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EDITED BY

JOHN A. KROUT

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PROCEEDINGS

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ECONOMIC RECOVERY AND MONETARY STABILIZATION

A SERIES OF ADDRESSES AND PAPERS PRESENTED AT THE SEMI-ANNUAL MEETING OF THE ACADEMY OF POLITICAL SCIENCE
APRIL 2, 1936

EDITED BY

PARKER THOMAS MOON

THE ACADEMY OF POLITICAL SCIENCE
COLUMBIA UNIVERSITY
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PREFACE

MONEY is a topic of perennial interest, practical and theoretic, but it has assumed more than ordinary significance in the economic crisis, the recovery program, and present calculations of what the future may hold in store. In much of the current debate on this controversial subject, partisan politics, prejudiced propaganda and a popular penchant for panaceas are all too prevalent. This issue of the PROCEEDINGS is intended not to add to the heat of the argument, but to focus a series of informed opinions and factual statements, by leading economists and financiers, on such questions as whether currency should be stabilized on a gold basis or freely managed, whether stabilization should be national or international, whether credit can be controlled, whether inflation lies ahead, whether the fiscal program of the government is directed toward prosperity or toward disaster.

These papers were presented at the Semi-Annual Meeting (Fifty-sixth Year) of the Academy of Political Science. The three sessions, held at the Hotel Astor in New York City on April 2, 1936, were attended by exceptionally large and representative audiences. It is appropriate to express the Academy's gratitude to the speakers and to thank the Committee on Program and Arrangements, the membership of which is here recorded: Leon Fraser (Chairman), Ethel Warner (Director), W. Randolph Burgess, S. Parker Gilbert, Thomas W. Lamont, George O. May, Ogden L. Mills, Wesley C. Mitchell, Shepard Morgan, William L. Ransom.

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PART I

CREDIT CONTROL AND THE RECOVERY PROGRAM—DOMESTIC ASPECTS

INTRODUCTION *

WINTHROP W. ALDRICH, *Presiding*
Chairman of the Board, Chase National Bank, New York

THIS is the first session of the semi-annual meeting of the Academy of Political Science. With today's sessions the Academy is approaching the close of its 56th year of honorable life. When it was organized in 1880, the purpose its founders had in mind was the creation of a forum where political and economic problems in the life of the nation could be discussed freely and openly for the benefit of a public desiring additions to knowledge and stimulations to thought. The views expressed by each speaker are his own views and are not necessarily the views of the majority of the members of the Academy. Frequently it develops that the words of one speaker do not conform with the words of another. Perhaps this freedom of discussion and diversity of opinion are the great merits of the Academy programs. Variation of opinion, granted a necessary quality of substance, provides the material out of which the public at large can frame its own conclusions.

The topic arranged for today's meeting is "Economic Recovery and Monetary Stabilization". At the session this morning we are to deal with the domestic aspects of this subject as expressed in the topic "Credit Control and the Recovery

* Introductory remarks of Mr. Winthrop W. Aldrich as presiding officer, opening the first session of the Semi-Annual Meeting (Fifty-sixth Year) of the Academy of Political Science. In order to meet the exigencies of the radio broadcasting schedule, Mr. Aldrich's principal address was broadcasted not at the beginning, but at a later stage in the program, *cf. infra*, pp. 26-29.—Ed.

Program ". At the afternoon session the meeting will consider the general subject again, but in its international aspects. And this evening the question will be further examined at the dinner session of the Academy. I am asked particularly to state to you at this point that dinner will be served promptly at seven o'clock. We must observe the hour with strict punctuality because a part of the evening program will be broadcasted, and as you know, a radio audience insists on absolute adherence to schedule.

This morning parts of our program also will be broadcasted and if I exercise my duty as chairman rather rigorously I hope you, and especially the speakers whom I may have to interrupt, will understand that I am merely fulfilling obligations with respect to a prearranged and inflexible schedule.

I hope the gentlemen who are to speak to us will carry out the Academy tradition of not agreeing too closely with each other. Each is an authority in his own field, and as such each is bound to have definite, and I trust, individual opinions. I do not promise even for my own part to agree with all of them. It would be too much to expect, furthermore, that all of them would agree in all things with me. It is through healthy diversity of view that we shall hope to gain the full advantage that the Academy sessions offer.

The first speaker whom it is my pleasure to introduce this morning is the director of Research and Statistics of the Federal Reserve Board in Washington. He has been in the service of the Board since 1919, is intimately familiar with its powers and duties, and more than that, he is the close observer week to week and month to month of the statistical raw material which the Federal Reserve Board must scrutinize and from which it must draw conclusions when it undertakes to put positive policies into effect. The subject he will discuss is " How Can Credit Be Controlled? ".

I take pleasure in introducing to you Mr. E. A. Goldenweiser.

HOW CAN CREDIT BE CONTROLLED?

EMANUEL A. GOLDENWEISER
Director of Research and Statistics
Board of Governors of the Federal Reserve System

THE subject of this paper is " How Can Credit Be Controlled? ". If one were to consult past experience, it would seem that machinery for controlling credit successfully has not yet been developed. Prior to the establishment of the Federal Reserve System there was no machinery in this country for credit control and whatever control there was, was of an automatic nature.

Since the establishment of the Federal Reserve System, we have had an enormous credit expansion during the war period, a very rapid contraction in 1920-21, with some disastrous results, a rapid increase in credit from 1922 to 1929, a collapse in 1929 that continued until 1933, a rapid expansion since 1933. It certainly is not a record that would indicate successful credit control. If we are to prevent the recurrence of such violent alternations in the expansion and contraction of credit as we have lived through in the twenty-two years since the establishment of the Federal Reserve System, the problem of credit control must be reëxamined.

There are those who believe that credit control should be essentially qualitative; that the most important thing about credit is its quality, and that if its quality is all right, the country will be safe. There are those, on the other hand, who lay their principal emphasis on the quantity of credit, either from the point of view of bank assets or from the point of view of deposit liabilities which are referred to as money.

The conclusion to which I have come, in thinking about this subject, is that a perfect, an ideal control of credit would be the same whether it controlled the quantity or the quality, because a complete quantitative control would result in satisfactory quality and complete qualitative control would result in satisfactory quantity. If no bank extended credit that was not of perfect quality from the community's as well as from the individual bank's point of view, the aggregate quantity of credit would also be in the best interests of the economy. On the other hand, if quantity were rigidly controlled and adapted to conditions that existed at all times, it is likely that there would be no great departure from adequate quality, because it is during periods of very rapid expansion or contraction that the quality of credit greatly deteriorates. I think, therefore, that this controversy is, like so many others, merely a matter of emphasis. From the point of view of responsible administration, both phases have to be considered, and considered in the light of the possibilities of regulation that are practically attainable.

There are great limitations on complete control of quality. In the first place, we have a banking system under which banks are chartered by forty-nine authorities without coördination. We have supervisory authorities scattered over the country, working under national laws and forty-eight state laws, and under different rules and regulations in relation to bank supervision. Under such circumstances thorough qualitative control is impossible or at least extremely difficult.

There are other limitations on the effectiveness of supervision. The best supervision involves one or two examinations a year, but many things can happen between examinations. Besides, there is the fundamental point that, even though the quality of the credit in an individual bank, from the point of view of its own solvency and efficiency, were perfect, there might easily be an aggregate situation that was not perfect at all. We all know, to use a very well known illustration, that brokers' loans were perfectly good loans and that no losses were suffered from brokers' loans by any bank, and yet the aggregate of brokers' loans during the period of greatest expansion was one of the things that did threaten the economy of the nation.

The multiplicity of banks conducted by individual managements makes the problem of supervision an extremely difficult one. Control of quality is much easier in countries where the number of banks is smaller and management is centralized.

There is, in addition to all of these considerations and others that I could enumerate, the great difficulty that the quality of credit depends on economic health and soundness. With bank credit serving as the basis of the principal means of payment that we have, the banking situation cannot remain sound if the economic situation is not sound. There is a mutual interrelationship. Perfectly sound loans and investments, made at a time when the national income is eighty or ninety billions of dollars and the price level is relatively high, become entirely unsound and disastrous when the national income is cut in two and the price level has precipitately dropped.

It is, therefore, not feasible, with existing machinery and in the present state of human knowledge, to control quality completely. All that can be done is to exercise an influence in the direction of sound quality. I might say parenthetically that it is for this reason that I dislike the word "control". If I were wording the title of my remarks, I would not use the word "control". I would use the much more modest term "influence".

There are limitations also on the control of the quantity of credit. First I might mention the fact that monetary powers are not concentrated in the Federal Reserve System. In the present situation, the powers of the Treasury in connection with handling the stabilization fund, its power and duty under the law to purchase silver, its power under the Thomas Amendment to issue paper money, and the control of very large funds which the Treasury can move in and out of the market, are powers that are monetary in their nature. Therefore, it is evident that the monetary authority does not possess complete monetary powers.

But, assuming that the two agencies work hand in hand, as of course they do, there are other limitations on the control of quantity. There is an imperfect control of the volume of deposits because it is not possible for monetary authorities to make the borrowers borrow or to compel the banks to lend or to invest when the situation is not propitious.

Since the beginning of the depression, the powers of the Federal Reserve System and of the Treasury have been exercised in the direction of continued monetary ease, the building up of member bank reserves to an unprecedented volume. The result has been a growth of deposits; but those deposits, even though now larger in quantity as far as demand deposits are concerned than ever before in history, have not been utilized to the extent that they would have to be in order to finance full productivity in this country. So we have a limitation on quantity control, if in the concept of quantity you include the use or velocity of money.

There are also limitations on the opposite side. When credit is wanted and used it has not yet been found possible to control its expansion completely, because drastic measures usually involve too heavy repercussions. The responsibility for drastic control of expansion has never yet been undertaken. Still I think that the control of expansion is more feasible than the control of contraction, and that the only safeguard against future depressions is in the prevention of inflation.

Aside from the regular fiscal functions of the Treasury, the powers which are inherent in the necessities of the Treasury situation have an important monetary aspect and one that is not fully recognized by many, because the problems of whether the government is going to borrow and spend, and how much, and at what time, and whether it is going to borrow from the banks or borrow from the public, all have distinct monetary phases that are quite independent of the general problems of fiscal policy.

What I am trying to say is that complete quantitative control of credit would involve a system of complete control of the volume and flow of the national income, of its distribution between consumption channels and productive channels. It would involve a system of taxation, of Treasury financing, of central banking control, that is far beyond any control that we have as yet ever visualized or that we are prepared to adopt.

For that reason, on the quantitative side as well as on the qualitative, the only thing that can be done is to influence the forces, to exercise the instruments of credit management that we have, in their relation to the many forces that are beyond our control.

In connection with what I have said, the question arises, what becomes of the concept of independence of a central bank from the government. If the Treasury policies, not only temporary monetary policies but fiscal policies, have such an important monetary bearing, can and should a central bank be independent of the Treasury?

After the war we had meetings in Brussels and in Genoa at which it was loudly proclaimed that the most important thing for a central bank is to be independent of the government. Those feelings reflected reaction against the terrible inflationary conditions through which the European countries had gone after the war. On final analysis, they were an outcry against

war rather than an outcry against government control of the central banks, because when there is a war, all national issues are submerged in the one necessity of winning the war. No war has ever been fought on taxation alone, and it is difficult to imagine that one ever would be, because taxation of the degree and quantity required to finance a war is not politically possible. Therefore, war invariably involves inflation; and during such a period the monetary systems of the world are disrupted. Whether they are disrupted, as they were in most countries, by the issuance of currency through a central bank and borrowing of the government from the central bank, or whether they are disrupted, as they have been in other countries, by the printing of money directly by the government, is in the final analysis not a matter of vital importance. Of the two, probably the central bank plan is a better one because it has better terminal facilities.

It does not seem feasible or practical for a central banking authority to function independently of the Treasury. It never has been independent anywhere, nor do I think it ever will be. What is meant by "independent" in a realistic sense? The Treasury has its principal function in the raising of revenue and distribution of it for purposes of meeting the expenses of the government. The central bank has monetary objectives. Between the two authorities there must be a close coöperation, a mutual understanding and mutual respect, a mutual influence. The two financial authorities must not be in conflict with each other. An independent central bank, in a realistic sense, means a central bank with so much courage and competence that it cannot possibly be ignored by the Treasury, first of all because the Treasury will wish to have the benefit of the central bank's judgment, and in the second place, because the public respect for the central bank in authority would be such that the Treasury could not ignore it.

That is the kind of situation toward which we have to work. That is really what an "independent" central bank means. That is the situation which prevails in England. The fact is not that the Bank of England is entirely separate from the Treasury. They coöperate, work together every day, but it is true that the prestige of the Bank of England and the competence of the bank are such that the Treasury would not disregard the Bank's advice.

Having reduced the subject of credit control to the question of the influences that can be exercised, I would like to say just a few words on what the objectives of that influence should be. We have had a great deal of discussion about the objectives.

There has been a long-standing agitation in favor of using all credit powers in the direction of a stabilized price level. I cannot take the time to discuss the weaknesses of that objective, but it is perfectly clear that stable prices, especially stable aggregate prices, are not always consistent with the best interests of the country, and have been accompanied at times by serious economic maladjustment.

I am inclined to think that even business stability—which is a vague term describing the goal toward which in a general way one should try to work—is not necessarily desirable. Stability has an implication of stagnation. A growing economy is not a stable economy. Every minute is a crisis and every period is a transition.

We have tried to formulate the objective of monetary policy in a general way as a policy that would result in the fullest utilization at all times of the human and natural resources of the nation. If the central bank authorities were capable of contributing consistently to the pursuit of that objective, I believe they would come as near to using their influence in the public welfare as is possible.

I have pointed out many of the limitations on the powers of the central bank. In a brief period I can say very little more on the subject. I want to add, however, that what I say is not intended as a plea of impotence or a counsel of despair. In steering a ship through the gale, one is not weakened by recognizing that one cannot control the waves and the winds and the storms and the tides. One should use such powers, such knowledge as is derived from the charts, such power as is lodged in the engines, and such direction as the rudder can give, to steer the ship safely to port in defiance of all hostile elements of nature.

I feel that a full realization of the limitations on what can be done, and of the forces which the policy must take into account and which, in many cases, it must overcome, will contribute more toward a realistic use of monetary powers than a belief in complete control without appreciation of the limitations that will remain in the way of such control as long as our general plan of economic and political life persists.

REMARKS BY THE CHAIRMAN

MR. WINTHROP W. ALDRICH: I am sure that you will all agree with me that we have just listened to an extraordinarily interesting and authoritative discussion of the limitations upon the power of the central bank to control credit.

I find myself in entire agreement with what Dr. Goldenweiser has said, and it might be appropriate to say that in my view the qualitative control of credit is primarily the function of the commercial bank, the quantitative control being centralized in a central bank. The commercial banker, in attempting to exercise his judgment as to qualitative credit at any given moment, is very often influenced by a situation which exists because of the fact that the quantity of credit is too great. I am going to say a word about that later on.

I now have the pleasure of introducing to you a speaker whom many of you know already. A friend of the Academy and a teacher of economics at Columbia University, he has generously agreed at almost the last moment to take the place on our program originally set aside for Professor Neil Carothers, Professor of Economics at Lehigh University. The speaker this morning has written books with which you no doubt are familiar. They are vivid contributions to the thought of our time. The topic on which he speaks is " Fiscal Policy and Credit Control ".

I am glad to introduce Mr. Ralph Robey.

FISCAL POLICY AND CREDIT CONTROL

RALPH ROBEY
Instructor in Banking, Columbia University

THE problem of fiscal policy and credit control has, it seems to me, two aspects that are more or less distinct. The first of these is the question of the relation of fiscal policy to the necessity of credit control. The second is the relation of fiscal policy to the possibilities of credit control. In the time allotted to me I should like to attempt to analyze both of these aspects, not as theoretical problems, but rather in terms of the situation as it exists in this country today.

I turn first to the question of the relation of the fiscal policy of the present Administration to the necessity of credit control.

The points at issue here, as I see it, are whether the fiscal policy followed in this country during the past few years has been, in and of itself, inflationary in character, and whether the policy has been conducive to inflation in other parts of our economic system. Before we can discuss these issues with clarity, however, it is necessary to get working definitions for the terms " inflation " and " fiscal policy ". This does not mean that we need to be in agreement on the meaning of these terms. Rather, all that is necessary is that we understand the sense in which the terms are used.

Perhaps it will be sufficient for the purpose at hand, therefore, for me to say merely that when I use the term "inflation" I shall mean fiat purchasing power—that is, purchasing power which at the time of its creation has no counterpart in the form of economic goods. I am making a distinction, in other words, between the purchasing power brought into existence by the government issuing greenbacks, or by the banks merely writing up pen-and-ink credits, and purchasing power resulting from the production of economic goods.

In the term " fiscal policy " I shall include all of the financial activities of the government. That is, I shall think of it not only as the handling of the receipts, the expenditures, the debt,

and the deficit of the government, but also as including its monetary policy. This is, perhaps, a somewhat broader meaning than frequently is assigned to the term " fiscal policy ", but during the last few years the monetary policy of the Administration has been so intimately related to the handling of the public debt that it seems to me that it is not feasible to consider the one without the other.

If you are willing to accept these definitions as adequate for the purpose of analysis, we can rephrase, in more meaningful language, the question of whether the fiscal policy of recent years, in and of itself, has been inflationary. We can restate this problem as, whether the monetary policy and the deficit financing of the last few years have resulted in the creation of fiat purchasing power. When put in this way, it seems to me, we have our issue in a form which is susceptible of statistical proof. To get this proof we need merely to look to our banking and financial statistics.

The record of these statistics is clear and unmistakable. It shows conclusively that our recent fiscal policy has resulted in the creation of fiat purchasing power. Such fiat purchasing power has come, it is true, not through the government printing greenbacks—although it has printed something just as bad, if not worse, in connection with the silver policy—but through our banks writing up pen-and-ink credits on their books in payment for United States government obligations. The amount of such creation of fiat purchasing power has been enormous. This is shown by the increase of bank deposits. Some figures on this are worth recalling.

Between November 1, 1933, and October 30, 1935—the last date previous to the new classification of deposits—the net demand deposits of the weekly reporting banks increased approximately $6,000,000,000. Such reporting member banks compose roughly 50 per cent of the banking resources of the country. Accordingly, if we assume that there was the same rate of increase in the rest of the banking system, we find that during this two-year period net demand deposits increased by about $12,000,000,000, or at an average weekly rate of some $115,000,000.

To appreciate the significance of these figures it is necessary only to refer to the comparable statistics for the last two preceding periods of inflation. From June 30, 1916, to June 30, 1920, the increase of demand deposits for the banking system as a whole was approximately $4,000,000,000, or some $19,000,000 a week. (This does not include "unclassified" deposits.) From June 3, 1921, to June 30, 1929, the increase of demand deposits in all banks was approximately $8,000,000,000, or again at the average rate of about $19,000,000 a week. During the first of these earlier inflationary periods, you will remember, the wholesale commodity price level of the United States more than doubled, and during the second, industrial stock prices more than quintupled.

As measured by the volume of purchasing power in the form of demand deposits in our banks, therefore, we recently have been inflating at an average weekly rate some six times as great as we did in the commodity price inflation of 1914-1920 and in the stock price inflation of 1921-1929.

It is not to be concluded from this comparison, of course, that all this increase of deposits in our banks has been the result of banks writing up pen-and-ink credits in payment for government obligations. That has been a large factor, but it has not been the sole factor. Neither has it been the sole means by which the fiscal policy of recent years has resulted in the creation of fiat purchasing power. For fiat purchasing power also has been created through our monetary policy, as it has related to both gold and silver.

The creation of the fiat purchasing power here has been by means of placing a new and arbitrary value upon the precious metals, and then using this new value as a basis for currency issue. In the case of gold the increase, as you know, was from $20.67 to $35.00 an ounce. This change involved a writing-up of the value of the gold held by the government by approximately $2,800,000,000. But this is only part of the fiat purchasing power resulting from our gold policy. Since the revaluation took place we have imported some $3,000,000,000 of gold. This is at its new value. Before revaluation the same quantity of gold would have been worth only about 1¾ billion dollars, instead of the 3 billions at which it now is carried on our books. There has been a further write-up here, then, of 1¼ billion dollars, or a total write-up as the result of revaluation of some 4½ billion dollars.

Not all of this write-up has been injected into the economic system. For example scarcely any of the original so-called gold profit has been used. On the other hand, all of the write-up on the gold that has flowed to this country since revaluation is in the economic system. Not only is it in the economic system, but it is in the system in perhaps the most dangerous way, for most of it is to be found in the reserves of our banks. In other words, the reserves of our banks today are some 1¼ billion dollars greater than they otherwise would be, even granting there would have been just as much gold imported without revaluation, and needless to say there would not have been.

As for our silver policy, from the point of view of the creation of fiat purchasing power, I have little to say. What we have done, as you know, is to buy the metal in huge amounts and then write its value up to $1.29 an ounce as a basis of currency issue. As far as I can see, it would have been just as sound economically to have used discarded paving blocks. In fact, paving blocks would have had one distinct advantage. Using them as a basis of currency issue would not have subjected foreign silver-using countries to severe pressure, as our silver policy has done. In other words, our silver policy has been a straight out-and-out program of inflation.

So much for the question of whether the fiscal policy of recent years, in and of itself, has been inflationary. The next point I listed for discussion was whether the fiscal policy has led to inflation in other parts of the economic system.

This, it seems to me, does not need extended treatment. It must be evident to everyone that the recent fiscal policy of our government has tended to restrain, rather than encourage, private borrowing. It is impossible to determine what this restraint has amounted to in dollars, but for the present purpose this is not necessary. All we need at the moment is the conclusion that the creation of fiat purchasing power through loans to private individuals has not been greater, because of our fiscal policy, than it otherwise would have been. Even New Dealers, I believe, would agree with this conclusion.

Such, then, in brief, is the analysis which it seems to me is a necessary preliminary to answering the broad question of whether our fiscal policy of recent years has given rise to a need for credit control. My answer to this question obviously is that I think it has given rise to such a need. My reason for thinking this, to repeat, is that the government, both through its handling of the deficit and through its monetary policy, has been following an inflationary course. It has been creating purchasing power for which, at the time of creation, there is no counterpart in the form of economic goods. It has been doing this, too, without setting up any automatic checks as to the amount of such fiat purchasing power that may be created. In fact, it has been doing it in a manner that makes it virtually impossible, politically, to turn back. Such a situation, I am convinced, if it is permitted to remain uncorrected, can mean only disaster for our economic system. I feel, accordingly, that it is imperative that the present inflationary policies be brought under control.

I turn next to the second broad aspect of my subject, namely, the relation of our fiscal policy to the possibilities of credit control. Here again, too, I think it advisable to subdivide the problem. Accordingly I propose first to discuss the problem on the assumption that we have a continuation of federal deficits, and then to discuss it on the assumption that we balance the budget. Actually there is no particularly compelling reason for making this distinction, for the problem is about the same under both conditions, if one is starting from the present situation, but since many people seem to think that once the budget is balanced our troubles will be over, it has seemed best to me to make the division.

First, as to the situation with an unbalanced budget: Is there a possibility of the credit-controlling authorities bringing about a tightening of interest rates when the government is constantly in the market for funds? The answer to this question depends upon the relation of the credit-controlling agency to the government. If the credit-controlling agency were in a position of complete independence one might have a tightening of interest rates even though the government were running at a deficit. If the credit-controlling agency does not have such a position of independence it must meet the wishes of the government as to when the money rate is to be tightened. And, granting the government is operating at a deficit, there is, probably, just one condition in which it would permit a tightening of the rate.

This is when the deficit is of a purely temporary character, and when the holding of the public debt is such that a tightening of money will not cause the government embarrassment, either directly or indirectly.

Now what is the actual situation in the United States today? Certainly the Board of Governors of the Federal Reserve System is not independent of the domination of the government. On the contrary it is under its complete domination. This is so much the case that I am not sure that it is not now an error to think of the Board of Governors of the Federal Reserve System as a credit-controlling agency. It would be more accurate, I believe, to think of our credit-controlling agency, granting we have one, as being the Treasury Department. That is the place our credit policies are determined today. The Board of Governors is merely a part of a mechanism to be used when convenient for putting Treasury, or Administration, policies into effect.

If we are to have a tightening of interest rates while the government is running at a deficit, then, it must be because the government itself thinks that such tightening would be wise. Is there any reason to believe that the present Administration would arrive at such a decision? There obviously is not, if a prerequisite of such a decision is, as stated earlier, that the deficit be of a purely temporary character. For if there is one point about our deficit upon which we can be sure, it is that it will not be of a temporary character if the present spending is continued, and as yet this spending has shown no signs of diminution.

On both counts, thus, it seems to me, the present fiscal policy of our government makes it impossible to anticipate the exercise of any restrictive control over our credit system. I think that this is the case, regardless of the type of control that is considered. In other words I think it is true both as to the possibility of raising the reserve requirements of our banks and as to the possibility of having the Reserve Banks mop up the excess reserves of the commercial banks by the sale of a part of their government obligations. I will grant, although I think it highly improbable, that we might have a slight increase of reserve requirements, or a sale of a few government obligations by the Reserve Banks, but I can see no possibility of either of these control measures being carried far enough to exert any significant influence upon money rates.

The final point we have for consideration is the question of the relation of fiscal policy to the possibility of credit control when the federal budget is balanced. Under some conditions, it is evident, the existence of a balanced budget means that fiscal policy is of no importance from the point of view of credit control. But we do not find these conditions in the United States today, and we would not find them if the budget were balanced in the near future. For just having a balanced budget is not all that is necessary in order to eliminate fiscal policy as a major factor in the determination of credit control policies. In addition, the public debt must be in good shape. It must be in good shape both as to those who hold it and as to the rate of interest it bears.

On neither of these points is it possible to say that at present our public debt is in good shape. Far too much of it is held by our banks, and the rate of interest on a large portion of it—on that portion composed of Treasury bills and notes—is far out of line with what must be expected once a real private demand for funds develops in this country. Even though we were to balance the budget, therefore, there still would remain some most difficult problems from the point of view of exercising any restrictive control over our credit system.

Specifically, we still would be faced with the problem of what would happen to the government bond market, and consequently to our banks, if there were a significant tightening of the interest rate, and we still would be faced with the problem of trying to keep the budget in balance if interest rates on the short-term debt of the government sky-rocketed.

This does not mean that I think that the budget should not be balanced. Quite the contrary, I think that it is essential if we are to save our financial system. But at the same time I think that balancing the budget is only one of the steps that need to be taken.

Remarks by the Chairman

Mr. Winthrop W. Aldrich: The next speaker will discuss "The Prospect of Inflation in the United States". Many of you will remember his book written a few years ago on the process of inflation in France, and more recently his discussion of the gold reserves of the United States. It is scarcely necessary to introduce to an Academy audience James Harvey Rogers, Professor of Political Economy in Yale University.[1]

[1] *Cf. infra*, pp. 128 *et seq.* for the paper presented by Professor Rogers.—Ed.

Remarks by the Chairman

Mr. Winthrop W. Aldrich: The next subject for discussion is "The Silver Purchase Program and Its Consequences". The speaker served his apprenticeship in financial writing with the Federal Reserve Bank of New York. He then went to the National City Bank of New York where little by little he has dovetailed into the work which his father, Mr. George E. Roberts, has done with distinguished success for a generation. The names of George Roberts, father and son, are indelibly associated with the excellent monthly review of financial and economic developments which has long been published by the National City Bank. Both father and son are well known to Academy audiences, so I announce rather than introduce the next speaker, Mr. George Bassett Roberts.

THE SILVER PURCHASE PROGRAM AND ITS CONSEQUENCES

GEORGE B. ROBERTS
Vice-President, The National City Bank of New York

It is about two years since the United States embarked on its program of doing something for silver, first, by buying up domestic production in accordance with the agreement on silver reached at the London Economic Conference, and, later, under the Silver Purchase Act of June, 1934, by nationalizing silver and extending the purchases into world markets.

