrowing, could be rendered free of cost by assuming simply the form of the issuance of noninterest-bearing securities.

> In other words, consistent coupling of open-market purchases with deficit financing might be necessary in periods which really call for deficit financing and it might even gradually lead to a policy of issuing money by direct borrowing whenever monetary expansion is desirable and of selling securities to the public..... (and of keeping the proceeds idle) merely when monetary contraction is required.[2]

One of the most constructive aspects of the proposals of this group is that the control of the Federal Reserve System over the commercial banks could be augmented. As Boulding says,

> The increase in the amount of government bonds held by banks is a highly significant aspect of the growth of the national debt, especially from the point of view of control of the monetary system. One result of the growth in the proportion of bank assets in the form of government securities is to undermine the control exercised by the Federal Reserve Banks over the commercial banks, because of the great increase in the liquidity of commercial bank assets. The power of the Federal Reserve Banks to affect the reserve position of member banks by means of open market policy is severely limited by the fact that any sharp reduction in

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[1] Simons, op. cit., pp. 221-222.

[2] William J. Fellner, Monetary Policies and Full Employment, Berkeley: University of California Press, 1947, p. 197.

> the prices of government securities by Reserve Bank sales would endanger the solvency of the whole banking system. Hence, under present banking laws almost the only curb on a very substantial expansion of bank credit is the conservatism of the banks themselves.[1]

Under the plan of the price-stabilizing school, any serious threat to bank liquidity could be met by noninterest-bearing securities, while credit expansion could be controlled by open-market operations in consols.

The members of this group are called "monetary theorists;" that is, they feel that the price level is a function of the quantity of money. ($P = \phi(M)$) Prices are thought to vary in a fairly dependable relation to changes in the money supply. This conclusion, if valid, is highly important for policy decisions. If the relation of prices to the money supply is indeed firmly rooted in the behavior patterns of the community as determined by the customs, habits, and institutional arrangements of society, then it follows that the monetary authority can readily control the price level merely by changing the quantity of money. A control of the money supply alone would be sufficient condition for the control of income and the level of prices.[2]

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[1]Kenneth E. Boulding, Economic Analysis, Rev. Ed., New York: Harper, 1948, pp. 414-415.

[2]Hansen, Monetary Theory and Fiscal Policy, op. cit., pp. 48-49.

However, to quote Boulding,

> If an increase in the quantity of money brings about a fall in the velocity of circulation or rise in the volume of trade, then an increase in the quantity of money need not be accompanied by any rise in the price level.[1]

The price-stabilizing school may have underestimated the possibility of an increased desire to hold money when the money supply is increased, or an increased volume of trade. In other words, in the equation MV = PT, the monetary theorists believe that increases in M will increase P, and that V, if it changes at all, will tend to move in the same direction as M. If they are mistaken, and T should be the dependent variable in the equation instead of P, then their idea of using the debt as a tool to help stabilize the price level might fail.[2]

Some may question the wisdom of using price-index stabilization as the fundamental basis of a system of debt management. A change in the price level changes the value of money. It is virtually impossible to change the general value of money without changing a great number of the relative values which are the really important factors in the economy. There are three important reasons for these disturbances. (1) The dollar is used

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[1] Boulding, op. cit., p. 314.

[2] Hansen, Monetary Theory and Fiscal Policy, op. cit., pp. 49-50.

as a measure of value over a period of time. A rise in the price level benefits the debtor and injures the creditor. A fall in the price level will benefit the creditor for he receives money in repayment which has a greater value than the money he previously gave up, and the debtor is correspondingly injured. A very large fall in the price level may injure the creditor as well as the debtor, for the debtor may be unable to pay back his debt. Either way, one party unfairly benefits at the expense of the other. (2) Many prices change slowly and with difficulty from one equilibrium position to another. Due to the unequal flexibility of prices of different commodities, goods produced under monopolistic conditions will not fluctuate in price as much as goods produced under conditions of pure competition. (3) Some forms of property have their value expressed as a fixed number of dollars, no matter what the change in the price level while the value of other forms fluctuates with the price level.[1]

This leads Fellner to say,

> Given the secular rise in productivity, the pressure for wage increases, and the resistance to price reductions, it would seem that, normally, a policy directed at a stable general price level has a better chance to

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[1]Boulding, op. cit., pp. 320-322.

> secure "economic stability" in a relevant sense than does a policy directed at stable money income rates.[1]

This group believes that Federal financial policy can be carried out with existing knowledge in such a way as to make a major contribution to economic stability. It is important, they feel, to recognize and emphasize that economic stability is the primary objective of monetary policy. In general, the Federal Reserve should act to restrict the money supply and tighten the reserve position of the banks in times of business expansion and rising prices, and to expand the money supply and ease the reserve position of banks in times of falling production and prices. While the instruments provided by changing the form of the debt may not be perfect in all respects, this school believes that they would be sufficient for the execution of a highly beneficial stabilizing monetary policy.

Flexibility is essential to wise monetary action. The monetary instrument has - at least by comparison with such instruments as tax and expenditure policy - great potentialities for timely and deliberate flexibility. The process of deciding what to do need not be as time-consuming as the enactment of legislation, and the time

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[1] Fellner, op. cit., p. 186.

lapse between decision-making action and effect can be relatively short.[1]

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[1] Research and Policy Committee, Monetary and Fiscal Policy for Greater Economic Stability, New York: Committee for Economic Development, 1948, pp. 25-51.

CHAPTER VIII

CONCLUSIONS

Will a huge national debt affect adversely the financing of another emergency? Should we pay it off as fast as possible? Should we increase it to maintain an economy of abundance and full employment? Can we use it as an instrument to regulate and manage the oscillations of the business cycle? If we choose to use it as a tool for regulating prices or employment or both, what methods of manipulation would be desirable? We have attempted to find adequate answers to these questions by investigating the recommendations concerning debt management of three of the current schools - the orthodox school, the full-employment school, and the price-stabilizing school.

Will a huge national debt affect adversely the financing of another emergency? There seems to be no proof that the size of the debt affects adversely the financing of an emergency. If the public refused to buy government bonds, the government could either print money to cover its needs or tax away hoards of currency already in existence. The lowest point in the post-World War I debt was reached on December 31, 1930 at $16 billion.

The government had no difficulty in almost tripling the figure to finance the emergency measures taken to alleviate the depression or in subsequently multiplying the 1930 figure seventeen times to finance the nation's effort in World War II.[1]

Should we pay off the debt as fast as possible? The orthodox school, which views the existence of the debt as inflationary, urges immediate and rapid repayment of the principal. However, the mere existence of the debt is not inflationary. Money or money claims do not of themselves create inflation. According to our definition in Chapter II, inflation occurs whenever the circulating medium of a country is expanded to such a point that the total money value of the goods and services offered for sale increases faster than the total quantity of such goods and services. If the current supply of goods and services does not rise proportionately to any expansion in the circulating medium, inflation will be apt to ensue. If part of the debt represents "pent-up" demand, as it did during World War II, that part forms an inflationary pressure. If the debt represents voluntary savings, its existence is not likely to lead to sudden bursts of spending or investment, which might be inflationary.[2]

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[1] Daily Statement of the United States Treasury, May 1, 1950, p. 12.

[2] Schumacher, op. cit., p. 107-110.

There is reason to believe that our $255 billion debt will never be completely paid off. The experience of the last few years might lead us to infer that only a small part of the debt may be retired out of a budget surplus at any time. The occurrence of a surplus tends to be greeted by Congressional demands for more tax reduction, which is of more obvious immediate benefit to voters.[1] If this be noted as a political event in a time of high employment and high prices such as 1948, how much more true will it be that deficits will tend to be incurred in the depression phase of the business cycle? The major items of government expenditure under the present circumstances probably will not be cut enough to afford sizeable repayments on the principal. Taxes could be raised to pay off the debt, but such a move seems highly unlikely.