The main arguments on behalf of the silver program were that it would put more money into circulation and correct an alleged shortage in the metallic reserve; also that by raising the price of silver it would increase the purchasing power of silver-using countries, while at the same time — paradoxically, it would seem—eliminating those countries as trade competitors by driving up their exchanges and making their goods more costly to buyers. It was said that our silver purchases would enable foreign countries to pay their debts and buy our agricultural surpluses, and that they would help redistribute some of our surplus gold stocks. In short, silver, according to its sponsors, appeared to be the sovereign remedy for the depression.

In passing the Silver Purchase Act, Congress intended to raise and stabilize the price of silver, broaden the monetary base, and encourage a wider use of silver as money among nations. The Act declared it to be the policy of the United States to maintain 25 per cent of its monetary reserves in silver and directed the Secretary of the Treasury to purchase silver sufficient to that end, subject to his discretion as to time, rapidity of accumulation and prices, and subject also to the limitation that the price paid should not exceed the coinage value of $1.29 an ounce. While the law appeared to stress the acquisition of silver rather than the advance of price, I think it

fair to say that the general interpretation was that the law had two ultimate objectives—to acquire more silver and to raise the price to $1.29.

The Law in Operation

With this mandate on the books, our government set out to buy 1,300,000,000 ounces of silver in order to realize the required ratio to gold. Later on, because of our imports of gold, this figure grew to over 2,600,000,000 ounces. This is more than one fourth of the existing stocks of silver outside of the United States, including coinage and the estimated hoardings of India and China.

Barely had we got started on this vast program before repercussions began to appear abroad. China was the first country to be heard from. When the program began it found China already in difficulties—the result of a period of speculation and over-expansion in 1930-31. At that time depressed conditions in the interior had caused an accumulation of silver in Shanghai and other coast cities, where the increased stocks, together with the fall in the price of silver then in progress, promoted a real estate boom and an increase of industrial activity. This had terminated late in 1931 when the depreciation of the pound sterling and of the Japanese yen left China with an overvalued currency. While in 1931 it took about two and a half Chinese dollars to buy one Japanese yen, by 1934 the Chinese dollar was actually selling higher than the yen. All this caused a loss of export trade, and as the remittances from Chinese emigrants also fell because of the depression, the balance of international payments became unfavorable, necessitating exports first of gold and later on of silver.

Hence China went through two years of deflation prior to the inauguration of our silver price-raising policy. Since Chinese exchange was tied to silver it appreciated further in terms of leading currencies, which in the meantime had depreciated. The result was the speeding up of the deflation, drastic deterioration of the balance of payments and an alarming exodus of silver from the country.

The Chinese government protested vigorously to our government, but without avail. Our purchases continued, until finally China was driven to the expedient of a sliding-scale tax on silver exports. By this it was hoped to check the outflow of silver and control the rise of exchange.

Despite this first warning that the purchase program was having results contrary to the predictions of its sponsors, the pressure upon the Treasury for rapid execution continued, and speculators grew more and more confident.

This speculation reached a climax about a year ago. At that time the open market price rose from 54 to 81 cents, and the Treasury increased its buying rate for domestic metal from 64.64 to 77.57 cents an ounce. By this time the disturbing effects of the program were spreading rapidly. Conditions in China were growing worse. Efforts to halt the outflow of silver were fruitless, due to the profitableness of smuggling caused by the spread between the bullion value of the Chinese silver dollar outside of China and its controlled exchange value. Money was tight, banks were failing, trade was depressed, and confidence generally was at low ebb.

Because of the rise of silver prices, many other countries found their silver coinage becoming worth more as bullion than as coins. As a result such pieces were being melted down and exported. In April, Mexico, the world's leading silver producer, announced the withdrawal of its existing silver coinage in exchange for paper, debased silver and base metal coins. Similarly, many other countries, including Costa Rica, Guatemala, Ecuador, Colombia, Peru and Iran, were forced to replace silver coinage with other kinds of money, or to protect themselves in other ways against being denuded of their currency. Had prices gone 15 to 25 cents higher, the coinage of Spain and the vast quantity of silver rupees in India would have been threatened with the melting pot.

Silverware manufacturers and jewelers complained of the rising costs, while later in the summer the American Tobacco Association in a memorandum to Congress expressed disillusionment with promises that had been made that higher prices of silver would promote tobacco sales in China.

Apparently the Treasury was impressed by this widening area of unsettlement; at all events, it ceased after April to buy on a rising market. As soon as it became clear that prices had reached a peak, the dependence of the market upon the Treasury was fully revealed. Speculators hastened to unload

while the unloading was good. Only the Treasury stood between the market and complete breakdown. By August the price was down to 65⅜ cents, with the usual deflationary wreckage, including the closing of the Bombay bullion market.

For fourteen weeks the market held steady at this level under United States government support. Then came the final crash. For some time rumors of Chinese devaluation had been current. Silver had continued to be smuggled out of China in large quantities and there seemed no hope of stopping it. During October the Chinese dollar broke sharply from 37 to 30 cents, and on November 3 the Chinese government came out with its new plan. All silver was to be nationalized and turned in to the government in exchange for paper. Exchange was to be controlled. China was adopting a managed currency.

This action by the last of the great countries still loyal to the silver standard, followed shortly by similar action by the British Colony of Hong Kong, was a staggering setback to the American purchase program. There was talk in the silver party of sinister foreign influences. Actually we had only ourselves to blame. China did what any other country probably would have done, and what many gold standard countries had done before her. Clearly there was need for a revision of our buying policies. Accordingly, the Treasury in December curtailed its purchases abroad, eventually retiring completely from the London market where the buying had been concentrated. The result was demoralization of world silver markets and collapse of the price to 45 cents, which is about where it was when the purchase program was started.

And still we do not have the required amount of silver. All told, we probably have bought about 960,000,000 ounces, at an approximate cost of 57 cents an ounce. We have expended, therefore, about $550,000,000, of which over $400,000,000 has gone abroad. Meantime, the original requirements have doubled by reason of gold imports so that we still have over 900,000,000 ounces to go. And the end is not yet; our gold imports continue, and every $1,000,000 of gold calls for an additional 260,000 ounces of silver.

Effects of the Program

Let us summarize now somewhat more broadly the effects of the program.

First, the effects on silver: As frequently happens when prices are advanced arbitrarily, the raising of silver prices completely upset the normal balance of demand and supply. It curtailed demand in all directions, not only in the industries and arts and for coinage, but also in the great markets of the Far East where the requirements for ornaments, currency and hoarding ordinarily absorb 70 per cent of the newly mined output. During recent years, China has been a seller of silver, while Indian consumption, which should have increased with the improved economic condition of the Indian peasant during the past two years, has likewise declined.

High prices tended also to increase production, and, what is far more important, attracted huge quantities of secondary silver from all over the world. *More silver was demonetized and thrown on the market in the two years 1934 and 1935 than in the entire fourteen years following the war.*

And, finally, the demonetization of silver resulting from high prices has been responsible for the accumulation of new stocks of silver in the hands of governments, the eventual disposition of which is a matter of concern to the silver market. In China alone the government is reported to have acquired 500,000,000 ounces under its nationalization law, and more may be received. While Mexico, Peru and China, under the terms of the London Agreement, are not supposed to sell silver from coinage, nevertheless an eventual disposal of this newly demonetized metal will be threatening the market—unless, of course, confidence in silver is reëstablished and nations reëmploy it in their coinage.

In other words, from the standpoint of silver, the purchase program must be acknowledged a failure. It has given silver neither stability nor permanent enhancement of value. It has discouraged rather than encouraged its use. This experience seems to confirm the truth of the old saying that one's best friends may sometimes be one's worst enemies.

Second, the effects on silver standard countries: There is—or was—only one commercially important silver standard country—China; its trade amounts to only 2 per cent of total world trade. Although the fluctuations of Chinese trade and exchange are disturbing in some degree to other countries, they cannot be regarded as mainly responsible for world prosperity and depression. Moreover, higher silver prices, as we have seen,

did not increase the purchasing power of China. On the contrary, the value of Chinese imports fell off 24 per cent in 1934 and 11 per cent more in 1935. In addition, a friendly people was given cause for resentment against us.

With suspension of currency convertibility and lowering of the exchange rate to 30 cents, China has experienced relief from deflation, and conditions today are improving. The ultimate outcome cannot be foretold. General opinion is that China will be most reluctant to go back to silver without some assurance against a repetition of her recent experience. Many people believe that she will tie up to either the pound or the yen. On the other hand, China in her present state of economic development, with a large part of the population accustomed to the use of hard money, is poorly adapted to a managed currency. For this reason there is skepticism regarding the new plan, and many persons familiar with conditions in the country believe that sooner or later a return to a metallic money basis will be found desirable. It remains to be seen whether the government can command confidence in its policies.

Third, the effects in the United States: (a) It has resulted in the issuance of nearly $600,000,000 of new money in the form of silver certificates. Inasmuch as the quantity of new money was already in excess of demand, this new supply cannot be said to have been responsible for the increase in total money circulation over the past two years. This increase was caused by the greater demands of business; the new silver certificates in circulation simply have taken the place of some other kind of money which has remained in the banks, thereby tending to swell excess reserves to new high levels. (b) It has weakened the monetary base by adding a stock of metal which in time of stress is likely to be an unavailable asset. The objection to the use of silver instead of gold as backing for the currency arises from the fact that silver at $1.29 an ounce is itself a credit currency and therefore cannot properly constitute reserve. In the event of a demand for redemption of the currency to meet an adverse balance of payments, or sudden withdrawals of capital, as in 1931-32, it would be impossible to realize any such price on these silver stocks, if indeed they could be sold at all. Thus in the last analysis, the security and stability of the currency rests upon the gold stocks alone.

While today the gold stocks appear ample for any demands likely to be put upon them, this may not always be true should we go ahead on the assumption that silver reserves are as good as gold reserves as a credit base. Therefore, silver purchases by the United States to broaden the monetary base, to provide a means of taking payments of foreign debts, to promote exports or redistribute gold stocks are not in our interest.

Fourth, the international effects: In addition to the adverse effects already mentioned, our purchases of silver in London have imparted an artificial strength to sterling exchange. All this tends to increase confusion in the exchange markets, and delay stabilization. There are indications that our silver policy, and distrust resulting from it, are obstacles to any agreement upon currencies.

Present Buying Policies

At present the Treasury is continuing to buy domestic silver at 77.57 cents an ounce, but apparently is limiting its purchases abroad to the new production of Canada and Latin American countries. In so far as this new policy represents a withdrawal from competition for existing stocks of silver, the change may be considered to the good. Experience has proven that it was a serious mistake to buy without regard for the effects upon the stocks of silver money in other countries. But why are we continuing to buy any silver from foreign countries? With our gold stock above $10,000,000,000, or more than twice what it was during the 1929 boom, we have no need for more metallic reserves even if silver were suitable for that purpose.

Conclusion

In conclusion, a few words as to the future. We have an interest in silver for several reasons. It is one of our products, but of even greater importance to us is the part that it plays in our trade relations with the silver-importing countries of Asia and the silver-producing countries of the Americas. Stability of values is of utmost importance in trade relations, and to achieve stability prices must be permitted to find their natural levels. This country cannot advantageously maintain silver above the level at which other countries will accept it in international settlements. An attempt to do so will cause us to

acquire more than we want, lessen the support from other countries, weaken silver's position and therefore make for instability.

The importations of India and China long have been the chief support of the silver market. The silver policy of the United States, by forcing abnormal price advances, converted both of these countries into exporters—an unfortunate development. However, since the price has declined to 45 cents, India has resumed importations, apparently in response to demands for normal distribution. This is a favorable sign. On the other hand, China is not yet a buyer, and apparently there are stocks of Chinese silver still coming on the market. While most of this silver probably comes from unsold stocks in London, there is still a possibility of some smuggling out of China owing to the fact that the bullion price of the Chinese silver dollar continues above the exchange value of the paper dollar. Should China be forced to sell silver to support her managed currency, this too would be a factor in determining silver prices. Thus the situation in China is unfavorable to stability at present, although China's need for silver undoubtedly is greater than India's.

It has been demonstrated that rising prices for silver do not increase China's trade or her importations of the metal. Rather the reverse is the case. It would seem that the best policy for silver that this country can follow is to coöperate with the government of China first in discouraging silver exports from that country and then in restoring the conditions under which China was a continuous importer on a large scale. As better conditions develop in world trade, silver absorption by Asia may be expected to regain the former volume and even increase. The price will respond to the relations of supply and demand, as determined by production and trade.

As to the plans for the restoration of silver to a larger use as money or as bank reserves the world over, either by general international agreements, or otherwise, they must be considered to have received a definite setback, at least for the present, as a result of the attempt to force matters.

CREDIT CONTROL UNDER A RECOVERY PROGRAM

WINTHROP W. ALDRICH
Chairman of the Board, Chase National Bank, New York

IT is now the function of the chairman before throwing the meeting open to general discussion to draw some broad conclusions on the central topic we have been considering, " Credit Control under a Recovery Program ". In doing so, I may perhaps refer to some of the material already presented by the speakers on the formal program and possibly differ in certain particulars with what may have been said. I would remind you that variety of opinion is one of the main advantages to be derived from these meetings of the Academy of Political Science. Pride of opinion we are supposed not to have; on the other hand, differences of approach and discussion are what is expected of us.

We have heard much on three principal points. We have been told, for example, that a vast volume of credit is available for use in the United States ready to be brought into play when the commercial banks in the first place and the Federal Reserve Banks in the second place are called upon to provide it. We have also heard how the Federal Reserve authorities have powers under the law to prevent an undue growth of credit or to check it when expansion is actually under way. And, finally, we have been told in more or less explicit terms that the chief agency in the United States which is now relying upon credit and which promises to rely upon it still further is the federal government itself.

Now I am far from wishing to disparage the value of those preventive measures or those brakes which can be applied in case of necessity. For my part I have proposed several times that one of those preventive measures be applied at once. I believe that the Board of Governors of the Federal Reserve System when the time comes, will have the courage to use the authority it possesses under the new banking act, and which the

Federal Reserve Board already possessed under the former banking act, to raise the reserve requirements of the member banks. I need not go into details here to show you how the exercise of this power would work if it were applied. It is to be noted here merely that I believe the principal advantage to be gained from raising the reserve requirements would be to put to one side one of the major elements of insecurity in our present situation.

To raise the reserve requirements is of course not the only way to deal with the excessive funds owned by the member banks which are now resting quietly in the Federal Reserve Banks, but which nevertheless are subject to withdrawal in a devastating flood. Another means of dealing with them, as you have already heard, is for the Federal Reserve Banks to sell to the market a considerable part of their holdings of government obligations. In paying for them the banks would draw down their deposits at the Federal Reserve Banks, and so tap off some of the material otherwise likely to descend in possible future floods. For my part I think this method, beyond a relatively small initial effort, should be held in reserve and that the instrument of raising the reserve requirements should be used first. But whatever the method, it is clear that a start should be made so as to forestall hasty and perhaps drastic action if the flood waters begin to rise. In all the discussions that have taken place in the last few months on this subject I have seen little to indicate that the cost of action now along either of these lines would amount to more than what one might call a very modest insurance charge.

Now let us consider this question of control from the other side of the picture. What we are thinking about is whether it is not the government's business and duty to step in and perform a major act of regulation. We have heard a great deal ever since the war about the restraints and controls which government ought to exercise over the lives of the people. We have made some unsuccessful experiments of that sort in this country ourselves. I am beginning to wonder whether we have not been asking too much of the government and too little of the citizens. In shifting to the shoulders of the government sole responsibility for credit control, for example, are we not shirking responsibility which is in large part our own? In urging Congress to pass laws, and in urging the executive officers of the government to control credit under the authority of those laws, we are really asking them to take a line of action which we should be following ourselves.

This is only a small part of a very broad question. A long speech could be delivered on it, which would go to the very roots of popular government. In general, it can be said, and the truth of it has been proven many times over, it is hard to execute a law, no matter how carefully drawn, unless it expresses the conscious and widely accepted will of the people. For one reason, if for no other, the administrators of the laws like ourselves are fallible human beings. In this matter of credit control, for example, not only the present law but its predecessors have given very wide room for the influential exercise of authority. But the tragic truth is that almost invariably action has been taken too late, and the Federal Reserve authorities have been behind the advancing forces rather than in front of them. This is not to be taken as criticism, but as a statement of fact which I think is inherent in the situation. The reason is not hard to find. Restraint upon credit expansion when exercised from above is necessarily so unpopular that our public officers, however able and however far-sighted, do not want to exercise it until everybody else sees the storm as clearly as they do. And then if they take action at last, it has to be drastic if it is to be effective. And if it is very drastic and very late the results may be almost as bad as the storm itself.

So I think we should not put too much reliance on the controls which depend upon official action. We have a part to perform ourselves. One would think, with the experience of the last few years so freshly in mind, that most of us would know our part and go ahead and perform it. Both banks and the customers of banks have lost a great deal in these years because of the abuse of credit. We now have an unexampled volume of credit ready for use. It must not be used wrongly, or else the abuses will do us perhaps even greater damage than they did before. Bankers, in doing their duty to their banks and to their customers, will, I hope, study the loans they make and subject them to the severe test of soundness. If they yield too far to the pressure to make earnings — a very general

temptation in these days—they will contribute to the erection once more of an unwieldy and top-heavy structure of credit, with very uncomfortable results for everybody. And the users of credit, those who seek to get from the banks some part of this vast volume of credit now in excess supply, must for their part exercise restraint upon themselves, so that their demands pass the necessary credit tests.

I indicated a few minutes ago that the largest user of credit at present is the federal government itself. It is the principal spender and the principal borrower. Many of the state governments in their own spheres are also great spenders and great borrowers. What I have said about private borrowers, and the need for them to exercise restraint if we are to avoid the evil consequences of credit abuse, applies to the federal government and the state governments with even more emphasis—federal deficits and state deficits, and the loans which they appear to make necessary, furnish the inescapable mechanism by which our vast store of dormant credit is slowly becoming active. As the process creeps forward, the danger increases that the forces will again get out of hand, to the lasting injury of the people as a whole. If anyone looks ahead, whether an arm's length or a lifetime, there is no more pressing patriotic service in sight than to curb public spending and especially public borrowing. No patriotic American can afford to close his eyes to this need, or to overlook the lesson for himself.

REMARKS BY THE CHAIRMAN

MR. WINTHROP W. ALDRICH: We can now proceed with the discussion of the papers to which you have listened. I would remind you that the Academy invites free discussions, provided, of course, that they are relevant to the general topic of the meeting. The rule is, as you will of course remember, that discussion by any one speaker is limited to a maximum of five minutes.[1]

Our half hour or so of discussion of the papers this morning will be introduced by the Associate Professor of Banking in Columbia University. Bankers know him not only because of his books on the Federal Reserve System, the Canadian banking system, and the New York money market, but because he is Educational Supervisor of the New York Chapter of the American Institute of Banking. I take pleasure in introducing Professor Benjamin H. Beckhart.

[1] Space limitations make it impossible to print in these PROCEEDINGS the interesting discussion by several members who spoke from the floor under the five-minute rule.—ED.

DOMESTIC ASPECTS OF CREDIT CONTROL AND THE RECOVERY PROGRAM—DISCUSSION

BENJAMIN HAGGOTT BECKHART
Associate Professor of Banking, Columbia University

THE addresses at this morning's conference have been devoted to the domestic aspects of the general problem of " Economic Recovery and Monetary Stabilization ". The selection of this particular topic would suggest that a relationship exists between monetary stabilization and economic recovery. In my opinion the two are closely linked together and I doubt whether we can achieve an enduring and healthy recovery without an international stabilization of the world's currencies in terms of gold.

One cannot but regret the great opportunity rejected by the American government at the time of the London Economic Conference, to bring about a stabilization of the world's currencies. The refusal of the American government to enter into a stabilization agreement has been one of the most important factors in delaying recovery. Instead of contributing to world economic rehabilitation, we have followed the Pied Piper along the primrose path of inflation, with the prospect of an unhealthy speculative type of credit boom in the offing.

Through the devaluation of the dollar we have subjected the gold bloc currencies to a heavy strain, and have given an impetus to additional restrictions on international trade. We have engaged in a fantastic silver purchase program which, as shown in Mr. Roberts' penetrating exposition of the subject, has had most unfortunate results. We have created huge federal deficits for the avowed purpose of priming the industrial pump and of raising the national income, only to find that the reduction in the volume of unemployment has been disappointingly small. Never in the entire history of the United States have monetary measures of such far-reaching importance been adopted with an equally reckless abandon or with such complete disregard of their effect on domestic and international relationships. The policies followed have neither been good economies nor have they been consistent with a "good neighbor" attitude in international relations.

Regrettable as the past policies have been, we cannot eliminate all of the harm done nor can we completely retrace our steps. In view of the developments which have taken place, a return to the former weight of the gold dollar would introduce new problems, new dislocations and strains in our economic system, and would force the business community to face new unknowns. We must make concessions to practical expediency and in a realistic fashion face the problems presented.

What then are the main monetary and credit problems confronting the American people? Summarizing this morning's addresses, it seems to me that the main problems are three in number:

(1) *The problem of excess reserves.*—The growth in excess reserves over the past two years has resulted in larger part from gold imports and in smaller part from the silver buying program. The imports of gold are themselves a reflection of an unbalanced world. A shift of the magnitude which has taken place is without precedent.

As large as has been the increase in excess reserves over the past two years, an increase of equal magnitude can occur in the future through the use of the profits of gold devaluation in meeting the general expenditures of the government and through the creation and use of profits of silver devaluation following upon a revaluation of the silver dollar.

The potential credit expansibility upon the basis of the present excess reserves staggers the imagination. It is altogether too likely that the potential credit expansibility will become translated into an actual credit expansion. Experience in the past has demonstrated that American banks always expand to a maximum upon excess reserves. This was true after the reserve requirements were lowered in the original Federal Reserve Act and after they were again lowered and their character changed in 1917. The problem of excess reserves constitutes the heart of banking and monetary problems at the present time.

(2) *The problem of artificially low money rates.*—The low money market rates are not the result of an increase in savings but are the direct consequence of monetary manipulation on the part of the Administration. Bank earnings are adversely affected and banking institutions are under great pressure to expand their earning assets. Over-investment will be stimulated and capital inflation engendered. The low rates of interest will induce corporations to borrow to install mechanical equipment. Greater reliance will be placed on machinery, less on labor. Unemployment will not decline as production increases.

(3) *The problem of the federal deficit.*—Since June 1933 the direct debt of the federal government has increased by six billion dollars. In the main federal obligations have been sold to banks. No serious effort has been made to sell government obligations to investors. On the basis of their excess reserves, artificially induced, the banks of the country have been coining the federal debt into purchasing power. The dangers involved in financing the deficit on the basis of creations of bank credit were given proper emphasis in the address by Mr. Robey.

In this field of public finance there are two additional disturbing problems: In the first place, the deficit has remained the same despite the large increase in tax receipts. The increased tax collections have been absorbed by increases taking place in the general expenditures of the government. In the second place, the low rates of interest at which the government has financed its floating debt cannot continue indefinitely. Money market rates of interest will rise at some time in the future. When this occurs the government will find itself in a very precarious situation by virtue of the large amount of the floating debt which will have to be refunded at higher rates. This will throw the budget further out of balance. In other words we shall face the same sort of crisis which confronted the French government in 1926.

Such then are the main monetary and credit problems at the present time—the problem of excess reserves, of artificially low money rates and of the federal deficit. Excess reserves are the basic problem, for without excess reserves, rates of interest would not be artificially low and the government could not sell its obligations to the banks.

In view of the monetary measures which have been initiated by the government and in view of the existing problems, what can be done? To prevent further harm I would suggest the following as a positive program:

(1) The Administration should make a definite promise that the present weight of the dollar will be maintained. In view of the large monetary gold stock in the country, the gold coin standard might well be introduced. At the same time the Administration should express a willingness to participate whole-heartedly in a world economic conference looking towards the stabilization of world currencies in terms of gold and a lowering of tariff barriers.

(2) The silver purchase enactments should be repealed. The Administration should withdraw all support from the silver market.

(3) The profits of gold devaluation, now assigned to the stabilization fund, amounting to $1,800,000,000, should be used to retire that part of the government debt held by the Federal Reserve Banks. The use of the profits of gold devaluation in this fashion would not affect member bank reserves and would rid the Federal Reserve Banks of a large part of their illiquid portfolio. This was the use to which the profits of gold devaluation were applied in both France and Belgium. Can we afford to be less conservative?

(4) The next recommendation involves the raising of member bank reserves. The Board of Governors of the Federal Reserve System might well use the powers conferred upon them by the original Federal Reserve Act to broaden the classification of central reserve and reserve cities. All cities in which Federal Reserve Banks are located should be made central reserve cities and many country towns should be designated as reserve cities. Upon the completion of this task, the Board of Governors could make use of the powers delegated by the Banking Act of 1935 to raise reserve requirements.

(5) The last recommendation involves the balancing of the federal budget. This point is all-important. Unless the budget is balanced, none of the controls enumerated by Professor Rogers will be used. If fiscal inflation leads to large gold exports, it is very likely that we will devalue the dollar again.

Balancing the federal budget will not be easy. Even assuming a change in Administration in January 1937, it will be difficult to reduce expenditures. The rigidity of expenditures is a trait common to all governmental budgets.

The ease of balancing the budget will not increase as time goes on. Indeed, if inflation is allowed to proceed, it will become more difficult. Government expenditures, by virtue of the increase in prices, will outstrip government receipts. Rapidly rising prices will encourage the deferring of tax payments.

The measures suggested point in the direction of the qualitative control of credit. The balancing of the federal budget along with the other measures will check credit inflation and will restore independence to the Federal Reserve System. Qualitative standards should replace attempts at quantitative control, which in the past has always involved a qualitative deterioration in credit.

I am not optimistic that the measures as suggested will be adopted, but without their adoption I am convinced that credit inflation will proceed. Bank portfolios will become further clogged with government obligations, with various types of investment securities and with real estate loans. The inflation in credit will proceed merrily until the next crisis. I do not wish to be a Cassandra but if we expand credit to a maximum upon the presently existing excess reserves, the next crisis will make the late unpleasantness seem mild by comparison.

PART II

CURRENCY MANAGEMENT AND THE GOLD STANDARD—INTERNATIONAL ASPECTS

MONETARY UNCERTAINTY AND CONFUSION *

ADOLPH C. MILLER
Member of the Federal Reserve Board, 1914-1936

NO one can look out upon the world today without being profoundly disturbed by the continued uncertainty and confusion which the monetary scene presents. More and more it is coming to be appreciated that the economic recovery of the world is being delayed by this continuing uncertainty.

How did this uncertainty and confusion come about?

The uncertainty has resulted from the all but universal suspension of the gold standard during the course of the depression.

After the suspension of gold payments countries fell back upon national currencies. These were paper currencies. Each country adopted the form of currency it thought best suited to its condition and needs. The result was monetary confusion, where before the suspension of the gold standard there had been simplicity and similarity.

How may an end be brought to uncertainty and confusion?

By a return to the gold standard, answers one school. By the establishment on a permanent basis of a new monetary régime, answers another school—by currency management, as they call it.

* Introductory address of the presiding officer opening the second session of the Semi-Annual Meeting of the Academy of Political Science. After broadcasting this address, Mr. Miller presented, toward the close of the session, a more detailed discussion of the history and future potentialities of the gold standard, *cf. infra*, pp. 83-92.—ED.

Between these two broadly contrasted and competing points of view lies a gulf, but not nearly so wide a gulf, be it noted, as is frequently supposed when we get down to the substance of the matter. To a certain extent the contest is between an old or older point of view and a new or newer point of view.

To most men of the generation which came to maturity before the World War, sound money, good money, meant just one thing—it meant gold standard money, that is, money based on gold and redeemable in gold, money which was " real " and had a definite meaning, money that above all had the priceless quality of certainty.

There are people who think that this is all there is to the gold standard—just so many grains of gold to the dollar if anyone wants to insist upon his pound of flesh—but this is a narrow, technical, legalistic view, altogether too much so to fit the facts of our day, though it might perhaps have sufficed as an account of the gold standard a hundred years ago. That standard has, however, long since taken on a larger meaning than that of merely giving clarity and certainty to the " obligation of contract " expressed in terms of money. If it is a footnote to any philosophy it is to the philosophy of economic integration and monetary orderliness. It has become very much more than a mere footnote to the philosophy of contract. It became in the course of time, as will be more fully developed later, as it grew to maturity, a piece of monetary mechanism, international in its scope and influence, for giving to the world a common form of currency, thus facilitating trade and financial transactions and the flow of investment capital among the nations; a mechanism capable at the same time, through good operation, of meeting the requirements of good national or domestic currency. The so-called central banks which existed in nearly all of the gold standard countries were integral parts of the gold standard system. It was a part of their recognized responsibility to watch over the gold standard and, within such limits as were admissible under it, to intervene at times in its operation, so to speak, to temper the wind to the shorn lamb in order to reconcile domestic currency requirements and the international currency requirements with one another. It is a mistake, and a serious mistake, to think, as many still do, that that monetary mechanism is a purely automatic mechanism, or that the gold standard could safely be left to its own devices. There was therefore an element of management in it, and that element grew as the world grew, especially as the world grew more complicated in its economic structure. Nevertheless, in pointing out the broad differences between the gold standard system and the so-called managed currency system, it should not be overlooked that there were limits of tolerance within which management or discretion might be exercised under the gold standard system. While these limits had a considerable degree of elasticity, they nevertheless existed, and the fact of their existence broadly differentiated the gold standard system from the so-called managed or free currency systems.

There is neither time nor is there need of reviewing the record of the gold standard in this brief survey. It is enough to say that the fact that it endured as long as it did and won the esteem and confidence of the whole world is evidence that the old gold standard did a good job in its day. Let us turn, then, to managed currency, examine its nature and take a look at its recent record in the United States.

To many men of the generation which has come to maturity since the war the gold standard does not possess the magic meaning which it has for many of the older generation. By good money many people nowadays mean what is being called managed money, and by managed money they mean, of course, well-managed money, rationally managed money, money managed by men who know what they are about. The men to whom they would entrust the management of money are expected so to manage it as to insure perpetual prosperity by never putting out too much money, by never letting the public have enough money to go wrong in good times nor so little as to force deflation in slack times. Under this conception managed money might be described as "human nature money". Fundamentally that is what managed currency comes to. It means in practice, as its critics contend, that unless the men who do the managing are always wise men, and wiser men at least than those to whom our government has usually committed the determination of its destinies, the money of the country might have a good quality under one administration and a poor quality under a succeeding administration—might be what has some-

times been characterized as "political money". Under this conception all would depend upon whether you or I were in command of the monetary mechanism. It might mean my stupidity today against your intelligence tomorrow; my good and easy-going nature against your prudent and careful nature; my poor judgment against your good judgment; my weak character against your strong character; in other words, money just as good and just as poor as the men who did the managing. Back of managed money lies, of course, a monetary philosophy, an interesting philosophy, an idea and belief that economic conditions can be made and altered and human behavior on the economic plane governed and controlled through the skilful manipulation of the monetary mechanism of any country with a highly developed credit and banking system. That philosophy has supplied in some sort and to some degree the inspiration and the objective which have shaped currency management more or less in most countries during the past few years and, it should be noted, with evidences of remarkable success in some. Great Britain, among the larger countries, supplies a striking example of such success, as does Sweden among the smaller countries.

Let us take a look at our own experiment in managed money.

When it comes to our American experiment in managed money it is not possible to speak with the same confidence: opinions differ, and will probably for some time continue to differ, with regard to the success of the monetary policy which has been developed and pursued in our country during recent years. There were those who confidently predicted that if the country's money supply was sufficiently increased and sufficiently rapidly increased it would float us out of the depression and lift prices up to the much favored 1926 level. The broad objective of our policy has been to raise the general level of prices and to ease the strain of private indebtedness by insuring an abundant supply of money to the country. The Federal Reserve System has, through the open-market policy which it pursued with energy, that is, the policy of putting out new and additional money for the use of the country through the purchase of United States government securities in the open market, made a large contribution to the increase of our national supply of money. Our revaluation of gold in 1934 not only increased the dollar value of the existing gold reserves but was followed by purchases of gold from abroad and from domestic mines amounting to more than three billion dollars, and under the Silver Purchase Act the country's supply of silver money has been increased by more than half a billion dollars. These huge accessions have given rise to what are called "excess reserves" of the member banks of the Federal Reserve System. Excess reserves are made up of the money which the banks have to their credit with the respective Reserve Banks in excess of the reserves they are by law required to hold in order to carry on their business. They are, therefore, in the nature of surplus cash owned by the banks, and can properly be described as idle money.

The total effect of these policies and changes has been to bring about a condition of extreme "money ease", as it is called. Rates for borrowed money for commercial use have never been so low for those who could get it. Rates for money borrowed by the government have been unprecedentedly low. So far as there is restorative virtue in cheap and abundant money, it looks as though the United States ought to have had the full benefit of the monetary and economic theories of those who insist that the cure of business depression is a superfluity of money.

The abundance, however, or, better said, the superabundance, has not been without some effect in creating grave anxiety in the minds of some as to the future safety of our currency. To date, as a matter of fact, neither the hopes nor the fears which have been occasioned by this great increase of money supply have been realized: both appear to have been greatly exaggerated. The inflation that was not only hoped for but confidently expected by some, and as confidently expected and feared by others, did not result—at any rate has not resulted thus far. And why? Let us see!

Our recent experience has again demonstrated what the history of money and prices in the past had already established—that increases in a country's money supply do not automatically raise prices and stimulate business activity. The country was not lifted out of the depression, nor were prices lifted to the 1926 level by the device of increasing the supply of money. It takes time for a change in the supply of money to exert its influence upon prices. Moreover, to what extent it will affect

the course of prices depends upon a great many circumstances. Money affects prices and business only as it is used. Money does not possess the power of spontaneous activity. The dollar works only as someone puts it to work. Money is a tool: it has often been described as an instrument of exchange or a means of payment. Like other tools, it exerts no effect until it is used. Idle money, like idle labor or an idle tool, produces no effects. It is the money which is used and passes from hand to hand, not the money that is merely in the statistical picture, that counts in affecting the volume of business or the movement of prices. When the economic outlook of the country is uncertain for any reason, when people are apprehensive for the future, they will hesitate to use their money; they will hesitate to buy or invest with the money which they own and they will also hesitate to borrow money, just as lenders will hesitate to lend. The leaven of faith in things present and future is what vitalizes and activates money. It is the ferment of enterprise that puts money to work. Where there is no peace of mind there will be no enterprise, and industry will drag. This world of ours, notably the economic and business world, moves forward only in the atmosphere of hope.

Broadly speaking, the net effect of our monetary policies as recovery-stimulants or depression-cures has not been noteworthy— certainly not when set against the background of the promises confidently made by their sponsors at the time the policies were adopted—but their effects in adding to and prolonging monetary uncertainty and confusion and the suspense of mind which these breed have been noteworthy.

The time is at hand, therefore, if not overdue, when the most competent thought we are capable of in the United States should be given to the question of how monetary uncertainty and confusion may be terminated in our own country, and the world at large as well as ourselves again given a monetary system enjoying an assured and incontrovertible position. Sober reckoning should be taken of what continuing monetary unsettlement is doing to keep alive the forces of doubt and hesitation. There is no other equally important contribution to economic restoration that can be so easily made as the termination of this monetary uncertainty. Shall it be by a return to gold in some form, or shall it be by going on with managed currency?

Remarks by the Chairman

Mr. Adolph C. Miller: The first of the speakers is Mr. Robert Warren, for several years on the research staff of the Federal Reserve System, first with the Federal Reserve Board in Washington, later with the Federal Reserve Bank in New York, and now an economic adviser to the private financial house of Case, Pomeroy and Company. It is a pleasure to introduce Mr. Warren.

THE WORLD CURRENCY MUDDLE

ROBERT WARREN
Case, Pomeroy and Company

MONEY is but one element in a political economy—an important element, but only an element. There were organized states with developed political economies before money came into existence. If money be admitted at all as an element of a political economy, it is admitted, not as something in itself, but as an element conducive to certain economic objectives sought by society. Because it is an element, it becomes contributory to general social objectives; admitted into an economy, it becomes to a degree a determinant of social objectives. Once the objectives have been defined and accepted, it is a comparatively simple matter to devise a monetary mechanism to further their realization. Until these objectives have been defined and accepted, discussions of monetary mechanisms remain hardly more than exercises in economic casuistry. Nine tenths of the current discussion on money concerns mechanisms; nine tenths of the problem itself concerns objectives.

Little is gained by a consideration of methods, mechanisms and technique until one has discovered the premises and the objectives. Little is gained by discussing ways and means of restoring or improving the gold standard, until we have first determined whether or not we wish to have any kind of gold standard at all; as there is little point in debating whether this or that group of individuals should be responsible for the management of our currency until we have resolved the preliminary question of whether or not we wish a managed currency.

From the outset, the very fact of money encounters a conflict of social objective; for we will recognize at once that there are two primary social objectives in international relationships—the so-called internationalist objective and the so-called objective of economic nationalism. No matter what kind of money system we create, it will have points of tangency with and impact on the money systems of other nations. Strictly speaking, no nation can have complete freedom of monetary action. It can only have more or less freedom. Whether our chosen policy be that of internationalism or that of national self-sufficiency, our money system will be either in harmony with that policy or in conflict with it. It cannot be segregated from it. Nothing could be more inconsistent than to adopt a money system whose utility largely presupposed intimate economic relationships with the rest of the world, and at the same time in all other respects to adopt a policy of isolationist self-sufficiency. For a time, the conflict might not be acute. In the end the one would be forced into conformity with the other, but at an economic cost. To cite a concrete example, we all know that in England there has been for years a lively conflict of social objective between those who were chiefly concerned for a higher price level, and those who were chiefly concerned for a pound stabilized with reference to foreign currencies—a conflict between those who were regarding money primarily from the nationalist standpoint and those who were regarding money from the internationalist standpoint. We do not know to what extent the British authorities might have been successful had they elected to pursue the first objective. We know that they have been quite successful in realizing the second objective; and that they have made no appreciable progress toward the first. Yet they have neither committed themselves to one, nor formally renounced the other.

In the absence of agreement concerning objectives, we take refuge in ambiguity. We speak glibly of sound money, but in the abstract the adjective is almost meaningless—a money is sound as it is conducive to an accepted social objective. If the *accepted* social objective of England were a rapid rise in the price level, then the British policy of maintaining the stability of the external relationships of sterling has been unsound. If I assert that a sound dollar requires instant, unlimited and unquestioned convertibility into gold coin on demand, I mean first that I consider that kind of dollar to be conducive to a certain complex of social, economic and political objectives which I regard as most likely to promote the welfare of the people of America; and second, that no other type of currency would be equally conducive to those objectives. If I rate such dollars as

sounder than greenbacks, it is not because of something inherent in either, but because of a consideration of their competitive utility with reference to certain social objectives. Nor is it sufficient that I arrive at such a preference on the basis of traditional authority or on the basis of personal interest. Unless I am intellectually lazy, I shall have precisely defined the exact social, economic and political objectives served by such a dollar—and taken into account the various adjustments that would be required to bring our economy into harmony with it. But the objectives that seem desirable to me may seem undesirable to you; or you may acknowledge the objectives to be meritorious, but not worth the costs of readjustment, so that the dollar which I would describe as sound, you might rate as unsound, and vice versa. In short, when we speak of "sound money", we are speaking in the first instance subjectively; and objectively only to the extent that our individual views coincide with the accepted social objective, and have accurately defined the monetary mechanism most likely to promote it.

Putting it quite bluntly, if the world, or a group of countries, or if you please, a single country had a clearly defined, commonly accepted social objective—if it could agree upon the function which it expects money to perform, as an element of its political economy—it would be relatively simple to devise a money system which would harmonize with and be conducive to that objective. It is the absence of such agreement that brings the twentieth century into such sharp contrast with the nineteenth century.

Now, by and large, during the nineteenth century the Occidental World was in general agreement on certain social, political and economic objectives. Three of them may be enumerated.

1. In trade and production, the doctrines of laissez-faire economics were generally accepted.
2. In international relations, in spite of the wide use of protective tariffs, the general philosophy was the encouragement of the international exchange of goods—which was enormously facilitated by the improved communications adopted during the century.
3. In government, there was a general tendency, deriving from the three great revolutions of the previous century,

to limit the state to rather narrow boundaries; and specifically, after the experience with the assignats in France and the Continental currency in the United States, the relation of the state to the money system was strictly limited.

These were, let us say, a set of bourgeois objectives; but the nineteenth was a bourgeois century. Before its birth, it was described by Edmund Burke: "The age of chivalry is gone; it has been succeeded by an age of calculators, sophisters, and economists." That is quite accurate—Adam Smith was the prophet of the nineteenth century, and Queen Victoria was the incarnation of its theory of the state. Further, it was a century that took peace for granted. Waterloo and the Marne bracket the most peaceful century Europe had known since the death of Marcus Aurelius.

It was against this background that the gold standard rose and flourished—its automatic functioning was in proper accord with the ideals of laissez-faire economics; its universal and unvarying interchangeability accorded with and promoted an ever-expanding volume of international trade; its disciplines and limitations were of actual assistance to a society whose objectives included the restraint of the aggrandizing tendencies of the state.

Already we can say with some positiveness that the accepted objectives of the nineteenth century are not the accepted objectives of the twentieth century. Whether these objectives are stated in terms of Social Democracy as in Russia, National Socialism as in Germany, the Corporative State as in Italy, the Cartel System as in France, the Trade Association System in England, or the New Deal in the United States, the survivor of the nineteenth century finds himself in a different world.

Wide as is the diversity among these systems, they have three things in common: in economics, rejection of the doctrines of laissez-faire; in international relationships, the prohibitive tariff, the embargo, the quota and even the quarantine are evidence of the extent to which the objective of economic nationalism has replaced the objective of world trade; and while the scope of the state varies widely between, let us say, Russia and England, Italy and the United States, in all countries it has assumed proportions which, while they would

seem familiar to a burgess of the fourteenth century, would seem incredible to a citizen of the nineteenth century. In the nineteenth century, the social objectives of England, Russia, France, Germany and the United States were fundamentally in agreement with each other, although this agreement was expressed in a variety of forms. The same fact may be stated today. The great nations of the white race exhibit remarkable diversity of form in approaching their objectives, but fundamentally there is more similarity than difference.

But the common objectives enumerated above are as yet negative objectives. All these states have rejected laissez-faire economics; but except Russia, none has defined in positive terms the ideology which is to replace laissez-faire; all have adopted doctrines of economic self-sufficiency—yet all are deploring the success of their collective efforts. All have demanded that the boundaries of the state be enlarged, but none, except Russia, has clearly delimited the new boundaries, and even in Russia they are shifting.

Now, not for one moment would I attribute the abandonment of the old objectives, or of the philosophy of money that went with them, to the wiles of the demagogue or the machinations of sinister forces. They were abandoned under duress, of which I would specifically enumerate three forms:

1. A burdensome, and, for some states an intolerable, debt structure largely inherited from the war.
2. An experience with price fluctuations beyond anything which organized society had hitherto encountered, at least since the third century.
3. A phenomenon of unemployment which was far beyond the experience of the nineteenth century.

Under the duress of these circumstances, it is easy to understand why society has cast aside its old gods, and sought new ones; and it is equally easy to understand why in the money mechanism it seeks changes which promise to alleviate the specific woes of which it is most acutely conscious from recent or current experience, namely

1. Unemployment.
2. The burden of debt.
3. The menace of violent price fluctuations.

It is out of consideration of these three oppressive problems that three schools of monetary thought have developed, in place of the single school whose opinion was generally accepted in the nineteenth century. Each is equally aware of the triple problem, each is equally social-minded; all are equally radical, in the true sense of the word, in that they would strike at the very roots of this triple problem, rather than resort to temporizations and expedients. All agree on one fact—that a money system, must have an accepted point of fixation, beyond political caprice or economic opportunism. The disagreement lies in the point of fixation.

1. One school would make some accepted domestic price index the point of fixation. That is, it would endeavor to attain some optimum domestic price level, and thereafter orient the whole force of monetary policy upon the maintenance of that level. This is essentially a program of monetary nationalism.
2. A second group would make the rate of interest the point of fixation, and the whole force of monetary policy would be directed upon establishing and maintaining an optimum interest rate calculated to effect some desired utilization of the credit mechanism. This, too, is essentially a program of monetary nationalism.
3. The third group would make the maintenance of a set of international currency relationships the point of fixation, maintaining these relations through the familiar mechanisms of the gold standard, although it will be realized that there is little agreement yet as to the rates of exchange upon which currencies might permanently be stabilized. This represents a program of monetary internationalism; and as such it imposes disciplines decidedly limiting freedom of national action.

Of these three schools, the last probably commands a more numerous popular allegiance than either of the alternatives. But both in Europe and in this country, the price-level standard has strong support; while in England a new point of fixation is coming forward among economists—the employment of the money mechanism to fix the long-term interest rate at some low figure, say under three per cent, and there to maintain it

without direct regard to the price level or to fluctuations of the foreign exchange. While this last theory has not received wide advocacy in the United States, there is no doubt that it could command a large following. If this country were suddenly confronted with the alternative of a 59 cent dollar and a five per cent interest rate or a 50 cent dollar and a maintenance of the three per cent rate, I dare say that we should find we are more deeply committed to this theory than the absence of discussion would lead us to suppose.

Time does not permit an argument as to the respective merits of these three schools, each of which has a legion of able protagonists. It is enough to point out that each recognizes one salient fact—that a money system must have somewhere a point of fixation, to which it is committed finally and definitely. For some months we have experienced (1) a stable price for gold with approximate stability of the foreign exchanges, (2) a stable price level, (3) a stable long-term interest rate, represented by a quotation of about 2¾ per cent on long-term government bonds. Which of these is our point of fixation? To which one of these are we most firmly committed, and which two are we prepared to sacrifice, if a choice must be made? For nothing in monetary history even suggests that all three can be maintained in their present and recent relationships definitely.

Or, I might add, if this country were suddenly confronted with the option of a 59 cent dollar with sterling at $3.50, or a 50 cent dollar with sterling at $4.87, would we demonstrate our allegiance to gold or seek admission to the sterling area?

If I were to ask this audience what kind of money it desired, I should get a unanimous reply, "Sound Money"; and if I further asked this audience what it meant by sound money, the reply would be, "Money of stable value". Such a reply would not be peculiar to this audience—an identical reply would be given by a comparable audience in London, or Paris, or Rome, or Berlin, or Tokio. But if I asked the third question, as to precisely what sort of stability is desired, what point of fixation commands your most sincere allegiance, the reply would be far from unanimous. Nor would I get greater unanimity in London, or Rome, or Berlin, or Tokio. Yet, unless a money policy is to be arbitrary, capricious and opportunistic, it must have some point of fixation; some last line to be defended at all costs. And the very fact of fixation in terms of one point presumes variation in relation to all other points. In choosing any one of the three, as our point of fixation, whether the price level, or the interest rate or the international relationships, we invite by implication the fluctuation of the other two.

The money muddle of the twentieth century lies in its inability, organized in its respective states, to determine upon a single point of fixation with the same resolution and unanimity as the nineteenth century determined upon and clung to the price of gold.

I have no doubt of the capacity of society so to organize itself as to realize the social objective of a stable price level; I have no doubt of the capacity of society so to organize itself as to secure the social objective of a low and permanently stable interest rate; I have no doubt of the capacity of society to organize itself on the premise of an unstable price level and an unstable interest rate, with international fixation on gold. I strongly doubt—more than that, I would deny—that any one of these objectives can be realized solely through the money mechanism. If stability of prices be the accepted social objective, our entire economy must be oriented on it. If an optimum interest rate be our objective, our money mechanism must be reinforced by a variety of social controls, all aimed at the same end. If stability of the international exchanges be the objective, then conflicting elements in our political economy must be eliminated or subordinated. And further, I must insist that no one money system will equally serve all three objectives; and any attempt to make it do so will only create confusion of purpose and invite the eventual disaster that is the penalty of divided objectives. Each of these social objectives promises some desired advantage; but we must be prepared to purchase that advantage at a cost.

The nineteenth century was at least able to make up its mind and was willing to pay the cost of its decision. It accepted fixation via gold of the international relationships, and paid for it with fluctuating price levels and fluctuating interest rates; and it accepted a political economy which was in harmony with its money policy—laissez-faire in production, internationalism in trade, and a limitation of the power of the state.

The twentieth century not only has not made up its mind, but finds fault with current monetary policies as determined by caprice and opportunism, without acknowledging that these policies reflect its own inability to choose between its three conflicting objectives. Government, whether in England, the United States or elsewhere, is in this case the faithful mirror of a public sentiment that day before yesterday insisted upon a money policy related to the domestic price level, yesterday insisted upon stability of the international exchange, and today upon a fixation of the interest rate. We throw shoes at the mirror because we do not admire our own reflection in the glass.

So far in this paper it has been my intent to present the theoretical phases of the monetary question; and especially to contrast the clarity and simplicity of the nineteenth-century concept of money with the confusion and complexity of the twentieth century. But such a presentation omits what is, speaking realistically, the salient fact in the money muddle. Broadly speaking, in the nineteenth century nations balanced their budgets; at the present time, nations do not balance their budgets. I cite this fact, not for the purpose of arguing that the nineteenth century possessed a superior sense of fiscal responsibility, but for the purpose of emphasizing two reasons for this contrasting behavior. The two reasons for unbalanced budgets in the world are, first, military expenditures and, second, the relief of unemployment. Neither of these presented an acute problem to the national treasuries of the nineteenth century. Judged by contemporary standards, military establishments were puny and inexpensive in a century that took peace for granted; their cost was easily confined within the limits of taxable resources. Second, unemployment on a large scale was a brief and infrequent abnormality in a century whose basic concern was a scarcity of labor adequate to meet the demands of its geographic expansion. In that century no treasury was called upon year after year to keep a nation-in-arms on a war footing or to provide for the maintenance of a large fraction of its population. To speak bluntly, the nineteenth century balanced its budgets because it could, or did, take peace for granted, and because it had no problem of unemployment. The twentieth century does not balance its budgets because it dares not take peace for granted and because it has a problem of unemployment. Even without these special expenditures the routine costs of every state require taxation which the nineteenth century would have regarded as ruinous to economic progress. With these special expenditures, deficits the world over have become so large as not merely to exceed the taxing power of the state, but to exceed its borrowing power unless the state can make the monetary system the adjunct of the fiscal system. In the catechism of the contemporary state, the chief end of monetary policy is to finance the Treasury. In the stratosphere of academic theory, we may discuss the merits of the gold standard, or explore the possibilities of managed currencies designed to guarantee that price level or this interest rate. But on the hard ground of current actuality, these discussions are irrelevant except as they are related to the immediate problem of the financing of the Treasury deficit or its counterpart, the support of a Treasury debt representing the accumulation of past deficits.

As I see it, the world money muddle is a dual problem. There is the problem as it presents itself to the economist seeking among several options the ideal money system. But there is also the problem as it presents itself to the finance minister confronted with a budget that he cannot meet except by exploiting the money system in the interest of his Treasury — commonly with a deficit caused by demands for the national defense or by demands for the relief of the unemployed.

The theoretical aspect of the money muddle derives from an honest perplexity as to the basic concept of money best calculated to promote the social objectives of our time, on the hypothesis that we are free agents, able not merely to devise but to adopt the money system of our choice. The practical aspect of the money muddle derives from the hard fact that at the present time in no important nation does any such freedom of choice exist. In every major nation, the exigencies of the national exchequer demand and receive first consideration and dominate both the formulation of monetary policy and the operation of the monetary system.

REMARKS BY THE CHAIRMAN

MR. ADOLPH C. MILLER: Our next speaker is to be Mr. John H. Williams. Mr. Williams is well known as a student, particularly of international finance, and now occupies the Chair of Economics in Harvard University. He is as well qualified as anybody to talk upon the subject which he has chosen, " Monetary Stabilization and International Flow of Capital ". I present Mr. Williams!

MONETARY STABILIZATION AND THE INTERNATIONAL FLOW OF CAPITAL

JOHN H. WILLIAMS
Professor of Economics, Harvard University

IN discussing the subject, " International Monetary Stability and Capital Movements ", I think perhaps the first question is whether we desire to have international capital movements. At the moment there is a great feeling of discouragement, not confined merely to this country. That comes, I think, in large part out of the experiences of the twenties and the depression that has resulted.

During the twenties, undoubtedly, we indulged in an orgy of international capital movements. Every war has been followed by such an orgy. It happened after the Napoleonic Wars. It happened after the Civil War. I have seen a list of foreign loans made by England following the Napoleonic Wars, and some of the countries on the list were so obscure that to me they were unidentifiable.

Perhaps this particular orgy is worse than any that has preceded. So far as this country was concerned, we found ourselves in a unique position. Unlike any other country preceding us, we had been thrust almost overnight into a new international position.

At the beginning of the war we were the world's largest debtor and by the end of the war, four and a half years later, we had become the second largest exporter of capital. I think a great deal follows from that sudden transition. We found that we had been making loans for non-economic purposes. We found we had been making loans that could not be collected, and very serious questions were raised as to whether they should be collected.

We developed a surplus of exports on an unprecedented scale. In four and one-half years of war our export surplus amounted to eleven and one-half billion dollars, which was equal to the sum of our export surpluses in the preceding forty years. As

a result also of the war, we found ourselves with large profits, with great savings, with greatly expanded industries seeking outlets abroad. America had become a reservoir of world capital and this reservoir was then tapped in every direction. It encountered an unusual, intensive and insistent demand abroad.

Part of the capital went into Europe for non-economic purposes. We all recall the extravagant movement of capital to Germany as a part of the reparations planning. Part of it went, under the auspices of the League of Nations, to Central European countries. Much of it went into the young countries of the world, the young agricultural countries which also found themselves greatly stimulated as a result of the war.

We found also all sorts of cross currents in our international lending. Though we had been thrust overnight into a new position, we still had many of the characteristics of a young country. We still found that our home investments were usually superior to the foreign opportunities for investment. We thus found ourselves twisted and torn between desire to invest abroad and desire to invest at home.

This contradiction affected the outside world as well. Our stock market boom was a characteristic phenomenon of a young country. It resulted in an inflow of funds from foreign countries into our country—a country which now in its new creditor position should have been exporting capital to the rest of the world, was actually taking capital in from the rest of the world. That, I think, was one of the major causes of the depression.

In addition to the long-term movement of capital, there developed after the war an unprecedented movement of short-term funds. It has been estimated that by 1930 there were no less than $14,000,000,000 of these short-term funds. They had developed in part out of the world's experiments with the gold exchange standard, and in part as a result of the reparations experience. In large part, I think, they grew out of currency disorder and fear. Currency disorder has the effect of shortening the period for which investments will be made. The investment of American capital in Germany began as long-term investment and then steadily shortened as time went on, and the outcome became more uncertain. The movement of short-term funds continually rattling about the principal money markets became one of the most unsettling factors in the whole post-war monetary situation.

As a result of all these circumstances, it is not unnatural that our country for the time being should have turned its back upon foreign investment. I think, however, that that is a temporary phase, and that as time goes along and we enjoy a recovery, it will be a recovery not merely of domestic investment but also of international investment.

Perhaps the period necessary for reviving international investment will be longer. That was Britain's experience after the Napoleonic Wars. There followed a very considerable interval in which the British had not yet forgotten their burnt fingers and were unwilling to go on.

The principal reason that I have for taking this view is that I believe it to be a part of the inexorable economic logic applicable to the case. I think we shall find, just as the British did in the nineteenth century, that development compels us to go seeking investment opportunities wherever they may be found for just the same reason that we desire to buy goods where they can be had most cheaply.

If we take the longer view and go back through the nineteenth century, we can hardly doubt the desirability of international investment. It was by this process that England was able to build up labor and capital on so small an island. The advantages were cumulative. The economists frequently explained in their discussions of international trade adjustment how the terms of trade are turned against the investing nation. That, to my mind, is a shortsighted view, a cross-section, a static analysis. It entirely overlooks the fact of growth. The fact of the matter in the nineteenth century was that the movement was beneficial both to the receiving countries and to the paying countries. We, in that time, were on the receiving end. I think no one will doubt that we were benefited by international investment. By this process our interior was opened up, our railway net was built, our industry and agriculture were stimulated.