Should we increase the debt to maintain full employment? The proposals of the full-employment school to increase the debt whenever less-than-full employment exists involve the clumsy mechanism of legislative spending programs. The funds obtained by deficit financing would be spent with the purpose of stimulating effective demand. It is doubtful if spending programs can be made effective

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[1] Annual Report of the Secretary of the Treasury, op. cit., p. 16.

quickly enough to check a downward turn in the employment cycle. Expenditure decisions are, and should be, made by a deliberative process in Congress. The process is time-consuming. A considerable period must elapse between the time the decisions are made and the time they begin to affect the economic circumstances. The effect of fiscal programs intended to flatten the curves of the business cycle will often come too late, unless the decisions are made in advance on the basis of forecasts. However, such forecasts may be erroneous, and action taken on faulty predictions could tend to contribute to instability.[1]

Furthermore, a government commitment to maintain full employment through debt policy may perpetuate maladjustments and obscure the need for economic reforms. Public investment in times of depression may prevent reduction of construction costs which may have become excessive for a healthy industry. Monopolists of business or labor might raise the price of their products to the point where unemployment resulted. The government would be called upon to offset this reaction, not by removing the source of the trouble, but by spending more money.[2]

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[1]Committee for Economic Development, Monetary and Fiscal Policy for Greater Economic Stability, New York: 1948, pp. 38-39.

[2]Arthur Smithies, "Federal Budgeting and Fiscal Policy," A Survey of Contemporary Economics, ed. by Howard S. Ellis, Philadelphia: Blakiston, 1948, pp. 176-177.

Can we use the debt to regulate and manage the oscillations of the business cycle? Most of the debt consists of "near-money," i.e., in its many forms it is highly liquid. Because of this fact, it can be used as an instrument of control over inflationary and deflationary pressures. Monetary action consisting of changing the form or amount of the community's holding of assets by open-market purchases or sales of securities can be taken very promptly.[1] By using the debt as a monetary device to stabilize the general price level instead of full employment, flexibility will be attained and the maladjustments in the economy would be controlled as much as possible by the automatic mechanism of the market place.

If we choose to use the debt for the purpose of manipulating prices, what methods of manipulation would be desirable? If the form of the debt were changed, the interest charge could be reduced, and the Federal Reserve System could use the debt in its efforts to control the supply of the circulating medium in the hands of the public. The issuance of noninterest-bearing certificates - another name for money - would serve the needs of the Treasury as well as interest-bearing securities do at the present time.[2]

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[1]Friedman, op. cit., pp. 254-257.

[2]Lerner, The Economics of Control, op. cit., p. 309.

Whenever the Government incurred a deficit, the Treasury could turn to the Federal Reserve System to supply its needs. If the price-index were falling and the Federal Reserve deemed the amount of money in the hands of the public to be insufficient, money could be printed to finance the deficit. If the price-index were rising, and the Federal Reserve deemed the amount of money in the hands of the public to be excessive, consols or perpetuities, not purchasable by banks, could be issued to finance the deficit.

The perpetuities, or consols, would be bought and sold on an open market with no Federal Reserve commitment to maintain their value. The three controls of the Federal Reserve System - the rediscount rate, the reserve ratio, and open-market operations - could once more become instruments for checking over-expansion of credit.

If the decisions of the Federal Reserve System were made with the aim of stabilizing the general price level, a flexible price structure could be maintained. A price index (which no one commodity could significantly influence) would provide a measure, an objective criterion by which the need for issuing money or consols can be determined. To attempt to stabilize the general price level is to attempt to keep fairly constant the value of money. Debtors, creditors, and monopolists might not tend to

benefit at the expense of other segments of the economy by a widely fluctuating price level. The uncertainties of entrepreneurs might be lessened which could have the effect of stimulating investment and employment.

Changing the form of the debt in this manner would simplify the current complicated structure of the debt; it would lower the interest charge significantly; and it would implement the powers of the Federal Reserve System.

Changing the form of the debt in this manner will not solve the problem of the business cycle. Industrial fluctuations probably cannot be solved exclusively by monetary devices.[1]

Monetary policy may well be less effective as a curb on depression than on inflation. Banks with large excess reserves may refuse to lend when the risk of losing liquidity seems too great. Therefore, monetary policy alone may not counteract a depression, but good monetary management may help to alleviate one.[2] The conversion of the debt ultimately into two forms, currency and consols, combined with a return to a free market for government securities, would be one step toward better monetary management because it could then be used rapidly to curb fluctuations

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[1]Simons, op. cit., p. 172.

[2]Committee for Economic Development, Monetary and Fiscal Policy for Greater Economic Stability, op. cit., pp. 29-35.

in the general price level, its form would be simple and its operations easily understandable, and the interest charge could be reduced.

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