Cairns, the English economist, paints for us a picture of the long-time cycle of change. Nations in the beginning are borrowers from abroad. At a later stage, they are payers of

interest on balance. At a later stage, they are exporters of capital on balance. And in the final stage, they are receivers of interest on balance.

That picture of the long-time cycle of change often comes into my mind these days because it carries for us some interesting implications. The first is that underneath the whole development there is a presumption of productivity. Why does a nation change from a capital-importing country to an interest-paying country? Only because the application of the capital has been productive. It yields an income.

We now find ourselves in the third phase. We have been, until the depression, a capital-exporting country. I doubt if we have ever been a creditor country in the true sense, a country entitled to receive interest on balance. That is, I doubt if we have been a creditor country in the income sense, but we are progressing toward that stage without any question. The economic logic of our situation, of the world's situation, will force us on that path, even though at the moment we are surrounded by exchange restrictions, trade restrictions, capital export controls and all the other devices looking toward autarchy, the closed economy.

Thoughtful economists would dismiss a great deal of what I have said as obvious, even platitudinous. They say, "Of course, we recognize that international capital movements have been instrumental in the development of the world, its resources, its trade, but we have now reached a point where the world is sufficiently developed and we can afford to put our minds on other problems. International capital movements have been a source of economic instability." The problem of stability today is more important, according to these economists, than the problems of productivity.

That is a rather challenging point of view and there is a good deal in it. Unquestionably, though there have been many other causes of instability, international capital movements have been one of the chief ones. It can be illustrated in various ways how the movement of capital does create an unstable situation. For example, according to the simple classical theory of international trade, you always have equal compensation among the trading countries. If prices rise in one country, imports increase, gold flows out, prices fall, exports increase, until you again strike a balance of exports and imports. It is a beautiful self-correcting mechanism. Capital movements do not subject themselves to that analysis at all. If, for example, prices rise in a country, there are likely to be profits. The appearance of profits will attract international investment as well as home investment. The inflow of capital drives prices higher, makes profits larger for the time being, and there will be another inflow of capital.

So the thing goes on as in a spiral and this is true whether the phenomenon runs in terms of commodity prices or in terms of security prices as in our late stock market boom. The process continues until there is collapse, either in the capital-receiving country or by the drainage of funds from the lending countries. And that this thing could happen to a country which was already an exporter of capital under other conditions apart from that particular boom, is a very striking proof of the instability introduced into the world economic mechanism by capital movements. That is one method of proof.

League of Nations studies have shown, it seems to me, conclusively that nowadays booms and depressions are coming to be more and more simultaneous in all the leading countries. The explanation is not difficult. From the point of view of the capital-receiving country, I have already given the analysis. From the point of view of the capital-paying country, the export of capital will be followed or accompanied by an exportation of goods. This will make for industrial activity, at least in the export industries. There will then be a demand for credit and a boom can be generated not only in the capital-receiving country, but in the capital-paying country.

Of course, I recognize that this argument assumes the existence of free reserves in both banking systems. That was not allowed for by the strict gold-standard theorists who always supposed that banking systems were loaned up. But central banking is a complete answer to that assumption. Central banking is based upon the opposite principle, that it is prudent for a country to have some slack in its banking system.

The central bank plans always to hold an extra reserve and with that reserve it can influence the money market, so that under modern conditions there is plenty of room for simultaneous expansion. As to contraction, we have the evidence of

the depression itself. Surely we experienced a simultaneous world-wide contraction in the thirties, at least until 1932.

The phenomenon of short-term capital movement can also be used as proof of instability introduced by capital movements. We have seen, for example, in the twenties, England using the short-term capital movement as a means of balancing her account momentarily, in a purely temporizing way. Lending money long-term, she was borrowing it short-term, in order to avoid the loss of gold and the fall of prices and costs which she felt would be too painful.

The question to be faced, therefore, is how to effect the best compromise between the two considerations, productiveness on the one hand and stability on the other. The world is now in process of searching for the answer. The current British answer is the system of flexible exchanges. The general purpose of this system is not necessarily to do away with international capital movements but to protect the internal economy from the strains and hazards of such movements. It is based on the view that the stability of the internal economy must come first.

There is not time to discuss in detail the question of flexible exchanges. As a depression policy, adopted under conditions of world-wide deflation, there was much to be said for it; indeed under the circumstances there was no other course. But from a longer viewpoint, I cannot but think that the well-being of countries like England will continue, as in the nineteenth century, to be largely dependent upon international trade and capital movements, for which some reasonable degree of international monetary stability will be found to be essential. Perhaps if England and Germany and Italy were not just now preoccupied with internal recovery, resting upon such temporary phenomena as a housing boom in one case, rearmament in another, and war in the third, they might find themselves more sympathetic to this point of view.

Flexible exchanges, in my judgment, will not remove the unstabilizing effects of capital movements. They will put the emphasis on the speculative aspect rather than on the investment aspect of such movements. They are likely to give us the maximum of the undesired characteristics of capital movement and to minimize the desirable characteristics.

Now, for our own country. What should be the policy? My time is getting short. Well, what are the alternatives? We, too, could go in for flexible exchanges. But if we do not do that, should we leave international capital movements wide open or should we subject them to some measure of control? I am very skeptical of governmental control. In England today it is not possible to bring out a new loan without approval of the Treasury. Indefinitely continued, such a policy might raise many questions. In the long run, political, economic and diplomatic questions are intertwined. With governmental control of loans in this country we might hear a good deal more about imperialism and dollar diplomacy. Are governments going to hold themselves responsible for the mistakes they make in foreign investment? Are they going to collect with troops the loans which they sanction?

Two points should be remembered in any attempt to improve our record as international lenders. The first is to learn the job better. We need higher ethical standards as well as more thoroughgoing analyses on which to base our international lending. We have been too much interested in the salesman's concern whether the bonds that we took were salable, rather than whether they were sound in an economic sense. The second point is that, since international lending involves distance and strange conditions, it is a job for specialists rather than for the small investor or even for the small banker.

Finally, I believe that the central bank has an important rôle to play. Fundamentally the problems of foreign investment and home investment are similar. The task, in the large countries, is to learn and to institute an effective policy of monetary control. If we succeed at home, in all likelihood we shall succeed abroad as well. If we fail, we fail in both fields. In the twenties we were unable to stop the mania of investment either at home or abroad. We have had various new tools handed to us during this depression and surely we are equipped to do a better job, provided only we have the knowledge. I would like to end on that note. Instead of conflict, there is an essential harmony between the aims of internal and external monetary policy. You cannot have domestic monetary stability without some measure of international good health, and you cannot have international monetary stability unless you keep your house in order at home.

Remarks by the Chairman

Mr. Adolph C. Miller: We now proceed with our meeting, addressing ourselves now to the subject of "The Sterling Area and the Stabilization Problem". Our speaker is Professor Alvin H. Hansen of the Department of Economics of the University of Minnesota. Professor Hansen is a man who is well known to economists and particularly for his penetrating studies upon the business cycle, and his recent volume on "Stabilization in an Unbalanced World", that is, the world of today. We hope not the world of tomorrow.

I have great pleasure in presenting to you Mr. Hansen!

THE STERLING AREA AND THE STABILIZATION PROBLEM

ALVIN H. HANSEN
Professor of Economics, University of Minnesota

THE topics under discussion this afternoon relate to the international aspects of money. An international monetary system presupposes the existence of well-established international relations if not of a highly international economic structure. Such a structure had indeed developed to a rather remarkable degree in the nineteenth century and in the decade prior to the great war. But the pre-war international world was in a sense not international at all; it was essentially a British world. London was the commercial and financial heart of the whole system. Not only was England the center of a world-wide exchange of goods but she also was the major source from which flowed vast capital funds into North and South America, the Orient and other parts of the globe. Moreover, in the migration of populations, one of the leading characteristics of the pre-war century, England played by far the most important rôle. Finally the British pound sterling was essentially the world monetary unit, since commercial bills were regularly drawn in sterling. All the factors affecting the balance of international payments, foreign trade, the movement of long and short-term capital, and gold shipments converged at London.

The pre-war international system, which as I have indicated may properly be termed a British international system, was destroyed by the war. The post-war efforts at international coöperation sought to rebuild a new world structure on a genuinely international basis. Had it been possible to escape the terrific world depression, this end might indeed have been achieved. For the time being, however, the depression shattered this hope.

It is surely no exaggeration to say that of all the world-shaking events which have come out of the depression none is more revolutionary or far-reaching in effect than the withdrawal of England from the world international system, and the erection instead of a more limited British system, a system which is not world-inclusive in scope, but restricted to an area more directly and immediately subject to British control.

I refer, of course, to two striking events, one having to do with monetary matters and the other with trade matters. The establishment of the sterling area in 1931 means the emergence of a limited international monetary system covering, however, an important part of the modern financial and commercial world. Logically and consistently this event was shortly followed by the erection of a systematic scheme of imperial preferences at Ottawa in 1932. The groundwork for this structure had already been laid in part by earlier Dominion preferential tariffs and by the definite adoption of outright protectionism by England early in 1932. To complete the trade structure and make its area substantially coördinate with the sterling area, the Ottawa preferences were in turn supplemented by special trade arrangements, notably with the Scandinavian countries. Thus, there was built up a closely knit international system composed of ten or a dozen sovereign and, to all intents and purposes, independent nations. This new British international world, the sterling area, while less ambitious in scope, is more homogeneous in its institutional arrangements and therefore more likely to prove workable. With its own monetary system, it is rapidly developing complementary and interdependent channels of trade. It constitutes an integrated world of its own, separated from the general world chaos.

It is quite impossible to view current world international problems realistically without having first of all a clear recognition of the existence, strength and probable continuity of this new entity. Future international developments will be determined mainly by the answer to the question whether this entity will become the focal point from which there may be developed a new and inclusive international system, or whether this new entity will prove the starting point of the development and continuation of a group of preferential systems, each striving for self-sufficiency and aiming to minimize its contacts and relations with other corresponding areas.

The breakdown of a truly international system and the formation of preferential and more or less separatist areas explain, at least in part, the current explosive international situation. Take the problem of raw materials. Access to essential raw materials has become again a leading source of international friction and conflict. This is so because of the breakdown of the international system. Access to raw materials could not possibly be a matter of concern to any country so long as we had a well-functioning international structure. The raw-material-producing countries cannot be charged, except in the rare case, with monopolistic restriction of output or with an arbitrary, selfish or nationalistic appropriation of natural resources. In general they are eager to sell their product in the world market, frequently even at ruinously low prices. The difficulty does not come from this side. The difficulty arises from a breakdown of the world currency and from inequality of treatment in commercial policy. A shattered, disorganized world does not afford ready pathways or easy access to the raw materials needed by modern civilization.

In a recent pamphlet Sir Norman Angell says that it is of course open to Germany to get wheat and wool on exactly the same terms as a Britisher gets them.

> The Britisher cannot get them without paying for them, and if the German could manage to change places politically with the Britisher, the former would still have to pay. And the point is that he would have to pay just the same price at which he could obtain the wheat without having to conquer the country at all. The change of political situation would not alter the fundamental economic situation in the least. . . . Argentine, Brazil, and Australia supplied Germany with food and raw materials in exchange for manufactured goods quite irrespective of the fact that they are not German colonies, nor part of a German empire. Australia supplied Germany with wool on exactly the same terms as it supplied Britain.[1]

All this is certainly not true. In this argument Sir Norman overlooks altogether the all-important fact that a country cannot buy unless it has the means of payment. In order to buy, you must also be able to sell. Thus political boundaries, in-

[1] *Raw Materials, Population Pressure and War*, p. 21.

volving preferential tariffs or other preferential trade treatment, become of immense importance. Germans can certainly not obtain wool from Australia on equal terms with Britishers for the reason that Germans cannot sell in Australia on equal terms with the British. Sir Norman's argument *would* be thoroughly sound in a genuinely international world, but it is utterly fallacious in the kind of world that, in recent years, is being built up all about us. At one point, indeed, it appears that he is just about to state the case correctly. He says, " Our problem is not to overcome any difficulty of access to raw materials arising from the refusal of the foreign producer to sell them; it is to find the means of paying for them ", and then instead of going on to point out that the means of payment is seriously interfered with by the erection of preferential areas, he says, instead, that this problem is not going to be solved by the rearrangement of frontiers. With this latter statement, I should, of course, not quarrel, but the really important thing is left unsaid.

The truth is that very many countries in the world today find access to raw materials well-nigh blocked, not because they cannot buy but because they cannot sell on terms of substantial equality. You cannot buy raw materials unless you can pay for them, and you cannot pay for them unless you can sell goods in exchange. Thus, of necessity, an effort is made to offset the development of preferential areas, by similar or equally effective methods. One preferential area breeds another. As in the case of so many human problems, one rapidly becomes enmeshed in a vicious circle. The world factors which have accounted for the formation of the British preferential area can, of course, be readily understood. But it is also not difficult to see that this action has stimulated unfortunate developments elsewhere.

We in the United States are in no position to cast bricks at the British imperial preference system. The British Empire has as much right to its preferential tariff system as we have to our high tariff policy, or at any rate to our preferential arrangements with Cuba and the probable impending preferential arrangements with the Philippine Islands following complete independence. Indeed, viewed realistically from the strictly economic standpoint, our American tariff system amounts to a preferential arrangement between more or less sovereign states. Moreover, the adamant tariff position taken by this country in the decade of the twenties played, as every one knows, an important rôle in the events which led to the general world breakdown.

England's abandonment of the gold standard was, as one can by now fully appreciate, a bomb loaded with enough dynamite utterly to shatter the international price and monetary structure. This concussion in turn set off fresh explosions, of which the chief was the depreciation of the dollar and the relinking of it to gold at an undervalued rate. After such shocks, the world will not soon recover its equilibrium.

The impact of sterling and dollar depreciation upon the commercial policies of Continental Europe is well known. Preferential quotas and clearing arrangements, which in effect work to establish preferential markets—these are the answers of Continental Europe to the erection of the sterling area, the imperial preference system established at Ottawa, and dollar depreciation. Germany's network of clearing arrangements amounts to a highly artificial and complicated set-up of preferential markets designed at whatever cost to feed Germany's great industrial machine with raw materials. The leaders of her commercial policy, indeed, insist that without this mechanism her access to raw materials would have been virtually closed. Whether or not this is true, it is at any rate clear that these preferential arrangements have violently shifted the established currents of world trade. Countries which through long decades have been the major sources of important world raw materials are now confronted with sharply reduced markets. In the face of accumulated stocks and ruinously low prices in the established raw-material-supplying countries, other parts of the world are rapidly producing substitute supplies. This could not have happened in an organized international world. It is, however, a brutal fact today. There could be no more conclusive demonstration of the grave error of assuming that access to raw materials presents currently no serious problem.

In France, and in the other remaining gold countries, quota allotments have served as the leading instrument by which preferential arrangements have been built up. In Italy the

trend has progressively been toward a close regimentation of foreign trade more or less comparable to the German system involving exchange and clearing controls. Thus on the continent of Europe generally there no longer exists in any real sense a price system so far as international trade is concerned.

What is the situation in other parts of the world? In the huge Russian Empire there prevails a complete government monopoly of foreign trade. Obviously the price system in international trade is non-existent for this large area. If we turn to the Orient we observe the increasing penetration of Japan into China. Larger and larger areas are coming definitely within the sphere of influence of the Japanese Empire. Moreover, the announcement and determined prosecution of the "Japanese Monroe Doctrine" point toward the weakening, if indeed not the complete disappearance of the Open Door policy in the Far East. Thus there appears to be in process of development an Oriental preferential area under the hegemony of Japan.

As one surveys the general world picture, one cannot fail to be impressed with the fact that in place of a general international system, there have already been created a number of preferential areas with the tendency toward a minimization of commercial relations between each of these groupings. One can divide these preferential areas into two main classes. On the one side, there are those which have been created and are functioning by means of rigorous regimentation and direct government control in the form of clearing regulations, fixed quantitative restrictions or outright governmental monopoly. In all these types the price system no longer functions so far as international trade is concerned. In the second main category are those preferential areas, such as the British system, in which the price system does continue to function.

In view of the present deplorable state of economic international relations, what may be done to rebuild a genuinely organized economic world? The beginning will have to be made in those areas in which the price system is still functioning, namely, the sterling area and the United States. The British sterling area and the United States are not only in the freest position to re-direct the world back to an international system, but they also have a major responsibility, because of the impact of their past policies, to insure for other countries reasonable access to the rich raw materials contained within their boundaries. Only by establishing again a workable international system can nations be made to feel secure in their access to needed raw materials.

Desperate conditions call for bold action. I am well aware that such action is difficult in international relations. Too often timid action alone appears to be practicable. The proposal which I am about to make may perhaps be regarded as visionary. I do not think so, and at any rate it is something which ought to be done whether so-called practical politics can find a way to do it or not. An example of what *can* be done under very difficult conditions is the trade agreements program so persistently carried forward by Secretary Hull. Twelve bilateral agreements have been completed in less than two years, a really remarkable achievement, when one considers the obstacles in the way. Thus far no agreement has been made with England, and in view of American-Dominion competition in the British market, a bilateral agreement will not be easy to execute. In these circumstances, a broader attack might not inconceivably prove more practical. I have in mind a broad multilateral agreement between the United States and the whole British Empire, the Scandinavian countries, and all those countries with which bilateral trade agreements have already been signed.

All these countries are operating, with few exceptions, so far as their foreign trade is concerned, under a price system. Together they could now take an important forward step leading toward the eventual development of a general international system. This would need to take the form not only of commercial arrangements but also of monetary stabilization. Such a convention would have to be drawn in terms which on the one side would establish no new preferences from which the rest of the world was excluded, and which on the other side, would give a definite incentive to all countries of the world to join.

With respect to commercial policy such a multilateral convention might take the form of a commitment on the part of each country to reduce the tariff ten per cent each year for a period of three years on those commodities of which 75% of

the total imports come from the combined countries joining the convention. These reduced rates would, however, be made available to all countries with which the contracting parties now have *de facto* most-favored-nation relations. This plan amounts in fact to the application of the principle of the leading supplier, which has already been made the guiding rule in the bilateral agreements concluded by this country. Such an arrangement would enable the contracting parties to reduce the tariffs chiefly to the advantage of each other without resorting to discrimination, with respect to the commodities in question, against non-contracting countries. At the same time, it would give a powerful incentive to non-contracting countries to join the multilateral agreement in order that tariff reductions might also be made on those commodities for which they are the leading suppliers.

An important part of such a multilateral agreement would be, if not a *de jure,* at any rate an experimental *de facto* stabilization of the dollar-sterling exchange rate. This should be accompanied by the invitation to other countries to join such an international stabilization agreement at rates to be established within such limits as could be more or less objectively determined by considerations of international cost-price equilibria.

A general forward movement by the United States, the British Empire, the Scandinavian countries and those countries which have thus far made bilateral pacts with the United States toward the reëstablishment of an integrated international system covering such a large part of the world would become a powerful magnet attracting other nations to its orbit and gradually leading to the breakdown of the isolated preferential areas which are now being fastened and are in danger of becoming fixed, frozen entities within the world economy.

These countries alone can lead the way in such a movement. They have the advantage of undervalued, or at least not overvalued, currencies behind which they can well afford a program of tariff reduction. Moreover, in the interest of world peace and indeed of their own fundamental prosperity, they must make available freer access to those raw materials with which they are so abundantly endowed. The solution cannot be any rearrangement of political boundaries or the wholesale transfer of colonies, but rather an organized and workable international system. This involves the reconstruction of an international monetary standard and sufficient leveling down of tariffs and other trade barriers so that countries can pay for the raw materials by means of exports. The markets of this great area must be made reasonably free and accessible to all nations. We cannot face reality without accepting these economic necessities.

The conclusion is that we must do our part to make it possible for the world to put aside all solutions of access to markets and raw materials which run in terms of the erection of preferential areas.

Fortunately under the able leadership of Secretary Hull, the United States has taken a firm and unflinching stand in keeping alive the most-favored-nation policy in a world which is being swept rapidly toward the preferential system. Had this country also embarked upon preferential arrangements, the outlook for the reconstruction of an international world would be far blacker even than is the case. The United States can, moreover, make its contribution by continuing, as a permanent measure, the program of trade agreements, and by making this the vehicle toward a progressive reduction in trade barriers. Finally the cause of world peace and security would be immensely strengthened if in 1937 Great Britain should be able to modify her imperial preferential structure in the direction of a more international system, instead of strengthening the tendency toward a closed imperial economy. Preferential arrangements create their counterpart elsewhere and they sound the death knell of the international system. Equality of treatment in commercial policy is essential to meet the problem of access to raw materials and to minimize the international frictions arising out of the unequal distribution of natural resources.

REMARKS BY THE CHAIRMAN

MR. ADOLPH C. MILLER: Our program is marching on. We are getting near the firing line.

The next subject is "The Place of Gold in the Monetary Standards of the Future". This subject is to be presented by Professor Frank D. Graham of Princeton University, whom I now have the pleasure of presenting to you. Professor Graham!

THE PLACE OF GOLD IN THE MONETARY STANDARDS OF THE FUTURE

FRANK D. GRAHAM
Professor of Economics, Princeton University

AN aura of uncertainty surrounds present monetary units and shrouds their future in obscurity. This atmosphere evokes in conservative breasts a yearning for the good old days when the gold value of all the significant currencies was, in a mildly restless world, a fixed point of reference to which the prudent might repair. Be it ever so defective the international gold standard has, to the cautious soul, all the attractiveness of home, sweet home.

It is not at all improbable, however, that, if we should find that home again, it would seem by no means as comfortable as it looks now that we are wandering in the wilderness. New worlds are never discovered by turning back. They have their dangers, no doubt, but they may also be flowing with milk and honey. Even the old world is no longer what it was and institutions which were appropriate to the conditions of yesterday may now be deleterious. It behooves us, therefore, not to flee from the unknown into tradition but to scout out the land into which we are moving and to take rational dispositions according to our findings.

No one can know, of course, what the future will bring forth but I do not look for a sustained restoration of the monetary conditions of 1913 or even of 1928. The British, and particularly the Scandinavians, are already exploring new monetary territory and are finding it good. There will be stiff opposition in those countries to the return to a fixed weight of gold as the basis of the monetary unit. I would not presume to guess whether or not this opposition will be immediately successful but I am convinced that the sands of time are running in its favor and that, later if not now, it will prevail.

The heyday of the international gold standard is over. That standard no longer commands anything like universal allegiance in either academic or business circles but is, on the contrary, subject to acrid and cogent criticism. Like other forms of religion it has ceased to be taken on faith. The change of atmosphere in recent years is astounding. Twenty-five years ago almost no responsible person doubted that the maintenance of the gold standard was the sole goal of monetary policy. The economic structure was therefore forced, at whatever cost, to adapt itself to the errant course of gold. Today we are acutely conscious of the fact that our monetary arrangements have not been good; we are not disposed to forget the end for the means; and we are bent upon making money serve rather than dominate our economic life. The advocates of the traditional type of gold standard are in consequence on the defensive. The defenders of the faith still retain the respect of the economically pious but they must meet the challenge of a growing and belligerent group of skeptics who are likely to force the orthodox at least to compromise with their convictions.

All Western monetary standards have for a century or more been managed but they have been managed for quite different ends from those which are now coming into prominence. The question is not whether we shall have management but what the objectives of that management shall be. The traditional objective was merely to keep all forms of currency of unchanging value relative to gold. The developing objective is much broader and seeks to keep the national economy on an even keel at a high level of productivity.

These objectives are by no means congruent; they may even be contradictory. Whatever ultimate success may attend the idea and practice of modern monetary management, we can feel certain that the idea will not be stilled. On the contrary the older form of monetary management will surely be forced to yield to the new and, where they conflict, the old must disappear.

The fundamental objection to the international gold standard, as we have had it in the past, is that it involves the surrender of national independence in monetary matters and, in the absence of international government, of the type of management essential to economic stability.

It is true that any country in more or less permanent possession of a great part of the world's monetary gold might play the game both ways. It is in a position, within fairly wide limits, to determine the purchasing power of the metal. It may sterilize much of its gold or permit it to fructify in the price structure. Such a country might, therefore, pick a given weight of gold as its monetary unit, and strive, perhaps with success, to give it any desired value. Any other nation with a large gold supply, however, might well frustrate its efforts while nations without much gold could hardly be expected to show marked enthusiasm for a standard which would reduce them to the position of satellites or vassals.

During the period 1925-1931, the British had the experience of being tied alternately to the French and American gold standard kites and it impressed them very unfavorably. They are now masters of their monetary fate. They can do what they will with the pound in their domestic economy; they can keep its exchange value against gold currencies substantially stable for as long as it suits them to do so; and they can alter it when they please. Even as regards the possession of gold they are now in a much more favorable position than in the years prior to the abandonment of that metal as a standard. This may perhaps lead them to return to gold but, for reasons already given and to be presently adduced, even the immediate probability seems to me to be as strong in the opposite direction and the ultimate probability very much stronger.

Not only does the traditional international gold standard preclude the beneficial management of currency in the modern sense of the word but it is not even neutral in effect. Some immediate disruption follows any tendency for national price levels to deviate from one another, when there is no possibility of an exchange adjustment, and the price level reconstruction which is forced on one or many nations is a painful and often pernicious process.

The gold or any metallic standard is, of course, a safeguard against extreme inflation. But against a perhaps still more devastating deflation it is so far from being effective as to be suspect as a fairly persistent cause. Not only does the gold supply recurringly run short of the amount necessary to prevent a general decline in gold prices but, even where the total

supply is adequate, all countries under the international gold standard are at the mercy of that one of them which, for any good or bad reason, desires to reduce its price level. The accompanying general deflation, with widespread unemployment and other distress, is a situation which will not be permanently tolerated by countries not too heavily encrusted with the cake of custom.

Deflation in a gold standard world is peculiarly disruptive of international economic relations. A very large part of international trade is associated with unilateral transfers on financial account. These are fixed in monetary terms while commodity prices are not. When the volume of financial obligations is large, the value of commodities sold at low gold prices, following an appreciation in the value of gold, becomes incapable of supporting the debt. National bankruptcy of the debtor countries, vis-à-vis the outside world, is then inevitable and this, of course, adds to the buffeting which creditor as well as debtor countries are then undergoing. The British ran into this difficulty after 1929 and salvaged a sizable part of their international investments only by alleviating the burden on the debtor through reduction in the gold value of the pound; but *we* were a little late and, in consequence, less successful. It is not too much to say that, if a rise in the value of gold should prove either large, frequent or persistent, international finance on a gold basis is impossible.

We should also remember that both the international gold standard and international finance on any substantial scale were developed synchronously in the century between the Napoleonic and the World Wars. The fear of a universal conflict was then at a minimum. In the present state of world trepidation, however, the flight to gold, wherever it is obtainable at a fixed price in a given currency, is from time to time so precipitate as to make the widespread maintenance of gold currencies impracticable even if a reasonable stability in the commodity value of gold could be attained. Fear so increases the demand for gold as to make any practicable supply insufficient.

It seems to me probable, therefore, that the monetary standards of the future will not be such as to provide for the universal acquisition and disposal of gold, or gold exchange, at a fixed price in the several currencies. There will be some such standards but a dual system of currencies would seem to be forecast. There seems to be no more reason to fear deliberate and extreme inflation in inconvertible paper-using countries with a sound financial sense than there is to fear the abandonment of gold by gold standard countries.

This leads us to the problem of exchange. When we say that exchange stabilization is urgently required, a great deal depends upon what we mean by stabilization. A mere reëstablishment of fixed rates of exchange between the several currencies would be of little consequence. Indeed, so far as the important currencies are concerned, we have had substantially this situation for many months without any general feeling of satisfaction. Unchanging exchange rates are one of the least important forms of stability and, as has already been shown, may give rise to more, and deeper, problems than they solve. The major difficulty now is that, at existing rates of exchange, national price levels are ill-adjusted to one another. To fix the present exchange rates would aggravate the trouble. What we really need, internationally, is a persistently accurate exchange-rate reflection of the relative domestic purchasing powers of the various currencies. This can be achieved much more smoothly with variable than with fixed rates. Exchange rates which moved in the appropriate direction, in proportion to shifts in price level relationships, would be a mollifying rather than a disruptive influence on the currents of international trade. This would bring real stabilization into international trading relationships and would permit the several countries to pursue independent domestic monetary policies without repercussions on the outside world.

Mere uncertainty with respect to exchange rates is not necessarily pernicious. The probability of frequent small fluctuations, or of even a sizable orderly alteration, is not an important disturbing factor in international trade. An active futures market will remove risk from those who do not hanker for it and an alert, but conservative, business man will be subject to no inconvenience in international transactions. It is a certain, rather than an uncertain, change, coupled with uncertainty as to its timing, which is devastating. If France should now definitely announce that the franc was to be devalued by a specific amount at some unspecified date the foreign

trade and finance in which France was involved would be thrown into chaos. No futures market would function. Even without a definite announcement, the general acceptance of the idea that devaluation is inevitable is a crippling factor. The present disruptive force in the exchange markets is not the instability of paper currencies but the fear that the members of the gold bloc will not be able to maintain the gold value of the currency units which they are essaying to hold at a level unwarranted by the underlying fundamental factors.

Wild movements in exchange rates, involving a great spread between the internal and external purchasing power of a currency, are of course an evil—but we should not draw the inference that all movements are to be avoided. If an international agreement could be reached on appropriate rates for the present, coupled with an undertaking by each of the signatory nations that no substantial change would be made except in response, and in proportion, to prior changes in relative national price levels or after a steady drain of gold, we should have all the stability which is either feasible or desirable.

The zone of permissible fluctuations, regardless of shifts in relative price levels and therefore of current norms of exchange, should, however, be considerably wider than the present spread between the gold points of gold standard currencies. It is ridiculous to be shuttling gold back and forth across the ocean in response to such slight stimuli as are now effective. The only gainers from this operation are the shipping companies and the bankers. It has no sound economic function. On the contrary, it ministers to, and exaggerates, any tendency to panic. It has been said that nothing is so timid as a million dollars and it would be very desirable to give them a little courage by making flight, and repatriation, more expensive. This would be useful with gold as well as with paper currencies and would be accomplished by creating, or somewhat widening, a spread between the official buying and selling price of gold.

Most seasonal and other temporary maladjustments could be remedied, without gold movements, if exchange rates were given somewhat more flexibility than has in the past prevailed between gold units.

Long-run adjustments, consequent upon an apparently definitive shift in relative price levels, would be effected by an alteration of the norm rate of exchange, as between independent currencies and gold, and by dragging price levels back into line in the traditional manner, as between those countries which adhered to a fixed-weight-of-gold monetary unit.

The place of gold in such a dual system of international currencies would be to take care of what we might call intermediate-run adjustments—to act as a stabilizer rather than as a preserver of a destructive rigidity in exchange rates and as an auxiliary rather than an arbiter of price levels. Its functions are clearly foreshadowed in the present stabilization funds. Gold would provide a means of payment—at either a fixed or a slowly variable price in the currency of the several countries—adequate to prevent great deviations of exchange rates from purchasing power norms. The supreme virtue of gold in this respect is that it would everywhere find a ready market in unlimited quantities, without prior search for a buyer, and subject to no tariff or other restrictions on movement. The stabilization funds, themselves, would always furnish bids and offers and gold would thus always be available as a makeweight in the international balance of payments. For the most part it would lie unused but this is, in some ways, a virtue. A desired but, for most purposes, a useless commodity is the one type of article for which demand is likely to show the steady elasticity essential to the purpose in hand.

If we succeed in achieving any semblance of an ordered world, moreover, it would be clearly advantageous to have the various central banks keep a sizable part of their gold stocks as special deposits in the Bank for International Settlements and transfer title rather than actually move the metal.

The stabilization funds would absorb the whole stock of gold in the financial system though a private free gold market might well be permitted. The operations of the funds, however, would dominate the market. As an independent currency tended to depreciate in terms of gold the stabilization fund in that unit would buy the currency at a slowly declining gold price and when the currency tended to appreciate, it would sell the currency at a slowly rising gold price, until the limits of the zone of permissible fluctuation were reached. These operations themselves would set up corrective tendencies, which would ordinarily stop the movement within the permitted temporary limits, and they would be clearly profitable to the fund. By the same token purely speculative, as opposed to hedging, transactions would show a bias toward loss, a matter for congratulation.

When either of the zone limits was reached, and the stabilization fund was persistently called upon to buy or sell at that level, this would be practically conclusive evidence of the necessity for a change in rate in the case of an independent currency and of price level in the case of a gold currency. Such changes would contribute to international trade stability and international agreement upon them ought not to prove difficult. To preclude undesirable speculation, no definitive change of the norm rate, at any one time, should be of greater magnitude than the zone of permitted temporary fluctuation.

A system of the character above outlined, which in its incipient stages is perhaps developing under our eyes, would give freedom to the several participants to follow whatever domestic monetary policy they might choose, without any disturbance to their neighbors. It combines the virtues of gold with those of free currency standards and would use the sacred repute of gold to foster, rather than to thwart, economic endeavor.

But, it may be asked, what shall we do about long-term international finance? The danger of undertaking international obligations in terms of gold has been impressed upon borrowers in recent years but the course of financial history goes to show that both borrowers and lenders learn but little from the past. We may therefore expect some new international investment in gold as the only medium likely to prove mutually satisfactory to some of the prospective parties. This may produce some awkward situations as between the gold standard countries and those with independent currency units wherever such countries are on opposite sides of a long-term financial transaction.

We should not forget, however, that the gold standard itself achieved international standing largely because it was the currency of Great Britain, which was the great international lender. In other words it was sterling, rather than gold as such, which became the international unit. After a period of partial eclipse, sterling, despite the severance of the tie with gold, seems well on the way toward resumption of its former dominance. If something like the present currency standard is retained in Great Britain, therefore, it is likely to be retained in many other countries. The tendency to tie to sterling rather than to gold is even now prevalent.

There is no reason to believe that borrowers will be reluctant to contract in sterling of unfixed gold value. Theoretically, this would subject them to possible exploitation by the British monetary authorities, who might raise against them the commodity value of the pound. In practice, however, it is well-nigh certain that sterling, if it remains untied to gold, either will be held substantially stable in commodity value or will depreciate. Borrowers in sterling, rather than in gold, would therefore have everything to gain and nothing to lose, unless we make the rather unlikely assumption that gold will steadily depreciate both in commodity and in sterling value.

It seems probable that sterling international loans will, under these circumstances, become increasingly desirable to borrowers, relative to loans in gold, and that gold standard lenders may be forced to adjust themselves to this situation. One possibility would be a division of the international investment field on sterling area vs. gold bloc lines with borrowing and lending transactions going on within each group but not between them.

If sterling shows substantial stability of value and gold does not, however, it is perhaps not fantastic to expect that a considerable volume of the international lending of gold standard countries will eventually call for variable gold payments, measured by some recognized, impartially determined, index number of the gold prices of international commodities.

The League of Nations might well begin the construction of such an index number. Since the bulk of the debtor countries are exporters of foodstuffs or raw materials, and foodstuffs and raw materials are the only goods which move at all freely in international trade, the index number might well be confined to such goods, which have the additional advantage of being standardized.

International indebtedness contracted along these lines would be automatically adjusted to the fluctuating ability to pay of the debtor countries, would be fair to both debtors and creditors,

would greatly reduce the tendency toward collapse in the mechanism of international finance, and would tend to preserve stability of payments in stable value currencies.

Such loans would readily be accepted as desirable by economists but they will seem strange to the financial world. They would certainly not develop except in response to pressure but that pressure may well appear sooner than most of us now expect.

It may be that here, and elsewhere, I have entirely misgauged the trend of the times and that in letting my imagination run I have let it run riot. I offer these remarks not as predictions, but merely as guesses at the trend of things, which only by accident, of course, follows the dreams of economists of any school of thought. Yet the present prejudice against paper currencies will, in all likelihood, disappear as soon as it becomes apparent that they can be superior standards of value, linked to a composite of goods rather than to a single commodity and that they need not be the purely arbitrary units — no *standards* at all—that they have always been in the past. The world will then readily accept a theory, elucidated by the course of events, which it could never understand so long as it remained a mere closet philosophy.

REMARKS BY THE CHAIRMAN

MR. ADOLPH C. MILLER: It is the nature of human society, as it is that of individuals, to learn through crisis. The child, if its parents have been wisely selected, does not repeat the same mistake too often.

These papers have well brought out what you already know, that the world today is in a profound crisis. The danger, of course, in such circumstances is that we try to learn too much from the crisis and, therefore, indulge in that most agreeable of all pastimes, to make the world over.

It is well to remember the old maxim, " Make haste slowly ", and particularly the maxim of Mark Twain, " Don't get out of an experience more than there is in it." (Laughter) " The trouble ", he said, " with the cat that sat on the hot stove was that forever afterward he was afraid to sit even on a cold stove."

Because I believe that the way to monetary restoration and certainty leads back to gold, I propose: 1. to review briefly the gold standard as it was developed in the nineteenth century; 2. to comment upon its premature reëstablishment during the years 1925 to 1928; and 3. to offer some suggestions on the problem of the return to gold in the future. (Mr. Miller then read his address entitled " Whence and Whither in the Gold Standard? ", *cf. infra,* pp. 83-92 —ED.

WHENCE AND WHITHER IN THE GOLD STANDARD?

ADOLPH C. MILLER
Member of the Federal Reserve Board, 1914-1936

I. The Gold Standard in the Nineteenth Century

THE opening of the twentieth century had witnessed the all but universal adoption of the gold standard by the nations of the world. It was in a fair way of becoming one of the established institutions of the modern world. The word " institution " is used advisedly. The gold standard is imperfectly understood, if it is regarded merely as a piece of monetary mechanism. It is that, but it is also very much more. The countries that were tied together in the gold standard system represented to a not inconsiderable degree a community of interest in and of responsibility for the maintenance of economic and financial stability throughout the world. The gold standard was the one outstanding symbol of unity and economic solidarity which the nineteenth-century world had developed. Implemented as it was by the central banking organizations which had grown up in most of the gold standard countries, any disturbance of an economic or financial character originating at any point in the world which might threaten the continued maintenance of economic equilibrium was quickly detected by the sensitive foreign exchanges. The processes of checking the threatened upset were set in motion and usually worked with such quickness and smoothness that only those whose business it was to keep in close touch with what was going on in the world of finance and commerce knew that anything had threatened. In this way, the gold standard system became in a very real sense a régime or rule of economic health, a method of catching economic disturbances in the bud and preventing the accumulation of stresses, strains and maladjustments in the economic structure which, if unchecked, would grow to catastrophic dimensions.

It is a mistake, and a serious mistake, to think of the historic gold standard as a system whose one and only objective was the maintenance of the convertibility of a country's currency and the stability of its foreign exchanges. It was in its larger significance a method—the most effective that the world has yet known — for promoting and cultivating conditions conducive to the development and maintenance of a well-compacted and stable economic and financial order.

It should, however, be noted, and particularly by those who are today proponents of an early return to the traditional gold standard, that conditions in the nineteenth century were on the whole exceptionally favorable to the efficient operation of the gold standard. Anyone who is well acquainted with the nature of the gold standard knows that it is not suited to all climes and conditions. It is, in a way, an aristocrat, and must be surrounded by satisfactory conditions. Of itself it cannot create those conditions, nor can it restore them when they have become badly deranged. Its business is the maintenance of good conditions when they already exist rather than their restoration when they have become bad.

The gold standard, it may not be overlooked, originated and developed under economic conditions which were highly competitive, and it functions best in such conditions. Such was the economic society which existed prior to the World War. In an economic world in which competition is the shaping influence and ruling force, the economic structure is flexible, things tend to find their level and industrial readjustments made necessary by monetary or other changes take place without long delays and painful dislocations. Under such conditions external prices and internal prices are kept in close adjustment with one another: so also are internal prices and costs—that is, wages and other forms of income; and thus, in the language of the economists, the price-cost structures of the different countries are kept in proper relationship with one another and purchasing power parities of the currencies of the different countries maintained. Such conditions are favorable both to the achievement and to the maintenance of economic balance and therefore to the efficient operation of the gold standard. It should be emphasized that it does not work as satisfactorily in a society whose economic structure is losing

flexibility—the problem of achieving and maintaining balance then becomes a much more difficult one, and so does the business of successfully operating the gold standard.

It is considerations of this character which make the question of the return to the gold standard in the world of today and under the conditions of today a problem which is far from being as easy of solution as too many of those who are impatient for its immediate or quick return assume.

The problem of monetary restoration confronting our country and the whole world today is at best a difficult one, and one not to be approached lightly or in a mood of merely sentimental attachment to ancient loyalities and moralities. The problem calls for the exercise of sustained objectivity, severe realism, and the patience and tolerance which proceed from understanding.

The mistake of premature restoration of the gold standard which was made ten years ago must not be repeated. Its consequences not only would be disastrous to the future of the gold standard, but might easily prove a tragic economic disaster for the whole world.

Such were in the high period of its historic renown in the nineteenth century the nature and working of the gold standard, at any rate in its larger and more significant lineaments. Let us now inquire how it fared when the attempt was made after the war to restore it.

II. The Restoration of the Gold Standard in the Years 1925 to 1928 and Its Breakdown

During the years 1925 to 1928, under the leadership of Great Britain, most of the countries of Europe and many in the overseas world undertook to hasten the economic and financial reconstruction made necessary by war by restoring the gold standard. Country after country, aided by Great Britain and the United States, reëstablished its currency system on a gold basis, each acting more or less independently of the others and without much regard to the effect that its action would have upon others in fixing the gold content of its monetary unit, and apparently without any serious inquiry as to whether conditions of economic equilibrium in the world had been restored to the degree necessary for any enlightened decision as to the relative values of the different national currencies which were to be defined in gold.

Events soon proved that the world was not yet ready for the restoration of the gold standard. It was with difficulty and only with the liberal assistance of the United States that the newly restored gold currencies of Europe and elsewhere were able to maintain themselves. The much-complained-of maldistribution of gold, the excessive amount of the world's financial funds held in the form of short-term and migratory money seeking a hide-out first in one country then in another, to the embarrassment no less of the country in which it took refuge than of the country it had forsaken, may be cited to show how seriously out of joint the world still was. The world was too disorganized, on both the economic and the financial side, to provide the conditions essential for the satisfactory operation of the gold standard. The history of these and the subsequent years of deep depression and distress which has not yet ended shows convincingly that the world had not yet recovered its economic balance, had not yet become a world suited to the regimen of the gold standard—in a word had not yet again become a gold standard world.

Monetary systems almost universally were still managed. In meeting the succession of economic strains and financial difficulties which were encountered even before the crisis of 1929 the old gold standard simply could not, and therefore did not, operate. It had to be managed, and managed mainly to keep itself from breaking down in many countries where from the beginning it at best enjoyed only a precarious position. The economic consequences which followed from this hybrid monetary régime are a matter of too recent history to require more than passing reference. It may be well to recall, however, that the train of antecedents dating back in the United States to the year 1924, particularly our great adventure in 1927 in helping to keep the weakened gold standard in Europe from falling, which finally culminated in the economic and financial catastrophe of 1929 with its legacy of tragic consequences, is not to be charged to the gold standard, but rather to the way in which that standard was perverted and managed. During the whole of this critical period the practice of the gold standard was more honored in the breach than in the observance, and under

the supposed protection of the gold standard the monetary systems of gold standard countries, almost without exception, were being managed to a degree and in ways utterly foreign to its nature. Events have since conclusively proved that the world had not yet sufficiently recovered to submit its monetary and economic life to the discipline of the gold standard and by force of similar circumstances throughout the whole postwar period there has been a managed currency basis. The world of today is a managed currency world and will continue so until the healing forces of nature and a large-minded statesmanship are brought to bear on the task of helping the forces which make for economic integration in the world and hindering those which make for further disintegration. The philosophy of the classic gold standard is the philosophy of economic integration. Its goal is a world which is integrated, not only as to each of its component parts, but as to all of these in their relations to one another. Until the world returns to such a position monetary systems will continue to be managed money systems in one degree or another, such as is the case today. The world will be fortunate if these systems are managed with a return to gold as their constant objective.

The mistake made by the premature restoration of the gold standard in Europe and elsewhere after the war was in thinking that monetary restoration through the gold standard could accomplish economic restoration. Events of past history and those of recent history to a poignant degree have shown conclusively that when the economic structures of the world and its leading countries have become badly disorganized and disintegrated and monetary systems demoralized and debauched, economic restoration must precede monetary restoration, or they must at least proceed hand in hand. Such situations require far more flexibility in the monetary mechanism than is consistent with the gold standard. The adjustments and readjustments in the process of helping the recuperative powers of nature require temporizing, compromise and management. Under such conditions, the flexibility of a managed currency system has advantages which the rigid form of the gold standard system does not possess in requisite degree. It would be shortsighted, therefore, to expect that in the present economic state of the world the gold standard system as it was in the days of its pre-war ascendency could be reëstablished and put into full operation in the near future, if ever again.

Such, in brief, is the tale of the unhappy career of the gold standard in the first attempt at its restoration after the war.

Are we to conclude from this recital that all thought of basing monetary systems of the future on gold must be abandoned? Not in my opinion. On the contrary, I see no reason for expecting or believing that any satisfactory and workable money system which all nations, or, at any rate, all the more important ones, may be expected to adopt and to coöperate to maintain and operate, can be designed unless it is based on gold.

The monetary problem confronting the world today is to work out the conditions—political, economic and technical—under which the return to gold can be accomplished — expeditiously, of course, but also, and chiefly also, safely and usefully.

III. *The Return to Gold in the Future*

In the return to gold, and particularly in judging when conditions are propitious for the return, the attitude of Great Britain will be most important. It may be well to recall that England was the birthplace of the gold standard. She gave it to the world. She built it up into a universal monetary system through the genius with which it was administered by her from the last third of the nineteenth century to the outbreak of the World War. During that period the gold standard developed into one of the great institutions of the modern world. England was its financial center: all roads led to London. The pound sterling became the universal unit of international settlement. The Bank of England, through its farsighted and skilful management, made the gold standard the balance wheel of stability and the symbol of international financial order and certainty. With the outbreak of the war, to repeat what has already been said, the gold standard broke down. Great Britain led the way back to its restoration in 1925. Later events proved its reëstablishment to have been ill-advised at that time. It led a precarious existence. After a desperate struggle, in the year 1931 Great Britain led the way off the gold standard. She suspended gold payment, i.e., the

sale of gold by the Bank of England at a fixed price, and left the value of sterling to the determination of circumstances and the judgment of the monetary authorities to whom she entrusted the management of her money. With such consummate skill have the Bank of England and the British Equalization Fund handled their problem that Great Britain presents to the world today the most striking instance in history of a successful enterprise in exchange and currency management on a large scale and under highly difficult conditions.

The United States suspended gold payments and a free gold market early in 1933, but did not abandon the gold standard except for a short space of time. It was not many months after suspension when the gold dollar was revalued and gold bought and sold at a fixed price of $35 per ounce. Since then the dollar internationally has shown a high degree of stability.

Considerable progress has therefore already been made toward the stabilization of the world's two principal currencies and has brought us appreciably nearer the day when *de facto* stabilization may end and a complete and assured stabilization of the currencies of the world's leading countries be contemplated and prepared for and eventually attained through the return to gold in some form suited to the circumstances of the world today.

The problem is now mainly one of bringing the two great countries of the English-speaking world into an accord in a determination and an endeavor to further monetary stabilization by preparing and testing the ground so that when the moment for restoration will have arrived gold parities, not only for their own currencies but for at least those of all the larger countries, may be ascertained and established, which the course of subsequent events will show to be truly adjusted to economic conditions and circumstances.

These conditions and circumstances, it must be recognized, have changed in many ways, in some ways profoundly, in the almost twenty-two years which have elapsed since the world last witnessed the successful operation of the gold standard. These changes may not be overlooked in devising the ways and means of effectuating a return to gold, nor the safeguards to which they point as suitable and necessary to the successful operation of the gold standard of the future. The economic and social structures of nearly all countries of the Western World have been losing flexibility since the World War, some of them to a degree that would perhaps better be described by saying they show signs of increasing rigidity. Such has been conspicuously the case in Great Britain, and such is also coming to be the case to no mean extent in the United States.

Monopolies and other forms of capital control, labor-organization control and the multiplying forms of government control, both economic and social, trade barriers, tariff discriminations, import quotas, subsidies and bounties may be cited to indicate the spread of the stiffening process which is creeping over the body economic of our own and many other countries today. These devices, which would have been described by the economists of an older day as interferences with the free play of competition, are symptomatic of far-reaching changes in political, social and economic outlook which the twentieth century has brought. The pressures which the World War and the great depression have exerted have, of course, greatly accelerated and intensified this drift, but it probably would have occurred in any case. The Western World had entered the "Age of Welfare" even before the war, but happenings since then and notably in the last few years have set countries, including our own, far ahead on the new course. The student of monetary science may not overlook the significance of this drift or trend in affecting not only the future of the gold standard but the whole problem of monetary organization and control in the future as well. The gold standard of the future will of necessity have very much less of an automatic, self-regulating character about it than that of the last century, because the economic world in which it will operate will also have very much less of a competitive and self-adjusting character. The operation of the gold standard in an economic society whose joints are stiffening presents a different and much more difficult problem than its operation in the flexible world of the nineteenth-century highly competitive society. As economic structures become more rigid the gold standard itself must become less rigid. It must develop the capacity to adapt and adjust its operation to a degree never in contemplation before the war. The gold standard of the future must lay aside the habits of the aristocrat and cultivate those of the

democrat. It must learn to adapt itself to new surroundings and their requirements and not regard itself as its own end. While continuing to perform, as before, the function of providing the commerce of the world with a common currency of indubitable character, it will also and at the same time have to perform the function of supplying national currencies adjusted to domestic circumstances, in order to meet the reasonable requirements of the economies of the different countries operating under the gold standard system. The application of the gold standard will have to be tempered at times and firmed at others. Implementation and guidance will play a far larger and more important part in the administration of the gold standard of the future than in the past. The central banks in Europe and the Federal Reserve System in the United States will be tied in very closely with that administration. They will perforce operate the gold standard of the future. They will be its guardians, ministers and masters. A high sense of purpose and responsibility, deep understanding, wisdom, skill and statesmanship will be called for from them, and not least in the preliminary trial period when the ground for a return to gold is being made ready and proved. The enterprise and responsibility with which they will be charged will be partly national and partly international, but always directed to a common end and to that extent, at least, a common enterprise. Its end will be the furnishing of the world and the several countries belonging to the gold standard system with a currency and a form of currency control that will do all that may be reasonably expected of the monetary mechanism toward keeping the economic systems of the several countries and the world economy in which they each have a profound stake in a going condition, i.e., as nearly as may be in a state of continuous functioning. Such an enterprise or endeavor must obviously follow the lines of mutual understanding and accommodation. No prescribed formula can be laid down in advance, least of all by any one country for the others.

That the gold standard can be re-created into an institution of both national and international monetary and economic service; that the gold standard of the twentieth century, when it finally takes shape and is given the support both of the peoples and the governments of the world, will again become a great institution not only of monetary certainty and safety but also of financial order and economic stability, and again give to the world a much-needed spirit of community of interest and responsibility, I do not doubt. That is why I am for the return to gold as the only secure foundation on which to rebuild the monetary systems of the future.

The time has come to end the period of monetary experimentation and hesitation and to begin the work of monetary reconstruction. Our own government has recently spoken: we are ready to proceed. The world now awaits a sign from Great Britain. When she has spoken the way will be open for the rebuilding of the old gold standard system into a twentieth-century institution.

Remarks by the Chairman

MR. ADOLPH C. MILLER: Professor Angell of Columbia University, a man who needs no commendation to a New York audience, will now lead the discussion. When he has finished, the papers that have been presented here will be open for brief discussion from the floor, but all remarks should be limited to five minutes.

I now have the pleasure of presenting Professor James W. Angell!

CURRENCY MANAGEMENT AND THE GOLD STANDARD: DISCUSSION

JAMES W. ANGELL
Professor of Economics, Columbia University

I SHOULD first of all like to congratulate the Academy of Political Science on its having had the privilege of listening to the preceding speakers, and to congratulate the speakers themselves on their admirable papers. There is no group of experts whom I would so gladly have heard on the intricate and difficult questions at issue this afternoon, and none who are more competent to discuss them.

I have a great deal of sympathy with the general position outlined at the start by Mr. Warren, when he intimated that the root of our monetary troubles lies in the fact that we really don't know what we want to do with the money system. Until quite recent years, and except for certain brief episodes like our silver agitation at the turn of the century, the great bulk of the populations in the Western countries had not realized that the money system was anything more than an end in itself. Sometimes they praised it, sometimes they called it harsh names, but in the main they simply took it for granted. Since the war, however, and particularly since the beginning of the world depression, an ever-increasing number of people have discovered that the money system is not merely an end in itself. They have discovered that it can be made into a tool of vast power, for the accomplishment of far-flung social and political aims, and perhaps even for the transformation of the state itself. The difficulty has been that hardly any two individuals can agree on what these aims should be. There is a money doctor on every street corner, each with a sure-fire prescription; but the prescriptions are all different.

The most fundamental cleavage of opinion, or at least the most urgent one, has developed over the apparent necessity of choosing between internal and external monetary stability.

Yet vastly more time and effort have gone into arguing the relative merits of these two objectives than into finding out what they really mean themselves, or even into finding out whether you really have to choose between them. For example, if we define external stability as meaning adherence to the international gold standard in some form, that is in itself an understandable concept. But the real implications of adherence to the international gold standard, I think, are not fully perceived even today. Several of the preceding speakers have indicated that it probably means you must sacrifice internal stability for external, and must place yourself at the mercy of the accidents of foreign trade, finance and even politics. I agree that past history lends a good deal of support to that view, especially post-war history. But is it impossible to devise an international gold standard which would be free of all or most of these defects? I doubt it. If the leading nations *wish* to set up a decently workable international gold standard, that would not produce intermittent violent distortions within each country—such a gold standard as has never existed for any length of time in the past—I am sure they could. The trouble is that to date they have never really wished to do so.

Then take the other and supposedly opposite objective, internal monetary stability. What does this really mean? Some say stability of prices; others, stability of production, or of employment, or of debt burdens, or of investment, or of money incomes; and others talk still more vaguely about a "general balance" in economic activity. Now something can be said for every one of these possible objectives. But, as Mr. Warren has quite rightly pointed out, you probably cannot have *all* of them at the same time. You must probably choose some one or perhaps two among them, and discard the rest; and with most of them you may also, in practice, have to discard part or all of the international gold standard. All this can be shown fairly easily, by reasoning which I shall not inflict on you here. The practical difficulty is again to decide *which* objective you will choose, and again hardly any two people agree. Some are Communists and some are conservatives; some are isolationists, and others remember William Jennings Bryan.

What it all comes down to, I think, is broadly this. The world today is in the midst of a vast whirlpool of conflicting social, economic and political forces, both national and international. The world's money troubles are in largest part the *result,* not the cause, of these profound and shattering conflicts. Until the conflicts are resolved, or at least are greatly abated, it is unlikely that an international monetary system will evolve which can offer any assurance of continued stability. Some of the conflicts, perhaps, will be settled only by the holocaust of war. Others I hope can be settled by a series of arrangements like those so skilfully outlined by Professors Hansen and Williams, and perhaps still others by a slow process of compromise and patience, giving a little to get a little. Until the nations of the world really want one, however, and will make definite choices and sacrifices, an enduring international monetary system can hardly be created.

But what of our own problem in this country? Do the foregoing remarks mean that we must either let our monetary system drift until the rest of the world will coöperate with us in some fashion—perhaps along Professor Graham's lines—or that we must choose once for all a policy of internal stability, at the price of external stability? I do not believe so. The long-run objective of monetary policy which I personally chance to favor, as some of you know, is substantially the stabilization of average money incomes per head of population. But this *is* only a long-run objective, or at least not an immediately urgent objective, and in our present situation there are various serious practical difficulties in the way of trying to achieve it overnight — even were it theoretically desirable. Moreover, while its accomplishment might save us from *future* severe depressions, it could do little to help haul us the rest of the way out of the *present* depression.

Our chief monetary problems at the present moment are of a different sort. To accomplish our own economic recovery today, I think we need, above almost anything else, two things: first, abolition of the present paralyzing uncertainty about the immediate future of the currency, and especially abolition of arbitrary interference with the money system for political reasons; and second, a rapid end to federal budgetary extravagance and the present process of hidden budgetary inflation.

The quickest and surest path to the first of these goals, and perhaps to the second as well, is an immediate return to an unrestricted international gold standard, at about the present levels. We should return to gold with the full realization that it is only a temporary stop-gap, intended to keep from us a flood of graver evils; and we should do it in the full expectation of passing on as rapidly as possible to a better monetary system. But after watching the violent upheavals and the failures of the government's monetary policies over the last three years, my present feeling is that to meet the monetary and the political dangers of next week and next month, we should return to gold today.

PART III

ECONOMIC RECOVERY AND MONETARY STABILIZATION

INTRODUCTORY REMARKS *

RUSSELL LEFFINGWELL
Of J. P. Morgan & Co., *Presiding*

IT is well to recall that all plans for reconstruction after the war in every nation were based upon monetary stabilization and the return to the gold standard or a gold exchange standard. The first to return to gold after the war was the United States. We lifted the gold embargo in the summer of 1919. The early post-war period of frantic paper money inflation in Germany, Austria and the succession states was followed in the mid-1920s by plans of reconstruction and monetary stabilization for those countries. England, France, Belgium, Italy and Japan returned to gold. Even India took steps in that direction. But monetary stabilization proceeded more rapidly than appeasement. While finance ministers and central bankers, aided by other banks and bankers, formulated plans to facilitate trade and recovery through monetary stabilization, politicians and statesmen and soldiers, and the people of each country, only intensified their nationalism, political and economic.

The politicians and the statesmen and the people of the world were not as much interested in peaceful trade and orderly exchanges as the finance ministers and central bankers and other bankers were.

I suppose it must be said that these banking people and these financial people were ahead of their time. Appeasement had not gone as far as that. Sound currency, stable money, de-

* Introductory remarks at the Dinner Meeting of the Semi-Annual Meeting (Fifty-sixth Year) of the Academy of Political Science.

pends upon peace in the world, upon freer trade, and upon budgetary equilibrium; and those great steps that were taken in the period of the 1920s under the leadership of the best thought that the financial world could give—under the leadership of the great central bankers and finance ministers, with the coöperation of private bankers—were based on an assumption that there was to be political and economic peace—an assumption which turned out to be unjustified.

How we in America came to be forced off gold, how necessary and grimly inevitable that action was, how cruel and devastating had been the consequences of monetary deflation, and how life-giving and revitalizing and essential to recovery the policy of insuring low interest rates, I need not repeat.

Sound and stable money is the handmaid of recovery, not the master. If we are to have sound and stable money we must have peace in the world—between nations and within nations. We must have freer trade in the world—between nations and within nations. And we must have budgetary equilibrium.

Budget Balance Defeated by Deflation

As long as unemployment, here at home, continues to be great, and government aid on a vast scale continues to be necessary, and capital issues are largely limited to refunding purposes and government issues, recovery must be conceded to be incomplete. It cannot be necessary to say to so intelligent and chosen an audience as this that there ought not to be any reversion to deflationary policies while recovery is incomplete. The great paradox of government finance is that fiscal and monetary policies must be such as to increase and not reduce the income of the people if the budget is to be balanced. A government cannot balance its budget by increasing the tax rates to be imposed upon declining incomes. No more than can a railroad balance its budget by increasing the rates it charges for transportation against a declining volume of business. Deflationary fiscal and monetary policies reduce incomes and increase the burdens thrown upon the state for relief and public welfare. Thus the state that seeks to balance its budget by deflationary policies defeats its object, burns the candle at both ends, increases its expenditures and reduces its income. If there be any among us inclined to oversimplify the problem, to find a happy solution by simply saying " balance the budget ", let him bear in mind this paradox. A government cannot balance its budget by edict. It cannot extract blood from a stone nor gain revenues by deflating the national economy.

Danger of Dear Money Policy

Low rates of interest must be maintained by Treasury policy and Federal Reserve policy if there is to be recovery and a balanced budget. Any premature effort to make money dear, in apprehension and in anticipation of an inflation which does not exist, will defeat its own purpose by retarding recovery, increasing unemployment, reducing income and increasing the need of government relief. A private business man may, if unrestrained by motives of kindliness and good will and social obligation, hire and fire as he pleases, raise prices and reduce expenses, curtail his business, or wind it up if it runs at a loss. Government cannot do that. Government is the residuary legatee of all the successes and all the failures of all of us. Government must keep itself going and keep its people going too. Government can balance its budget only by enriching its people, not by impoverishing them.

Relief Necessary

Government must intervene to relieve the sufferings of the people. It is intolerable in the modern world with its elaborate mechanism of trade and finance, its highly industrialized and mechanized economy, that our people should be left to starve or to endure privation almost worse than starvation. It is intolerable that the monetary mechanism evolved for the sole purpose of achieving stability and human welfare should be permitted ever again to run amuck as it did from 1929 to 1933. It is an archaic superstition that money is stable if its value remains fixed in gold only, while prices collapse more or less generally to the point of bankruptcy, as they did in that tragic period. During the last three years government policy put an end to deflation, brought about some measure of recovery, achieved monetary stabilization and provided necessary relief. Let us not be unmindful of the depth of economic despair from which in three years we have emerged, nor the vital necessity of government action along these lines, however critical we may be of the extent and manner in which public expenditures have been made, or of this and that phase of monetary policy.

Dangers Ahead

But while we must be grateful for the immense progress achieved and recognize the validity of the emergency which called for the emergency use of government credit and for emergency monetary policies, we must not close our eyes to the perils ahead.

One reason why America financed her part in the war well was that she had no debt to speak of when the war began, a little more than a billion and a quarter dollars. That debt she increased to nearly 27 billion dollars in less than two years and a half. Thereafter, promptly she began debt reduction and continued it for over a decade. From a peak of nearly 27 billion dollars in August 1919 the debt was reduced to the post-war low point of 16 billion dollars at the end of 1930.

It is partly because the United States government debt had been so greatly reduced in the post-war decade that the government's credit was readily available to meet the emergency of the great depression. What do we have credit for? To use it when the need arises. How do we have credit to use then? By not abusing it ever. The great peril which confronts us today as a people is that we may learn to abuse the government credit after the emergency need has passed.

Mounting Public Debt

In a little more than two war years the public debt rose 25 billion dollars. In eleven years it was reduced by 10½ billion dollars. But now for five years and more it has been rising steadily and without intermission, until today it has reached an all time peak of over 30 billion dollars, having almost doubled itself in the period since the depression began.

These figures do not include 4½ billion dollars of debt guaranteed by the United States government incurred since the depression began nor the rapidly mounting debt of the states and municipalities.

I have said that the use of the public credit for relief in the emergency and going off gold to stop the deflation were necessary emergency measures. But these were major operations justified and only justified by the magnitude of the calamity that had befallen the American people. We must not drift into the notion that these emergency powers can be availed of as a habit.

Emergency Measures Not for Everyday Use

The credit of the United States and the resources of the American people are so great that the financial risks involved seem even now, after five years of mounting public debt, quite remote. And the easy money policy, which is still so necessary for economic recovery, gives an artificial facility to public borrowing. But cheap money and a mounting public debt are habit-forming drugs to be used sparingly and in an emergency only. The use of them must be discontinued as promptly as possible or, first, they lose their stimulating effect and, then, become severely depressant. Emergency use of the public debt in a crisis is to be applauded. Its abuse becomes a menace. Once let the impression arise that a government has become addicted to these drugs and its credit goes, and along with it the value of its money. Then inflation sets in. And there is no deflation so complete and devastating as that which comes when government credit is vanishing, and with it the buying power of money. That is another paradox—that the most deflationary thing that can happen to a people is a paper money inflation.

Moral and Political Risks

And what of the moral and political risks? The habit of turning to the public treasury for relief and aid and subsidy is deeply ingrained in the American people. This is not a vice of any man or any party, or any period. From the foundation of the Republic, Congress has been besieged by appeals for grants in aid and subsidies and doles, for tariffs and pensions, for rivers and harbors, for public buildings and public works, for roads and canals, in aid of this and that organized national or local group of voters. The pork barrel and logrolling are not new or even recent discoveries. The deterioration of our public life I attribute in large measure to the irksomeness to the public man of the pressure for placating his constituents by grants and favors from the public purse, if he is to attain, or to retain, public office.

Some of us are all too prone to concern ourselves with the mote in another's eye and ignore the beam in our own. Some are apt to be self-righteous in criticism of a soldiers' bonus or unemployment relief, though we rightly approve necessary aid

to banks and railroads; to complain of paying money to farmers for what they don't grow, and yet be complacent about the infinitely more costly tariff favors habitually showered by Congress upon our manufacturing interests.

Evils to Be Avoided

Today the problem of monetary stabilization and recovery appears to have progressed in this country as far as it can while recovery is so largely dependent upon emergency aid from the government, and restricted by the disastrous effect upon our exports and foreign trade of tariffs, embargoes, quotas, disturbed foreign exchanges, wars and the fear of war. The great peril which confronts the Republic aside from the disturbance of world affairs and the curtailment of world trade, is the threat that the long-established and ever-growing habit of treating Uncle Sam as a sugar daddy will undermine the independence and self-respect of the American people and will corrupt the electorate and their chosen representatives.

The Need of a Civil Service

The growing importance of government in our affairs whether we like it or not gives added importance to the efficiency and incorruptibility of the public servant. Next after corruption of the electorate through grants and favors to special groups and communities, the government of the Republic is imperiled by the failure to establish a first-rate civil service by offering a permanent career to first-rate men. The American is too often a jack-of-all-trades and master of none. We are too prone to think of the public service as an honor or a reward for the individual, too little as an opportunity to serve the public. The American people are entitled to something better in the field of public service than the spoils system or the laboratory system. Public service ought not any longer to be regarded as a reward for political service, for campaign contributions, as a field to teach ignoramuses the public business nor for theorists to experiment in. We do not wish to be guinea pigs for laboratory experiments by freshmen students of government and political science.

The increasing power of government and its enlarged functions call out above everything else for the abolition of the spoils system and the laboratory system and the substitution of a trained permanent civil service of men immune from political attack, immune from political removal, devoting their lives to the public welfare. The upper levels of the civil service of the United States should be made to appeal to the very best of the graduates of our colleges and law schools and business schools. Our government is political and should be. That is the nature of democratic institutions. The president and his cabinet and one political undersecretary should rule each department. The remaining officers and employees should be permanent civil servants trained to their tasks from the highest to the lowest and honored in accordance with their competence.

Eminent Career Men

Tonight's speakers are both trained men, trained in the public service, and both illustrate the value of experience and devotion to public duty. They are both career men in the truest sense, though neither of them has ever held office or emolument from the government of the United States. They are the perfect type of public servant devoted to quasi-public careers. Such men we should have in the service of the United States as well as of its central bank and of the central bank of central banks.

Graduate of Columbia, and holder of many academic degrees, newspaper reporter, lawyer, lecturer and instructor in political science and public law, enlisted as a private in the United States Army, major judge advocate general, decorated with the distinguished service medal of the United States and with many foreign decorations, associated with the work of the Dawes plan and the Young plan for Germany, President of the Bank for International Settlements created under the latter, Vice President of the First National Bank of New York, I have the honor to introduce Mr. Leon Fraser.

ECONOMIC RECOVERY AND MONETARY STABILIZATION

LEON FRASER
Vice-President, First National Bank of New York
Former President of the Bank for International Settlements

OUR topic this evening is "Economic Recovery and Monetary Stabilization". May I commence with a profession of faith? Economic recovery is making rapid strides in every country of the globe save a few. I believe its full attainment to be impossible without monetary stabilization at home and abroad. I believe that once monetary stabilization is realized in and between the *principal* nations of the earth, a period of pronounced prosperity will forthwith ensue; and I equally believe that, in order to preserve that new prosperity and to avert the recurrence of fresh disaster, the leading nations must work together in the monetary field in an endeavor so to regulate and coördinate their credit policy that undue fluctuations in business activity with the attendant sharp variations in price levels, fluctuations which are attributable to monetary causes, may be steadied and kept in check.

In the brief time I purpose to detain you, permit me to mention the outstanding impediments which obstruct the realization of this desideratum of monetary stabilization; to dwell upon certain progress that has been made in eliminating these impediments; to suggest a possible time of bringing stabilization about; and finally to set forth prerequisites to the maintenance of stability, once restored, with particular reference to the contributions required from the United States, if that permanent end is to be reached.

Let there be no equivoque! By stabilization is meant the re-creation of an international monetary system based on gold —a reformed gold standard—to be sure, improved by the lessons of experience—but fundamentally a currency system anchored to the one basic metal all the world accepts and wants.

It is frequently said with superficial simplicity that the gold standard was the cause of all our recent woes. A closer analysis, also seeking simplicity, would describe the primary cause of the financial breakdown in one word instead of two — the word "debt". Indebtedness, excessive in every country, either internal, or external, or both, attributable in its origin to the inflationary impulses naturally loosened by the war, left with us, after the inflation receded from its peak, an oppressive burden which was the more visible because it was expressed in a measurement of gold. But it was the weight of the acquired indebtedness, however, and not the scales which measured it, that bore us down. The enemy was inflation rather than the monetary standard, and inflation, in the long run, will wreck any currency system, however constructed—wreck it hereafter, just as in the past. To cope with the consequences of vast inflation and to lighten the burden of the acquired debt, most countries, through duress or choice, have followed the way of revaluing gold in terms of currencies, and many countries are permitting their exchanges to float without definite relinking even to the revalued gold. We shall not delay to examine whether these steps were inevitable. They are accomplished facts.

Let the past lie—our faces are turned toward the future. What will the coming monetary mechanism be? Despite the demonstrated inadequacies in the operation of the gold standard, most of which are susceptible to correction by deliberate action and coöperation, after attentive consideration of that school of thought which would discard the gold standard entirely and embark upon uncharted waters, *preponderant* world opinion agrees with the public pronouncement of the Chancellor of the British Exchequer repeating the affirmation of the entire British Empire gathered at Ottawa and at London, when it was redeclared:

> The ultimate aim of monetary policy should be the restoration of a satisfactory international gold standard. The problem with which the world is faced is to reconcile the stability of exchange rates with a reasonable measure of stability, not merely in the price level of a particular country, but in world prices.

The issue is no longer whether the coming international monetary system shall be based on gold. The inquiry is rather

what betterments are possible to make its operation more satisfactory; and the immediate question is upon what terms and when are the *principal* trading nations likely to be ready to re-attach their currencies to gold? Are we prepared ourselves?

In an address on March 5 last, the Secretary of State recalled the announcement of the Secretary of the Treasury that when the world "is ready to seek foreign exchange stabilization, Washington will not be an obstacle". Mr. Hull also pointed out that the American dollar has been completely stable in terms of gold for the last two years. He did not say, but it was implicit in his remarks, and it is a fact, that the United States two years ago returned to the international gold standard as the basis of our monetary mechanism in our external relations—that is to say, we have been accepting gold at a fixed price in settlement of dollar balances due us from abroad and, equally important, we have surrendered gold at a fixed price whenever the dollar exchange weakened and reached, as it twice did, the lower gold point in relation to a currency also on the gold standard. It is fashionable to denounce the present Administration for the vagaries of its monetary policy. Certainly, that policy has furnished ample ground for criticism, and even ground for condemnation. Yet an objective enquirer must recognize that after a period of painful trial and harmful error, the authorities have seemingly reached three conclusions, each vital to monetary stabilization at home and abroad. First, they have in fact, but in silence, rejected the proposed elastic dollar and have relinked the dollar to gold instead of to some commodity index. Second, they have been, and are, practicing the gold standard internationally, subject to certain qualifications deemed to be necessary because of the present chaos. Third, as the logical next step, they stand ready to participate with other countries in the restoration of foreign exchange stabilization—"Washington will not be an obstacle". Excellent—but a more affirmative stand will become necessary, a more explicit recognition of the responsibilities which the advocacy of stabilization implies, and some assurance of a readiness to discharge these responsibilities in order to help maintain the reëstablished order. The international standard cannot be left to itself in the vain hope that it will work automatically. Its successful functioning hereafter, particularly as regards endeavoring to obtain reasonable stability in the price level through credit control, requires deliberate direction and continuous coöperation between monetary authorities of the principal countries, especially our own.

If Washington now has the will to stabilize, where then is the prime obstacle? With apologies to our London guests,* Sir Arthur Salter and Sir Alfred Zimmern, I venture to suggest that today it is Great Britain. In 1933 *we* were the obstacle. Many of the measures taken by us at that time, and since, have contributed to the British procrastination. But that procrastination is not mere perversity. Behind it lie the reasons which reveal the whole subject of stabilization to be so complexly difficult. Many of the reasons have been officially stated; others publicly discussed. An examination of them is illuminating — first, because it is encouraging to note that some progress has been made in overcoming the declared impediments; and second, because the truth is that, inasmuch as no one intelligently supposes that we are likely to have a simultaneous world-wide currency stabilization as a result of a full-dress international conference, the crux of the whole problem resolves itself to arrangements between Great Britain and its principal partners in the sterling area, ourselves, and the gold bloc. After these regions have come to terms, other economically weaker states will later join, either because they have attained equilibrium through their own hard efforts or because they are again granted aid from the stronger financial units.

What are the essential causes of the British hesitancy besides the fact that, so long as the sterling area holds together and Great Britain heads it, they are enjoying relatively stable monetary relations within that particular area, while keeping their hands free against the contingency of violent developments in the gold bloc or here? The reasons are:

First, the Chancellor of the Exchequer declared in 1933 that it was a condition of return to the gold standard that the world level of wholesale commodity prices must recover sufficiently to restore equilibrium between costs and prices, so that an economic return might be had. Since that declaration was made, these prices have risen by very substantial amounts and

* Sir Arthur Salter and Sir Alfred Zimmern were guests at the dinner meeting.—Ed.

more and more adaptation of costs to prices has everywhere occurred. Economic return *is* being had. It is suggested that a further rise in prices and greater economic recovery are retarded by uncertainty about sterling and other currencies, by the unparalleled hoarding of gold, and by the failure to employ available credit, which are the natural consequences of the lack of a sense of security in the world's monetary systems.

Second, the Chancellor stated that exchange restrictions and the prevailing abnormal impediments to the flow of commerce, such as quotas, must be first removed. It is suggested that these barriers, nearly all of which were imposed *after* the onset of currency depreciation, are the natural protective reaction against floating exchanges and that it is hopeless to expect any considerable removal of these obstructions unless the future of exchange rates is tolerably certain. The vicious circle must be broken at some point, and the point at which to break it is where it began. In some instances, such as that of France, for example, the simultaneous abolition of quotas can be demanded as the counterpart of fixing a new parity for sterling.

Third, the Chancellor announced that the gold standard should, in the future, be so administered that wide fluctuations in the purchasing power of gold, attributable to monetary causes, would, to the greatest possible extent, be prevented. I reveal no secret when I say that the Bank for International Settlements has continuously studied the methods of attaining this end and of improving the technique of the operation of an international gold bullion standard, with restriction of the use of gold to the settlement of foreign balances. The Bank has been acting in unison, not only with the Bank of England and other central banks, but with the British Treasury officials, as well; and I believe that it is in agreement with them all that any successful administration of the gold standard requires, among other things, the permanent, uninterrupted coöperation of central banks in the conscious direction and control of the monetary mechanism, acting preferably through a common center. The rules of the game, which were tabulated at Basle, were unanimously agreed upon by the monetary committee of the London Conference, subject to the abstention of the United States delegates.

Fourth, the Chancellor stated that the British external ıalance of payments must be brought in equilibrium. This, ndeed, is vital to all countries seeking stable money. Since the :risis began, every land has been progressing, by devious nethods, toward this indispensable equilibrium. Happily, the British balance of payments on current account, according to official publications, is, and for some time has been, in satis-:actory equilibrium. Any disturbing movements on capital account appear attributable to the desire to seek a more certain nedium of conserving wealth. As important items in the :ompilation of the balance of payments and the likelihood of ts continuing to be balanced, the Chancellor observed that a settlement of reparations and war debts was essential. Repara-:ions *are* settled—the debtor settled them. It seems likely that the debtors will settle the war debts, too; they have made extraordinary progress in the last two years. Let them not disturb that progress by asking for formal approval on our part, unless and until they are prepared to make some moderate offer as a final adjustment.

Fifth, Great Britain must increase its gold reserve. This has been accomplished. The Bank of England—as is also the case of certain other central banks in the sterling area, like those of Finland and Sweden—holds by far more gold today than at any time in its history. The Exchange Equalization Fund holds additional gold supplies and, given stability, quantities of hoarded gold now locked up in London vaults would be surrendered against sterling and some of it find its way to the monetary reserves. Finally, it seems almost certain that, with the advent of currency security, part of the superabundant metal now held in America will flow back to the points of departure whence it fled, because of fright over the possibility of more currency depreciation.

Sixth, Great Britain fears to stabilize because of her uncertainty about the outcome of the American monetary and fiscal policy, which will have inescapable repercussions upon its own credit structure and price system. They consider us light-hearted in our gay experimentations with gold and silver, and light-headed in our program of bigger budget deficits. With so unstable a partner, they question the effective permanence of any arrangement for stability. The answer to this

legitimate reservation must be given by our government through a continuous improvement in its fiscal conduct and by our monetary authorities in a demonstration that they can and will control any inflationary credit expansion. Sound economic policies at home are the prelude to any enduring stability in the world's exchanges. If Great Britain, although officially declaring a preference for the gold standard, and although acutely aware of the indispensability to recovery of an international monetary standard—as is indeed evident from her attempts to widen the sterling area and to make that as international as possible—if Great Britain still wavers, it is chastening for us, before condemning her, to recall that we ourselves are not without sin.

Seventh, general British opinion doubts that the gold bloc can hold until the combined forces of internal deflation and the rise of prices abroad bring this area into equilibrium with the outside world. Until they see more clearly the future of the French franc, they deem it prudent to wait before fixing the sterling exchange rate. As the French franc goes, so goes the whole gold bloc. Can the franc withstand the impact of the unbalanced budgets, repeatedly permitted by the French legislators, with the result that the volume of short-term public debt is now of menacing proportions? The battle is in an acute stage, even as we talk. Paradoxically enough, cruelly enough, because of this British attitude, the date of general stabilization, so long desired by the French, may well be hastened, should the battle be soon lost. The battle is being so valiantly fought that it may well be won. Until it is clearly won or definitely lost no negotiations can successfully be commenced. Thereupon, they should be immediately attempted—not in the glare of an international diplomatic conference, but quietly, between the central banks at the Bank for International Settlements, with the American monetary authorities participating. Whereas it would then be preferable by far to agree forthwith on *de jure* exchange stability, it is likely that this decision will have to be preceded by a *de facto* stabilization program operating for a specified period to observe how the exchanges work; and during that period, a common Exchange Equalization Fund may be desirable.

Furthermore, inasmuch as confidence is the paramount condition precedent to stability, we cannot expect a successful outcome until there is some solution of the principal political problems of Europe, which are the foes of any confidence. If, as I am rash enough to hope, out of the present controversy with Germany, there shall evolve a new set of understandings in which Europe has reasonable faith, then the best groundwork will have been laid.

A series of arduous conditions precedent, you say; — conditions so exacting that stabilization and full economic recovery may be long delayed—but there is more yet. The United States will be called upon to make certain contributions to the restoration of confidence and toward the effective working of the new gold standard. At the very least, we shall be asked the following:

First, to make legal and binding our present system of accepting and releasing gold for international transactions—a system now operated at the discretion of the executive solely, and terminable without notice or cause. There is nothing stable about that.

Second, to abandon, in return for fixed parities from Great Britain and the gold bloc, the reserved right to cut the gold content of the dollar a further 16%. There is no stability in that continuing threat.

Third, to let gold flow out freely at all times to foreign central banks only, even if the dollar is not at the export point. We have too much gold and should facilitate its redistribution for monetary purposes.

Fourth, if it cannot be utterly abandoned by repeal of the legislation, then our silver policy, so disturbing to our neighbors, must be definitely circumscribed—in some such way, for example, as limiting it to the purchase of the output of our own silver mines. Few incidents have so impeded the prospects of stabilization as our silver activities, not merely because of their intrinsic extravagance but because of the irresponsible monetary mentality which they have exposed.

Fifth, possibly, to act officially upon a readjustment of the war debts, but I trust that our debtors will have

the wisdom not to over-stress this point, and will realiz that there are involved questions of a delicate and extra economic order which patient time can best eradicate.

Sixth, we shall be expected to pursue a sounder fisca and budgetary policy, more akin to that of Great Britai than to that of France. We shall be reminded, perhaps of the sound advice telegraphed to the London Monetary Conference by our president, when he cabled tha "reduced cost of Government" was important to ultimate stability, and that permanent stabilization could be properly discussed—"when the world works out concerted policies in the majority of nations to produce balanced budgets and living within their means. . . ."

Seventh, we shall be invited to declare our adherence to the principles for the future working of the gold standard, often called "the rules of the game", which were unanimously accepted at London with the American delegation not voting; or to offer, for general adoption, amendments to those proposals. The aim of these rules, in part, was to consummate a marriage—a union of what was best in the old gold standard, corrected on the basis of experience to date, and of what seems practicable in some of the doctrines of "managed currencies" (many of the aspirations of which are laudable even if their system be theoretical and inapplicable)—so that the resultant technique of the working of the bettered gold standard may be more satisfactory hereafter.

Eighth, we shall be invited to join the Bank for International Settlements, in order to coöperate most efficiently and easily with the other monetary authorities in the joint task of operating and preserving the reformed gold standard, and of continuously studying changing developments, so that the application of the principles of that standard may be modified as experience shall prove desirable. We shall serve our best interests, without curtailment of any of our independence, if our monetary authorities occupy the seats reserved for them on the Board of this non-political institution, dedicated to the cause of more stable monetary conditions and a sounder credit structure throughout the globe.

The difficult goal of monetary stabilization is not an end in itself. It is but an instrumentality to complete that economic recovery which is on the march. The experiment of floating currencies, whatever its passing justification and temporary advantages, has reached the point of diminishing returns. If we wish to see unemployment reduced, business more prosperous, happiness more general, opportunity more widespread, world trade revived, and nationalism less rampant, then we wish to see the restoration of a stable monetary mechanism, the existence of which was so determining a factor in the expanding prosperity of the nineteenth century.

The world awaits a courageous move that holds out hope of founding this restoration upon ground firmer than the shifting currency values that now prevail. To have assurances that America will not be an obstacle is heartening. To have America demonstrate, by sound monetary and fiscal example, that she comprehends the practical implication of these assurances, would be inspiring.

Mr. Leffingwell: I am sure that you will agree that I understated my case in favor of the trained man.

We have had the privilege of listening to a great speech by the man who has been presiding over the deliberations of the Governors of the Central Banks of the World—to the exclusion of the Central Bank of the United States. Perhaps the most important thing that suggests itself from this great speech is, on analysis, how little are the obstacles that stand in the way of agreement between the two great English-speaking nations. Just as sure as human progress is to occur, it will occur by virtue of collaboration between Great Britain and America. As we learn to understand that the love of peace in those two great democracies is the basis of the hope of the world, these technical difficulties are going to disappear before us and we are going to be working together for reconstruction.

The technical subject of money is a meaningless thing if we cannot work together for peace. You cannot have sound money except in peace. You want sound money for trade and for human welfare.

Graduate of Yale and of the Harvard Law School, legal secretary to the late Mr. Justice Oliver Wendell Holmes of the United States Supreme Court, Captain during the war of the American Red Cross overseas, counsel to the Federal Reserve Board in Washington, Deputy Governor, Governor and President of the Federal Reserve Bank of New York, I have the honor to introduce Mr. George Harrison.

SOME ESSENTIALS OF MONETARY STABILITY

GEORGE L. HARRISON
President, Federal Reserve Bank of New York

WE will agree, I think, that monetary stability is not an end in itself. What we desire is to promote and maintain a prosperous level of trade and employment. Our objective is economic stability, and monetary stability is important only as a means to that objective. We all know that money itself is not wealth—we cannot eat it, we cannot wear it, it will not keep us warm. But we know, too, that we live in a money economy, and that a stable mechanism of monetary exchange and a stable measure of value are essential to our economic life.

I am one of those who believe that the world has now reached the stage where international trade—the movement of goods from points of surplus to points of shortage—is an important factor in maintaining economic stability and in producing a higher standard of living, not only for the world in general but for this country, too. It may be true that a nation can live within itself if it must do so, but the price of complete nationalism must be a lower, not a higher, standard of living. In prehistoric times the family unit was the economic unit; the caveman had to content himself with his own ability to hunt for his living; he provided as best he could for himself; his standard of living depended entirely on his own powers to provide for himself. As time went on, as the economic unit grew from the single family to groups of families, or later on, as peoples became organized into geographical or political units, they too, owing to an inadequate mechanism for trade, had to live largely within themselves and to be satisfied with what they could grow or make for themselves.

After centuries of struggle, with the development of transportation and communication to the point where goods and people and opinions can be moved about rapidly and cheaply,

the world has learned to expect and to demand much broader opportunities and a much higher standard of living than was possible when those facilities were lacking. Improved methods of communication and transportation have not only made the opportunities for distribution greater, but the press, the telephone and the radio have stirred the imagination and enlivened the desires of peoples everywhere for the products of other communities and other nations. People are no longer content to accept only that which their own nation affords them any more than people within a nation are satisfied with the produce of their own particular locality. It is true that there have been much discussion and even advocacy of the ideal of a closed economy. I cannot but feel, however, that we are still far from taking seriously such a definition of our ultimate goal—that it is a passing phase, an expression of the world's discouragement with the tangled state of affairs resulting from the war and the depression.

It was as a natural development of the growth of international trade, and of the recognition of the importance of international monetary stability as a means to that end, that the international gold standard was developed. Our problem today is not that international trade is any less essential to the maintenance of a full economic life, but rather that we have been compelled to recognize by the events since 1914 that international monetary stability has become far more difficult to maintain than it was during the last century. The war disrupted and dislocated previously existing economic and monetary arrangements. We have been struggling with the consequences ever since. Probably no monetary system that human ingenuity could devise could have withstood economic changes of such magnitude and rapidity as the world has witnessed since 1914. Just when and how we are to succeed in restoring some definite workable arrangement, is hard to tell.

Primarily, the specific responsibility for international monetary stability rests with governments. The difficulties cannot be dealt with by economists working under laboratory conditions, nor by central bankers alone. Rather, the solution of these difficulties depends on a whole background of world conditions and on the development of a public understanding of the problem which will make it possible for governments to act and in turn discourage governments from doing those things which will threaten the success of action once it is taken. The solution requires a meeting of many minds.

Anyone who has followed the course of international negotiations since the war must realize how difficult it is to reach agreements even under the most favorable circumstances. We all remember the amount of worry and work, the amount of international discussion, and the amount of patience and good will that went into the effort to reëstablish international monetary stability in the ten years after the close of the war. In the light of that experience, we have no reason to hope for a quick and easy solution of our present problems. The complete cure is not to be found in a single international conference, nor in some flash of governmental wisdom, but in persistent and painstaking efforts over a period of time. Our efforts in the twenties temporarily achieved their objectives but failed of a permanent solution. The question today is whether we can do a better job than we did in the twenties. We start with a handicap of failure behind us which in certain ways makes our task more difficult. On the other hand, we should have learned something from our experiences.

No meeting of minds on international stability can be expected or desired without a favorable combination of circumstances that will give a reasonable assurance that any formal agreement which might be reached will have a fair prospect of being sustained. At the moment, with a large part of the world harassed by grave political uncertainties and many important governments, whose budgets are already badly out of balance, spending more and more borrowed money for necessary relief, and for what I hope are unnecessary military establishments, it is hard just now to foresee any very early combination of circumstances that will permit of definite world currency stabilization by international agreement. We can only hope that there may soon develop a quieter and more coöperative atmosphere.

Already there is a favorable side to the picture. The progress of world recovery since the middle of 1932 is now creating underlying economic conditions which make international monetary stability more feasible. During the depression the fall of world prices, the general contraction of

production, and the decline of national incomes, greatly accentuated the many elements of unbalance resulting from the Great War. Each nation felt forced to resort to policies designed to protect its internal economy. The result has been a tangled network of defensive measures such as the depreciation of currencies, the arbitrary control of foreign exchanges, and the restriction of trade through embargoes, quotas, clearing agreements, licenses and tariffs.

All these defensive measures, while different in form, were essentially of the same origin, purpose and effect. Whether they were necessary or unnecessary, the general result was a progressive strangulation of international trade, which in turn reacted seriously, in many cases, upon domestic trade and employment. At the lowest point, the total value of world trade was only one-third that of 1929, and the physical volume of trade had fallen by 25%, the largest decline in history.

On broad economic grounds one might now expect a reversal of this process. For, just as nations during the depression cut themselves off from external deflationary influences, they ought in recovery to seek, by a removal of barriers, to share in the beneficial effects of a general trade revival. In other words, nature is now on the side of the doctors.

It is a mistake, however, to suppose that the problem will eventually solve itself, even when political conditions become quieter. There is much that can and should be done to pave the way for effective international stability when governments determine, in the light of both the political and the economic situation, that the time is ripe to act.

One of the first things we may well do is to think through and try to dissipate the philosophy of defeatism which has been growing up with respect to the possibility of operating an international monetary standard, even in modernized form. We must, I think, fairly recognize that there is now a considerable school of thought which is frankly skeptical about the desirability of a return to the gold standard or to any international standard. Their doubt arises in part from the general drift towards national economic autonomy. It is more largely derived, however, from theoretical considerations as to the relation between domestic and international stability, and these considerations have led many to believe that there is a fatal antagonism between the two.

I think that this belief has grown out of the pre-war theory of the gold standard and our experiences of the past twenty years. The pre-war theory of an "automatic" gold standard carried the implication, in its abstract logic, at least, that economic disturbance, wherever originating or whatever its nature, could be dissipated and corrected by the flow of gold. There was a sound core of truth in this view, but it also contained the dangerous suggestion that all a country had to do was to adopt the international standard and fold its hands in the confident expectation that that beneficent system woud protect it from all economic ills.

That there were shortcomings in the gold standard, as we have known it in the past, no one now questions. But it was not the gold standard *per se* that failed us after the war. World recovery was never soundly reëstablished. The reparations question, despite all that was done to effect a settlement, refused to be settled. War debts remained a source of disturbance. The economic position of a number of the countries of Central Europe was never really adjusted. The rates of stabilization of some countries, such as England, for instance, were such as to require a greater economic readjustment in those countries than could easily be achieved with existing inflexibilities in those countries. America's new position in the world's economy favored a flow of gold to this country which weakened the position of a number of other countries and formed a basis for excessive speculation here. These and other economic causes for instability were back of the later financial disasters. They were responsible in a large measure for the tremendous volume of short-term funds washing about the money markets of the world in defiance of all the ordinary rules except the rule of fear.

It was against this background that the events of the years from 1931 to 1933 succeeded in generating an overpowering psychology of fear which became in itself a disturbing element apart from its original causes. Fear, following the failure of the Credit-Anstalt in Vienna early in 1931, precipitated a crisis in Germany. Fear then crossed the Channel to England and forced the suspension of gold payments there. Fear of disaster

here began to draw gold from the United States in vast quantities. As the focus of fear turned upon this country it found to feed upon a banking situation built up very rapidly during the past three decades, when weak unit banks were allowed to spring up like mushrooms all over the country. We know the results. When such fear takes hold of the imagination of the people nothing will stop it until the structure itself collapses.

No one who went through the banking crisis of February and March 1933 will ever forget the irresistible rush of panic through the country. On February 14 the Governor of Michigan declared a state bank holiday, and then in rapid succession one state after another in different parts of the country took similar action until on Saturday, March 4, practically every state in the Union had closed its banks. In the period of about three weeks from February 9 to March 3 the people of America, in fear, had withdrawn approximately $1,700,000,000 in money from their banks, an amount which equaled about 35% of the total money in circulation in the country, even in the boom days of 1929.

We shall never forget the first three days of March in the Federal Reserve Bank of New York. On Wednesday, March 1, in that bank alone, we paid out $51,000,000 of currency to our member banks; on March 2 it was $80,000,000; on March 3 it was $176,000,000. On that last day, March 3, we also lost $87,000,000 through transfers of funds to other districts, and $78,000,000 through gold exports and earmarkings. In addition the public crowded into our bank corridors to withdraw gold. In those three days, they carried off in bags, in suitcases and in their pockets over $100,000,000 in gold coin and certificates. The movement was cumulative. Each day was worse than the preceding one. This was a fear which would wreck any sort of banking system. It was this situation which President Roosevelt must have had in mind when he said in his radio address to the nation at the end of the bank holiday in March: "All we have to fear is fear itself."

I do not suggest that the collapse of the gold standard in the early years of this decade was entirely due to international maladjustments or to the psychology of fear which spread through the world. We must also recognize the effects of an increased rigidity of the internal economic mechanism of many countries which had been developing over a long period of time. The impact of external forces, operating through gold flows, upon the internal economy of these countries had become much more painful than was formerly the case. It is not too much to say that this increasing inflexibility has become the central economic problem of our generation, the root difficulty, whether one is considering the feasibility of international monetary stabilization or the problem of how to achieve and maintain economic stability at home. Given a rigid internal price structure, rigid costs of management and labor, there is danger that the international gold standard may have exactly the opposite effects from those which the gold standard theory contemplated. Instead of correcting economic disturbance, instead of encouraging stable prices, the gold standard may then become the channel of communication through which disturbances are transmitted around the world, bearing the germs of disease rather than the serums of prevention and cure.

I think this becomes clearer if we bear in mind the fundamental distinction between rigid and stable prices. A rigid price structure is a static thing in a dynamic world. It resists adjustment, and so intensifies maladjustment. Stable prices, on the other hand, are dynamic. The ship and the airplane offer no blind resistance to the winds and currents, but move steadily through them by a process of constant adjustment. They move, they have a destination, and they carry passengers and freight.

Now, the increasing rigidity which we have witnessed has been cited by some as proof that an international monetary standard is no longer workable. That seems to me the shallow and shortsighted conclusion. It ignores the great dangers and hazards of fluctuating exchanges as well as the competition in defensive measures to which they lead. Financial armaments, like military armaments, are expensive and unsatisfactory. Moreover, there is implied in this whole view the fallacious notion that nothing more is involved than a mere act of choice—that we are entirely free to choose between domestic monetary stability and international monetary stability. It would be nearer the truth, in my judgment, to say that neither is possible without the other. Unless each country is literally to build a wall around itself, our economic problem will always

be one of interplay between internal and external forces, and no amount of choosing between fixed or flexible exchanges will get around that fact.

We are apt to think of the world as an abstraction, as something apart from the countries that make it up. If we get beyond this, we are apt to think of it as consisting of some sixty countries, all mutually and more or less equally interacting upon each other. It is perhaps nearer to reality to think of the world as consisting of a few pivotal countries and their economic spheres. What happens to the world depends primarily upon what happens to these pivotal countries. From this point of view is it not reasonable to conclude that the money question is mainly one of the impact of internal monetary conditions in these few countries upon the remainder of the world? If these countries could preserve monetary stability at home, coupled perhaps with some safeguards against excesses of international capital movements, then fixed exchanges and gold flow would provide a means of imparting to the rest of the world the stabilizing influences developed and maintained in the pivotal countries.

This approach focuses attention on the problem of internal control in the leading commercial countries. On it would depend the achievement of both internal and external monetary stability. There is, after all, nothing very novel in this view. Stated in homely terms, it simply means that we who make up this group can do much to keep the world in order if we can keep our own houses in order.

We in this country have already made some progress in this direction. The dollar has been stabilized in terms of gold since February 1, 1934. We have maintained that stability in relation to other gold currencies by the free purchase or sale of gold at fixed prices. Furthermore, responsible officials of our government have indicated, in effect, that we are ready to consider international currency stabilization when other countries are ready to do so.

We have enacted legislation designed to avoid a recurrence of some conditions which contributed to our own and to world difficulties. That is particularly true with reference to the speculative apparatus which in the late twenties drew funds to this market from all over the world, funds which we did not want and funds which the rest of the world sorely needed.

In certain particulars we have amended and, I believe, strengthened our central banking mechanism by giving the Federal Reserve System additional powers of credit control, such as the powers to fix margin requirements and to change reserve requirements. The exercise of these powers will call for wise judgment and courage. It must be admitted, however, that even though the powers of the Reserve System for dealing with credit problems have been increased, they are not complete in themselves partly because other governmental agencies also have vastly increased powers. The System, therefore, cannot of itself assume final or full responsibility, at least not until some of the emergency laws dealing with monetary and credit matters have expired or have been modified or repealed. These emergency laws not only divide responsibility; conceived in depression, they risk being real sources of danger in recovery.

So, also, our commercial banking system which collapsed under the strain of 1931, 1932 and 1933, has been safeguarded in various respects. After the banking holiday of 1933, only those banks believed to be sound were permitted to reopen, so that many weak banks were eliminated from the banking structure. Furthermore, a large number of banks have since joined the Federal Reserve System and are now under some form of national supervision through the Federal Reserve System or the Federal Deposit Insurance Corporation. The capital structure of under-capitalized banks has been restored through private subscriptions and through the Reconstruction Finance Corporation.

In spite of these steps, however, there are still some fundamental shortcomings in our banking system which, to my mind, must some day be corrected if we want to avoid future weakness.

Our commercial banking system grew up much like Topsy. At the beginning of the depression it consisted of about 24,000 separate unit banks all organized and operating under 49 different sets of laws—the federal law and the laws of the 48 states. Some of these banks were members of the Federal Reserve System but two thirds of them were not. The Federal Reserve System was superimposed upon this heterogeneous group of banking institutions without any substantial change in the basic system itself. No central banking system can be made

a substitute for a sound commercial banking system. So, while many steps have already been taken, we shall not be able to boast of a wholly adequate banking structure until such time as it may be possible to develop a more unified commercial banking system with greater concentration of both authority and responsibility.

This implies a greater uniformity of banking laws between the different states, on the one hand, and between the states and the federal government, on the other. It implies greater consistency and effectiveness of banking supervision, responsibility for which is now divided among too many agencies. It implies the necessity of improving the general character of bank management through the development of some more liberal system of branch banking within appropriate areas. It implies some satisfactory disposition of the knotty problem of separating the commercial banking function from the savings banking function. The combination of these two functions in the same institution has been one of the apparent causes of our banking troubles of the past. Lastly, it implies the ultimate necessity of bringing all the commercial banks of the country into the Federal Reserve System.

The precise answer to these questions is difficult to determine either as to time or method. It will require thoroughgoing and thoughtful study, and perhaps a gradual solution; but we should not rest content until the problem has been recognized and its solution undertaken. I do not mean to imply that our banking system today endangers the economic stability of the country or the funds of its depositors. But I do mean, that it will never function to the full limit of its usefulness and safety until these questions are considered and disposed of in some satisfactory fashion.

In this brief summary of some of the things which we have done in this country and still need to do in setting our house in order, I have referred altogether to the financial aspects. To avoid misunderstanding, let me add this general qualification: that the financial soundness of a country is not something independent from the soundness of its whole economy. It is not possible to have sound finance unless there is also a sound industrial policy, a sound labor policy, a sound basis for the distribution of the national income, and a sound governmental fiscal policy. To a considerable extent the financial well-being of a country is but the reflection of its whole economic life. So I have been discussing not the whole of the problem but rather that part of it which comes more within the direct sphere of the responsibilities of a bank of issue. One of the results of our complex existence is that responsibilities can never be wholly segregated and fixed. No question of great importance in terms of human welfare can be narrowed down and dealt with in a single sphere. Each question is dependent somewhat on the other.

It is obvious, therefore, that domestic problems will not solve themselves any more than will international problems. We should not be content to sit back and wait complacently for the solution. Each nation, while working for a removal of the international barriers to stability, might profitably direct its course towards domestic stability.

As I say, we in this country have made some progress; but we have more to do. The same thing is true of others. Many nations have unbalanced economies, drastic trade and exchange restrictions, problems of relief and unemployment, or budgetary difficulties, quite apart from political uncertainties. The solution of some of these problems and the removal of at least some of the existing obstacles to international trade, might well be undertaken promptly in order to facilitate world monetary stabilization. If these things are not done, if governments persist in stifling international trade for uneconomic reasons, and if nations or whole groups of people, over too long a period, are denied the right of a decent standard of living because of man-made barriers to the exchange of their goods and services, then, in the light of past history, they will seek that right, sometimes ruthlessly and by force, just as men have done from the beginning. If, on the other hand, nations now persistently and vigorously apply themselves to a solution of these questions, then when the time does come for international monetary action, whether it be between large groups of nations or simply between the nations whose currencies are the principal media of international trade, we can look upon whatever action is wisely taken with a fair degree of confidence that it will survive and contribute to the prosperity and happiness of peoples everywhere and, not least, to our own people.

REMARKS BY THE CHAIRMAN

MR. LEFFINGWELL: I know that I speak for you all in parting, when I thank Mr. Fraser and Mr. Harrison and the Directors of the Academy of Political Science for the privilege of listening to two great speeches, spoken with the high authority of men who have devoted their lives to distinguished public service.

THE PROSPECT OF INFLATION IN THE UNITED STATES *

JAMES HARVEY ROGERS
Professor of Political Economy, Yale University

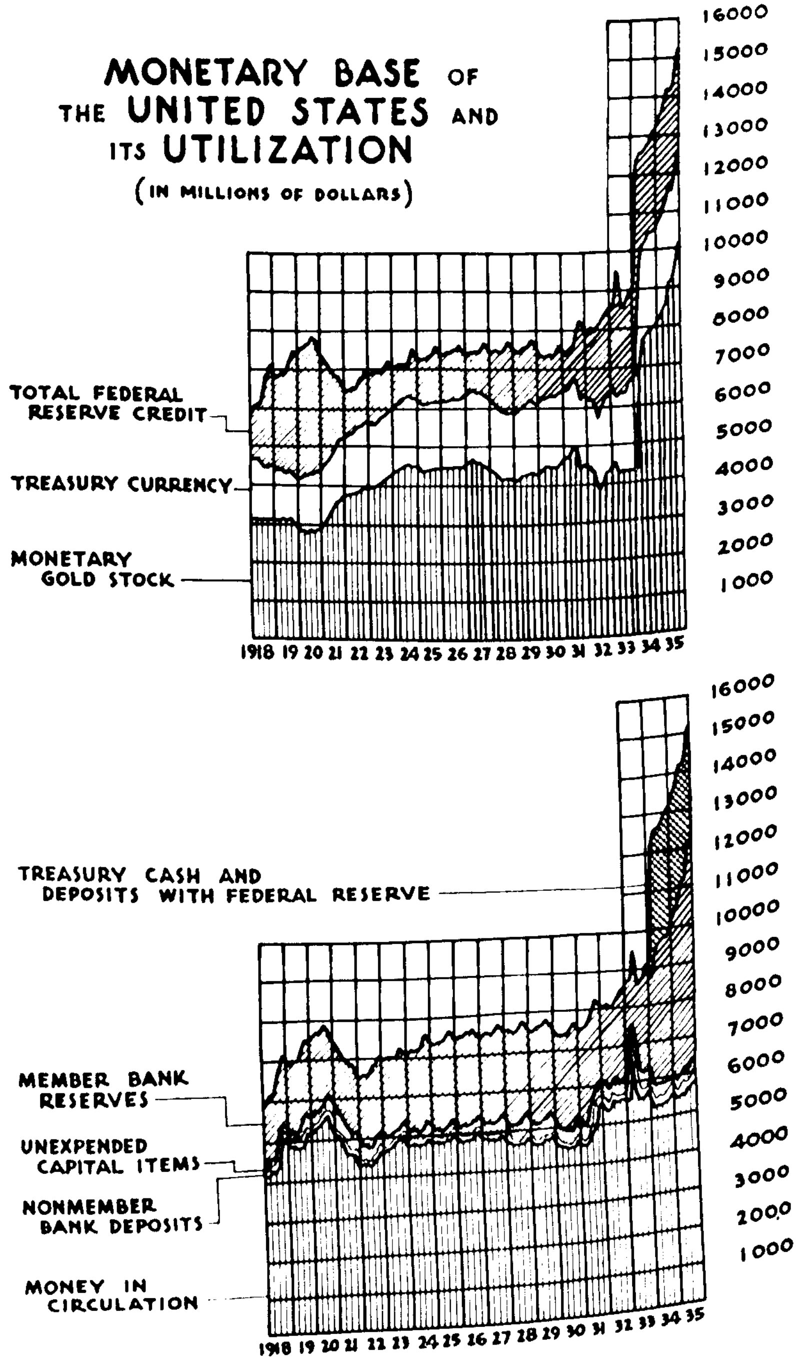
IN the twenty minutes allotted me I shall attempt to discuss the prospect of inflation, and virtually nothing else. In particular I shall not discuss the *effect* of inflation. But in view of remarks of the second speaker this morning,[1] perhaps I should begin with a definition of inflation. I can assure you that I shall not mean anything mysterious.

I have contended from the beginning that recovery and the early stages of inflation could not be told apart by anyone. They are identical in every respect. Whether we now have inflation, or whether we have recovery, or whether we have just credit expansion, is a matter of definition and nothing else. We have, of course, credit expansion, and we have a certain degree of recovery, as is well understood by most people. If I should define inflation (that is, what I shall mean this morning when I am talking about the prospect of inflation), I should say very simply that it is a considerable further rise in prices, accompanied by a further rise in bank credit expansion; and if you wish me to define "considerable", I should say perhaps something like double, that is, a doubling of the present price level. I should certainly call that inflation.

I shall begin by reviewing very briefly the things which may be pointed out as possibly leading to inflation in this country, and then I shall proceed to describe these as accurately as I can. The first is our huge gold reserve. Some people regard that as an inflationary influence. Second, the huge excess reserves of our member banks, which are higher today than at

* Under the title "Prospects for Inflation" this paper has been published by the University of Minnesota Press; it is reprinted here by permission of the publisher, and with minor changes due to the occasion.—ED.

[1] Mr. Ralph Robey, *cf. supra*, pp. 10-16.—ED.



any other time in our history. Third, a temporary inflation trend. Fourth, a highly undervaluated dollar. Fifth, a national budget deficit—and a big one. I shall discuss these in turn as they seem to appear logically in the argument.

What is the threat of inflation?

First I shall take it up from the money side, and I take it up especially in this form because it happened that the evening after we had gone off the gold standard, or rather after the American public had discovered that we had gone off the gold standard, I was speaking on the subject of inflation in New York City, and on the same platform with the last speaker.[2]

Some people thought when we had gone off gold we were going to get a terrific rise in our *general* price level almost immediately, in fact within the next few days, or the next months at the latest, and from the money side purely. Having been in a way connected with what happened in our money system, that is, with the money manipulation, if you please, I think it fitting to begin with that side, by showing you its inflationary effects and the controls that have been built up. At every step precautions were taken to build up controls.

I call your attention to the chart, and as it represents a balance sheet of our money system, I invite your careful attention at this moment.

You will notice that we have a top chart and a lower chart, and the ordinates for every single month are the same in the top as in the bottom. I call it " Our Monetary Base and Its Utilization ". In this upper chart I have the total monetary funds that are available for our use: and I show exactly how we use them in the bottom chart.

Let us look at this balance sheet. We have three major sources of our monetary supply. The first is the gold stock, which comes either out of the mines or else from abroad, and goes directly into our money system: that is represented by the gold portion on the chart, and it represents of course the major portion of our total monetary base. Then we have two *organizations* in our financial structure that are issuing currency. One is the United States Treasury, the other is the Federal Reserve Banks. The Treasury currency is the un-barred portion of the upper chart. The Federal Reserve credit that is

[2] Mr. Robey.

outstanding for each month is the obliquely-barred portion. Each quantity is built on top of the one below, so that total ordinates give us the total money supply. However, part of it is not money at all, but Federal Reserve credit, so I speak of the *monetary base* instead of total money, Federal Reserve credit being identical with the others for this purpose.

The utilization chart is at the bottom. Strangely enough, even though only a little over one tenth of our business is done with money, a great portion of our credit base is used for money in circulation, as indicated by the vertically barred section. Then there are the two minor items, the dotted portion representing capital, surplus and undivided profits of Federal Reserve Banks and the unshaded item representing non-member-bank deposits. Then come member bank deposits, which take up the next largest portion of the total monetary base and finally we have the checked section which represents the stabilization fund and the deposits that the Treasury has with the Federal Reserve Banks. That is what has been impounded of our total monetary base; in fact the stabilization fund was created in such a way as to impound a part of the monetary base so that it would not go into member bank reserves, as it otherwise would have done, and thus tend to make these member banks' reserves correspondingly more difficult to control.

This is the monetary set-up, and remember, the ordinates in the lower chart are exactly balanced with those in the upper, to millions of dollars, which is a very close balance indeed for a set-up of this sort.

But what about the inflation threat?

Of course, in the first instance, any expansion of our total bank credit comes in the member banks, and on the basis represented in the chart by the member banks' reserve account. The excess reserves of these banks are at their all-time maximum of about three billion dollars, furnishing a possibility of very great expansion. That we would call *primary* expansion, or *primary* inflation, which expansion can take place at any time unless certain controls are used to stop it.

How great the expansion of deposits on these reserves could be would depend on how much money would flow into circulation in the course of the expansion, and also on how much gold would flow abroad in the course of the expansion. To the

extent that gold flows abroad, it lessens the whole of the credit base. To the extent that it flows into circulation, it will be absorbed, and will reduce the base on which expansion could occur. I should say a four- or five-fold expansion—twelve to fifteen billions of deposits — on the existing excess reserves would not be great. We might even get a ten-fold expansion —thirty billions of deposits.

Furthermore, let me call attention to one possible form of increase in the monetary base itself, one which is continuously before us, since Congress is continually bringing it up. Suppose that the stabilization fund were abolished, simply taken over into the revenues of the Treasury. Two billions would be added to the excess reserves by simply utilizing this vast sum instead of keeping it impounded in the stabilization fund. Its expenditure would throw the two billion dollars into the excess reserves, and thus increase the basis upon which any direct expansion might occur.

Now, however, I turn again to the unshaded item above, the Treasury currency. To the extent that the Treasury is printing silver certificates, that item is increased, so that a like increase appears in the total of our credit base, and simultaneously in member bank reserves, for the simple reason that the other "utilization" items, being dominated by different influences, will not take it. So, to the extent that we are increasing our silver certificates (which is small at present and not dangerous) we likewise increase the member bank reserves, and in that way make possible a still greater expansion.

So much for the *primary* expansion possibilities, *with the monetary set-up as it is at present.* Let us look now at the *secondary* expansion possibilities.

I spoke of the great increase in our gold reserve, which came out of devaluation. Early in 1934, we devaluated the dollar. Notice (on the chart) the increase in the gold supply (value) that came with that monetary action. An increase of 69 per cent came on account of devaluation itself. Since that time the gold imports and the increased production of new gold have led to a still higher total, so that we have now a little more than ten billions in our monetary reserve. This is not dangerous, for the simple reason that I think we can assume that our Federal Reserve authorities can control it, and will not expand unduly except for other influences which I shall discuss later; hence the possibility of a secondary expansion coming out of the early utilization of that gold supply seems not very great.

I call attention again, however, to the fact that the existence of that gold supply puts us in much the same position as after the great gold discoveries of the Klondike, of California, or of the Transvaal, or even as after the discovery of the Americas flooded the world's money systems with new gold and silver. But for the present, it is impounded sufficiently and is not an immediate threat.

We have all learned, however, and I think we have learned for a long time to come in this country, that expansion possibilities are very different from expansion actualities. The fact is that when we built up our excess reserves, I, for one, thought they would be used somewhat more rapidly than they have been used; and many thought they would gradually be utilized because of the very plentiful money and low rates to which they gave rise; but we have discovered that the full potential rise has not even yet become actual.

Hence, still another side of the picture. What are the stimuli to further bank credit expansion?

Of course, you immediately expect me to turn (and I do turn) to the subject of budget deficits. Our budget deficits, as you know, have been financed only partially by selling bonds to the public, and in considerable part by selling short-term government paper to the banks; and thereby we have gotten a bank credit expansion to the extent that the banks have bought government securities.

One might raise the question as to why such financing is inflationary. As a matter of fact, it is inflation of the purest kind. We have increased the expansion of bank credit, increased the purchasing power of some one (in this case the American government) without taking away any funds from anyone else who was going to spend them for other purposes. It is pure expansion of bank credit, with the resulting increased purchasing power being turned over to the federal government —just the type of inflation that was needed before recovery started.

I was talking to a group in London in 1933, and a good many people interested in this subject were present. One of the

Board of Governors of the Bank of England expressed the wish that the British government would greatly *unbalance* its budget —if necessary, by returning all of the taxes. He had spoken to certain government officials, he said, and advocated it. Such action at that time would have been extremely intelligent in that it would have provided the sort of inflationary influence that was needed to make the machine start again; but I was tremendously surprised that one of the Board of Governors of the Bank of England should dare suggest it.

Our budget deficit has provided much of the expansion we have had to date; and it begins to look as though it might provide much too much, now that we have passed the turn, and now that the budget is again upset.

But, as to the other possible stimuli.

Some people said when the dollar was made as low as it was, foreign buying would set in. Today the greatest bargains one finds in the world are in America. Foreigners would find enormous bargains here. But that has not proved much of a stimulus because they cannot get over here with their money. There are all sorts of restrictions; tariff barriers, quota systems, and exchange restrictions of one sort and another, all prevent them from getting into our markets. In the immediate future I do not expect much more stimulus from that source than we have gotten to date, so we can leave that influence out temporarily.

We are getting, however, a degree of domestic recovery. Business is recovering. Business borrowers are coming back into the investment market; they are selling their securities. Even the short-time loan market shows prospects of recovery. So, added to the stimulus from budget deficits and resulting inflationary finance, we are getting another stimulus which is coming from business itself.

What about the controls?

I said a few minutes ago that when our monetary system was revised, controls were built up with very great care indeed. The " stabilization fund " was created to keep extra new funds (the gold profit) from going into excess reserves. It is of the utmost importance that Congress should not take that fund and spend it. If we can hold the " stabilization fund ", we have checked, to a considerable extent, the threat of inflation coming from the great gold profit which appeared when we devalued the dollar.

One of the normal means of reducing bank reserves would be to sell the "earning assets" of the Federal Reserve Banks. These are not great enough, however, to eliminate the excess reserves even if all of them could be sold. There are certain portions of the reserves that could be disposed of, but in the disposition of them, great difficulties are likely to be found, because the part that is easy to dispose of is made up of government securities, and the government is not going to welcome such competition from the Federal Reserve Banks. Therefore, it may be extremely difficult to use that particular device. Control through the discount rate is pretty limited; rates are so low and money so plentiful that the discount rate is of no use at present.

What is left?

One other control, the one which was put into the last bank act, is the power of the Board of Governors of the Federal Reserve System to raise the requirements of the member banks by a maximum of 100 per cent. I am sure the bankers present will not like the idea of having their reserve requirements raised, but it may be necessary; and to raise the reserve requirements of member banks by doubling the present reserves will give sufficient control to reduce the excess reserves to a place where they are no longer dangerous. My contention is that it *may* be necessary to raise greatly the reserve requirements, and, if it is necessary, they *should* be raised.

Now, I come to something else. What about utilizing the control forces? These are very great, and here hangs the whole problem.

With the big budget deficit, and with no prospect of its becoming much smaller immediately, Treasury financing will be very large. Treasury financing means selling government securities of some sort. I think it means increasing the sale of short-term government securities, because the buyers, as recently, will have to be the banks, to a very considerable extent. Moreover, every single control device, by its very nature, has to be a device which will reduce the member bank reserves upon which the whole credit expansion rests. To the

extent that these are reduced, the capacities of the banks to buy government securities will also be reduced, no matter what device is used.

Unless we can get our budget into control, the Treasury will have to finance, and if the Treasury has to continue long to finance on a large scale, its policy will conflict with that of the Board of Governors of our Federal Reserve Banks when the latter try to tighten money and pull in bank reserves—and I, for one, do assume that the new Board of Governors has backbone enough to apply the controls and will understand the necessity of reducing bank reserves in this way. However, I see an inevitable conflict between the policy of the Board of Governors of the Federal Reserve System and the necessary financing of the United States Treasury *unless we can get the national budget under control.*

I make a very definite answer, therefore, to the prospect of inflation. It is directly dependent upon the control of the national budget. If a balance within the next few years can be definitely provided for and clearly foreseen, the spectre of uncontrolled inflation can be dismissed. If, on the other hand, future approaches to a well-ordered and gradually balancing budget such as the one recently proposed to Congress are to receive the disrupting treatment given that one, the prospect of inflation is very grave indeed.

It was budget difficulties that produced all the post-war inflations in Europe. If we have inflation, it will be because our budget gets out of control. I think, therefore, the problem of the prospect of inflation can be reduced to those terms.

PROCEEDINGS

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TRANSPORTATION DEVELOPMENT IN THE UNITED STATES

A SERIES OF ADDRESSES AND PAPERS PRESENTED AT THE ANNUAL MEETING OF THE ACADEMY OF POLITICAL SCIENCE
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EDITED BY

JOHN A. KROUT

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PREFACE

THE railroad problem is a recurrent one. In times of business prosperity, as well as in periods of economic crisis, the adjustment of our rail facilities to meet our national transportation needs has required statesmanship of a high order. On several occasions the Academy has endeavored to focus attention on the problem in the hope that a frank discussion by representatives of various interested groups would contribute to the formulation of sound public policy. Although this issue of the PROCEEDINGS records disagreement among economists, railroad executives and financiers concerning a future program for the rehabilitation of the American transportation system, it does contain a convincing analysis of the plight of the railroads, as they emerge from the prolonged depression, and constructive proposals designed to aid them in their present competition with highways, waterways and airways—proposals which raise the insistent question of the desirablity of federal regulation of all transportation agencies.

These papers constituted the program of the Fifty-Sixth Annual Meeting of the Academy of Political Science, held at the Hotel Astor in New York City on November 12, 1936. The officers of the Academy are deeply indebted to the distinguished speakers, who participated in the three sessions, and to the efficient Committee on Program and Arrangements, the membership of which included Arthur M. Anderson (Chairman), Ethel Warner (Director), Henry Bruere, W. Randolph Burgess, Nicholas Murray Butler, Louis K. Comstock, Walter S. Gifford, Oswald W. Knauth, Thomas W. Lamont, Samuel McCune Lindsay, George McAneny, Roswell C. McCrea, Ogden L. Mills, Wesley C. Mitchell, Shepard Morgan, William Church Osborn, William L. Ransom, Jackson E. Reynolds, George Roberts, Henry S. Sturgis, Gerard Swope, Thomas J. Watson, Leo Wolman.

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PART I

RAILROADS AND THE NATIONAL ECONOMY

INTRODUCTION *

HON. WILLIAM L. RANSOM, *Presiding*
Trustee of the Academy of Political Science

IT is a privilege to call to order this notable meeting, under the auspices of one of New York's most useful institutions—The Academy of Political Science. Before I present to you the subject and the speakers, I wish to speak briefly as to the Academy.

This is a time when America has reason to take stock, to see what are its independent agencies of informed public opinion. Thus far in America we have held fast to the idea of the open forum—free public discussion and the untrammeled presentation of views. In the judgment of many, the democratic process can function and survive only through the maintenance of institutions which have public confidence and which present reliable information and reasoned views, in aid of an enlightened public opinion. In that category, we recognize, of course, the great universities and colleges, the courts, the newspapers and magazines, the radio, and the learned professions; but I think we should also place high value upon the independent public platforms, such as that of the Academy of Political Science. For more than fifty years, this Academy has made a continuing contribution to public understanding of major economic and social problems; and the need for such an independent forum was never greater than it is today.

The Academy of Political Science selects subjects and presents speakers; it does not sponsor their views and it is not the advocate of any cause; it has no function of propaganda.

* Opening the First Session of the Fifty-sixth Annual Meeting.

Its impartial programs make no representation except that the selected subject is of public importance and that the selected speakers have something to say that is worth hearing and considering, as a part of a balanced examination of the subject.

Neither the Trustees of the Academy nor its Program Committee "take sides" on any subject discussed; individually, they may and do differ profoundly, with the speakers and with each other, on many subjects. Truly, there is need and place for such an institution and such an independent forum. It deserves the membership and support of everyone who wishes to keep open and untrammeled the processes of public opinion.

Today the Academy presents for your consideration, some of the problems of America's fifth largest industry—transportation. It was recently estimated that about ten per cent of all income in the United States, received by individuals from private industries and occupations, was provided by the transportation industry. I submit to you that there are many reasons why a symposium of informed views as to the future of American railroads is most timely.

If you will permit me to make a few observations for which the Academy is in no way responsible, I remind you that the railroads were the first industry to span the continent and unite the states. They grew and developed in typical American fashion—the creation of American enterprise, courage, invention and private capital. Courage and vision surmounted many obstacles and made many mistakes; but the result has been a tremendous investment of private capital in supplying the basic facilities of transportation, on which industry, trade and life so largely depend.

More than forty years ago, the railroads became the first nation-wide industry subjected to drastic federal control. Through the years, the intervention of government in management has become ever more active and acute. Labor costs, taxes and operating expenses have been forced relentlessly upward; rates and revenues have been forced drastically downward; the ability to obtain new capital for modernization of facilities has been hampered and impaired. The railroads have been expected to compete with other means of transportation and to keep pace with the needs of their patrons and

the progress of the art, but they have been insistently denied the means of keeping pace.

The result has been and is an industry, a vital public service, which has offered few temptations to public ownership and has diminished in attractiveness to private investors. As I see it, public ownership of the railroads, transferring to government pay rolls their vast army of employees in all parts of the country, is likely to come, if at all, not through any eagerness of government to own, but because government crushes and frustrates private enterprise and private capital to such an extent that weary investors give up their burdens gladly. The public ought to consider very carefully whether it wishes the policies of government to be such as to make a continuance of private ownership of this industry impossible and thereby virtually to compel the socialization of the railroads.

At the present time, I believe that there are many signs that the dauntless spirit and adaptability inherent in American private enterprise are challenging the obstacles and are moving forward to keep for the railroads their primacy in basic transportation. Modernization of facilities and schedules commands admiration. Teamwork between labor, management, investors and government becomes highly important. The chances of success should be frankly appraised. A great deal more than the vast investments in railway properties is staked on the success of these efforts.

The Academy invites you to think today as to the future of transportation in the United States. The views which will be presented from this platform will be sharply divergent, but will merit your most careful consideration. Today's discussion will be printed promptly in an Academy volume which will be a valuable contribution to the present-day literature of the subject.

The subject for this morning's session, under our general heading of "Transportation Development in the United States", is "Railroads and the National Economy". The first speaker will discuss as part of that first subdivision "The Relation of Airways, Highways and Waterways to the Nation's Transportation System". The speaker is Professor William J. Cunningham, Professor of Transportation at Harvard University. He has had a diversified experience, both in the railroad industry and in the academic field. For many years following his technical education, he was identified with prominent and outstanding railroad enterprises of this country. Since 1916 he has been Hill Professor of Transportation at Harvard University. At one time, from 1918 to 1919, he was Assistant Director of Operations of the United States Railroad Administration.

From that background he will discuss the subject "The Relation of Airways, Highways and Waterways to the Nation's Transportation System". Professor Cunningham! (Applause)

THE RELATION OF AIRWAYS, HIGHWAYS AND WATERWAYS TO THE NATION'S TRANSPORTATION SYSTEM

WILLIAM J. CUNNINGHAM
Professor of Transportation, Graduate School of Business Administration, Harvard University

ONE of my friends who saw the program of this morning's session suggested that the title of my address should be abbreviated to "Wings, Wheels and Waterways". Such a title, instead of the longer one, would, perhaps, be more in keeping with the length of the allotted time. It is obviously impossible in twenty minutes to deal with the subject in comprehensive fashion. I must, therefore, confine my attention to a very few of the more important aspects. If I disappoint some of my audience who expect me to deal specifically with airways, highways or waterways, I am sorry.

In the main, my thesis is that the post-war developments in transportation facilities, so extensive in degree and so revolutionary in nature, have provided a *transportation system with a capacity far beyond the national demand for transportation service.* The nation is enjoying the benefits of service much better than ever before in expedition, flexibility, convenience, safety, dependability and charges, but because in this post-war period each agency has been developed independently, with little or no thought to a wise policy of coördination or correlation, we are now confronted with a major problem in deciding what to do about our substantial surplus in transportation capacity.

In the introductory section of his second general report, of March 1934, as Federal Coördinator of Transportation, Mr. Eastman drew attention to a striking fact. In 1920, when railroads still had a virtual monopoly of inland transportation, the investment in their roadway and equipment was approximately 19 billion dollars. Between that year and 1932 the railroad investment was increased 6⅓ billion; the pipe lines added to their investment the sum of 424 million; the capital outlays on public highways and streets totaled 12½ billion; and the appropriations by the federal government for improvement of rivers and harbors aggregated 604 million. Allowing for the abandonment of many electric railways, the net additions to the total investment in transportation facilities in the twelve years were $19,100,000, a sum equal to the cumulative investment in railroads during their first ninety years of development. Making allowances for facilities used in purely local transportation, or which are otherwise not competitive with established agencies of transportation, Mr. Eastman gives as a conservative estimate that the capital outlay in additional transportation facilities from 1920 to 1932 was substantially 25 billion dollars. This estimate does not include governmental expenditures in aid of air transportation —beacons, radio beams and meteorological service; nor the added investment of public utilities in high power transmission lines, which supply power formerly furnished by rail-transported fuel; nor the very large investments in commercial motor vehicles, inland watercraft and aircraft, and their terminal and maintenance facilities.

The greater part of the additional investments in railroad facilities was made between 1920 and 1930. Since then railroad capital expenditures have not been substantial. The depression, however, did not materially retard the capital extension of competing forms of transportation. Indeed, the policies of the government, both federal and state, in spending public money to furnish employment, have resulted in abnormal activity in highway and waterway improvements.

There are several reasons for the spectacular enlargement of the investment in transportation facilities. As for the railroads, they had been found wanting in 1917 when overwhelmed with war traffic and again in 1920 were embarrassed when a post-war boom caused serious congestion and embargoes. Their shortcomings were due in large part to inability, because of inadequate net income, from 1910 to 1915, to keep up the former rate of additions and betterments. When the railroads were returned to private operation, after the period of war-time, federal operation, the Transportation Act of 1920 promised them a fair return on the value of their properties. There was

then a twofold stimulus for embarking upon the comprehensive program of capital expenditures—first, it would increase their traffic-carrying capacity and enable them to handle expeditiously a large volume of traffic with greater satisfaction to the public, and, second, the new capital would increase the base upon which the promised return would be earned. Although the promise to the railroads of the 1920 law proved to be a mirage, the substantial amounts of new capital devoted to additions and betterments brought fairly satisfactory returns up to 1929 in reducing unit costs of operation and in greatly improving public service. The record-breaking volume of traffic in 1929 could not have been handled without congestion or delay, if those capital expenditures had not been made.

As the railroads stand today, however, their freight traffic is about one-third less than it was in 1929, and in passenger traffic the loss is more than 50 per cent. So far as physical facilities are concerned there is a large amount of unused capacity, representing an investment upon which no return can be earned until the volume of traffic is substantially increased.

The increase in the investment in facilities devoted to highway transportation is incidental to the development and rapid growth in that form of transportation since 1920. The same observation applies to the renaissance in inland waterways. In both cases, and in smaller degree in commercial transportation by air, public policy generally has encouraged the development of competitors which would act as a check on railroad rates and as a stimulus to improvement in railroad service. Likewise, the improvements in the design and operation of pipe lines and the demonstration of their low operating costs, in addition to their suitability for gasoline as well as oil, have justified capital expenditures on a large scale for the existing far-flung system. *Yet, as in the case of railroads, there is a substantial amount of unused capacity in all of these agencies competitive with railroads—greatest in the case of inland waterways and least in the field of commercial highway transportation.*

This national problem of overexpansion of transportation facilities, with the resultant economic loss in unproductive capital, might not confront us if the long-time trend in the annual growth in ton-miles and passenger-miles had not been interrupted by factors not allowed for in the plans of the railroads and other transportation agencies between 1920 and 1930, and if the depression from which we are now emerging had not had such an unprecedented effect in reducing transportation demand. The possibilities not adequately considered when the railroads in 1923 inaugurated their comprehensive plan for additions and betterments were at least five in number. The first is that there are relatively few territories requiring the construction of new railroads. Railroad mileage has been static since 1913. They, therefore, may not count on traffic from newly developed regions. The second is that the rate of increase in population has recently been much less than in earlier periods when there were few restrictions on immigration. The third is that the volume of export and import traffic has been seriously diminished. The fourth is that the remarkable improvements in technological processes have brought large economies in the use of fuel and in the utilization of by-products, so that a smaller amount of raw material is now needed for each unit of finished product. And the fifth is that there has been a widespread movement in relocating factories and warehouses in closer proximity to raw materials and markets, thereby reducing the distances over which commodities must be moved.

One other factor, unpredictable in 1923, has an exceedingly important bearing. The investments we have been considering are those in commercial transportation agencies—common and contract carriers who transport for hire. Threatening these carriers is the growing tendency of large industries to provide their own transportation and to use for their private purposes in their own vehicles the improved public highways and waterways. So long as the commercial carrier can perform transportation service at rates which are less than the cost to a manufacturer of using his own trucks or boats, there is no incentive for him to do his own transporting of raw materials or finished product, but when the rate charged by carriers is higher than that cost, or the service is inferior to private transportation, the manufacturer with capital to invest in trucks or boats will avail himself of the opportunity to reduce his production and distribution costs. The manufacturer, moreover, has an advantage over the common and contract carrier in that

he is not subject to the same degree of governmental regulation and escapes certain obligations which add to the cost of the "for hire" operator.

The present situation, then, is one in which we have a serious national problem in the *substantial and disturbing oversupply of commercial transportation capacity*. There is not now, and for a period of unpredictable length there is not likely to be, enough commercial traffic to maintain the solvency of all commercial carriers. The seriousness of the situation may diminish in degree as business activity increases, but against that possibility there is likelihood that the government will continue to pour large sums annually into highway, waterway and airway facilities, and that the carriers by highway, water, air and pipe line will add to their equipment and extend their services. The surplus in capacity, therefore, is likely to keep pace with the growth in transportation demand. The solution calls for wisdom and foresight, not merely from the individual viewpoint of each of the agencies affected, but also from the broad viewpoint of public interest in preserving and strengthening that which is economically sound and minimizing the pains of capital losses in the process of readjustment. Such losses, although borne in the first instances by the agencies which are weakest when tested by principles of economic soundness, are eventually assessed, in one form or another, on the public at large. The success of the ultimate solution depends in part also on fairness in treatment and due regard for the fact that there now exist important differences in the degree of public regulation and public aid.

Omitting from consideration electric railways, city bus lines, taxicabs, local trucking organizations and power transmission lines, there are five forms of inter-city transportation—railroads, motor carriers, water carriers, pipe lines and air carriers. Two of these forms—railroads and pipe lines—are financed entirely by private capital and receive no governmental subsidy, unless the land grants and other aids to the few in the early days of railroad development are considered as continuing subsidies. The other three—motor, water and air transportation—are in large part financed by, and receive continuing subsidy from, the government. The extent of subsidy in the case of water and air carriers is fairly definitely known and is substantial, especially in water transportation. In the case of motor transportation the extent of the subsidy cannot, in the light of the data now available, be stated definitely, but it is an important factor in competitive relationships with other forms of transportation. The railroads and pipe lines operate on and maintain their own rights-of-way and terminals. The commercial motor vehicles operate on highways provided, maintained and policed by the public, and to some extent use the public streets as their terminals. The water carriers operate on waterways, most of which have been improved for navigation at heavy cost to the government and are being maintained, with navigation aids, at public expense. To a large extent the water carriers, furthermore, have the use of municipal water terminals at nominal cost. The airplanes, in the use of the free airways, are guided by beacons, radio beams and radio weather service at public expense, have the use of municipal airports, and receive subsidies in the rates paid for the transportation of mail.

In one respect all five forms are similar in that each finances, maintains and operates its own equipment — locomotives and cars on railroads, trucks and busses on highways, steamboats, tugs and barges on waterways, and airplanes in the air. In practically all other respects there are substantial inequalities —in costs or charges for use and maintenance of rights-of-way and terminals, in taxation, and in the extent of public regulation. As between the five agencies the degree of inequality differs widely.

When the reports of the Federal Coördinator of Transportation on subsidies and other forms of public aid to railroad, motor, water and airplane carriers are finally published, we will know much more than we now know about the extent of such subsidies and their relation to comparative transportation costs by each agency. Until we have available the exhaustive data, analyses and conclusions of Mr. Eastman and his competent and unbiased assistants, we will be without an authoritative basis for determining for highway, water and air transportation the extent to which the so-called "hidden costs", assumed by the government, should be added to the incomplete costs which are charged to shippers and travelers by subsidized carriers competitive with rail. Without such

subsidies it is apparent that the remarkable growth in transportation by highway, water and air during the past sixteen years since 1920 would not have occurred. In the present state of transportation surplus, with a pressing necessity for a careful and comprehensive survey of each agency, with a view to the adoption of the wise public policy toward each agency, *it is vitally important that the true cost, including expenditures by the public as well as by the carriers, should be known, so that we will have a true basis for determining the economic sphere for each.* When that sphere has been found, the wise course for further encouragement or limitation will be clear.

Even without complete data relating to subsidies certain conclusions seem to be clear. We know that each form of transportation excels all others in certain respects. The railroads have no peer in the mass transportation of heavy commodities relatively long distances, and in the present state of air transportation the railroads can produce long-distance passenger-miles much more economically and safely than the air carriers. We know that the motor truck is much more flexible, speedier and cheaper, even with an allowance for possible subsidy, than any other form of transportation for the movement of merchandise relatively short distances. The motor coach, too, has its advantages in the passenger field, where distances are relatively short and service is much more flexible and convenient than by rail. The airplane excels the railroad in speed for long-distance trips and the rates, aided by governmental subsidy, are now not much more than those charged by railroads in Pullman cars on limited trains. Water transportation is inherently cheap on the natural waterways and is especially suitable for the port-to-port movement of low-grade commodities in bulk. But when the service by truck and bus is extended into the long-distance fields, their advantages vary inversely with distance, and under present conditions they are performing service that the railroads could furnish more economically on the basis of true cost. With respect to water transportation, notably on the canalized rivers, there is sound basis for the statement that a large part of the tonnage now moving on the improved inland waterways could be moved by rail more expeditiously and at lower true cost, if the shipper were called upon to pay the hidden as well as the direct costs. And in the case of the airplane, which caters to those who respond to the time-saving appeal and are willing to pay a premium for speed, it is doubtful if the air carriers could afford to carry passengers at existing rates if the subsidies for the carriage of air mails were withdrawn and the air lines as a whole were called upon to pay for the free service they now enjoy in lighted airways, radio beams and radio weather reports.

In the Transportation Act of 1920 the friends of water transportation prevailed upon Congress to enact section 500 which is a declaration of the policy of Congress "to promote, encourage and develop water transportation, service and facilities . . . and to foster and preserve in full vigor both rail and water transportation." The same principle was embodied in the Motor Carrier Act of 1935 but in different language. Section 202 is a declaration of policy by Congress "to regulate transportation by motor carriers in such manner as to recognize and preserve the inherent advantages of, and foster sound economic conditions in, such transportation and among such carriers in the public interest. . . ." In this case nothing is said about "fostering sound economic conditions" in railroad transportation or about "the inherent advantages" of railroads. It goes without saying, however, that the Interstate Commerce Commission, now charged with the triple duty of fostering railroads, certain waterways and interstate motor carriers, with the possibility that its fostering responsibility will sometime be extended to cover coastwise and all inland waterways as well as airways, cannot place its fostering arms about any one form of transportation without considering "the inherent advantages" of all other forms.

In his second general report (1934) as Federal Coördinator of Transportation, Mr. Eastman summarized the objective of a sound policy. He said:

> It is clear that no regulations or restrictions should be imposed on any form of transportation merely for the purpose of benefiting some other form of transportation. The test must be the public interest. On the other hand, whatever the public interest may require ought to be done no matter how it may affect private interests. These are principles which no one is likely to gainsay. Yet they need emphasis, because

> private interests are vitally involved. Much of the demand for regulation and restriction of the other transportation agencies has come from the railroads, for their own protection. Equally selfish interests are uppermost in the opposition. The controversy has been largely between private interests, but it is the public interest which must be paramount and controlling.
>
> In the final analysis the public interest requires a national transportation system so administered and controlled that service can be furnished at the lowest possible charges consistent with adequate maintenance and ability to provide the modern facilities and the character of service which the best interests of commerce and industry demand.

With this admirable summary I am in hearty accord but I would like it even more if it were definite in defining "lowest possible charges" as those which are based on total costs, including costs borne by the government.

The need of a central coördinating agency is so obvious as to require no extended argument, but there may be difference in opinion as to the form, scope and authority of such an agency. Time does not here permit me to discuss the alternatives or to support with reasons my own opinion that *the Interstate Commerce Commission, now authorized to regulate railroads, pipe lines and interstate motor carriers, with some degree of regulatory power over waterways and air-mail compensation, should have the same degree of control over each of the newer forms of transportation as it now has over railroads.* We would then have a tribunal which could deliberately establish a national policy under which each form of transportation could be fostered and protected in the fields in which it has economic superiority; the public would have the advantage of a coördinated system in which each agency would serve in the field in which it can best serve; wasteful duplication would be avoided; the true inclusive cost could be reduced; and the quality of service, because of elimination of needless waste, could be bettered.

REMARKS BY THE CHAIRMAN

HON. WILLIAM L. RANSOM: In behalf of the Academy I thank you, Professor Cunningham, for this clear and comprehensive survey of the transportation situation, with which this conference is most appropriately opened.

In considering the railroads and the national economy, we note the changing position of the railroads, and it may be desirable to have that stated in an authoritative way, as the subject is viewed by the railroads themselves. The next speaker, who will discuss that subject, began his career in the railroad industry in humble capacity in 1898, following his graduation from Yale University. He came up through the various positions of the operating end of the railroad industry. Since 1932 he has been the President of the New York Central Railroad Company. We are privileged to have as our next speaker, Mr. Frederick E. Williamson, the President of the New York Central Railroad, who will present "The Changing Position of the Railroads". Mr. Williamson! (Applause)

THE CHANGING POSITION OF THE RAILROADS

FREDERICK E. WILLIAMSON
President, New York Central Railroad Company

I

AT this time when change and uncertainty in the political and economic situation are so marked, and the future as measured by the old standards so uncertain, it seems particularly fitting that this organization should give some thought to the changing position of the railroads, which is the subject assigned to me for comment.

Experience has shown that the only permanent thing about business is change. Things do not stay put. The problems met today rise in a new form tomorrow. These changes that occur in any industry, including the railroads, are of two kinds and may be called short-time changes and long-time changes.

What I have called short-time changes include the ups and downs of business that last only for a relatively brief period. They appear in the form of the temporary changes in traffic and are due to such things as short crops, more or less extensive disasters of drought, of flood or storm—that is, acts of God, as they are called. There are also periods of boom and periods of depression in business.

The years 1929 to 1936, so tumultuously changeful for all of us, show the full range of effect upon the railroads. In the former year, the Class I railroads of this country originated about 115,300,000 tons of freight; in 1935 they originated 76,300,000 tons. Their ton-miles in the former year amounted to about 447.3 billions; in 1935 they were 282 billions. Gross revenues in 1929 were 6.3 billions and 3.4 billions in 1935. Net railway operating income in 1929 was $1,375,000,000 and reached a low of $447,000,000 in 1932. Return on investment in 1929 was 4.84 per cent and the low was 1.25 per cent in 1932.

Behind these dull figures lies the dark and dramatic story of the business depression, unemployment, drought and flood. The railroads faithfully reflect them all in their accounts.

During the one hundred years or more of railroad development there have been accumulated knowledge and experience that have been capitalized from time to time in all sorts of improved methods of operation. Today the rail carriers are engaged in extensive research studies to find further improvements and further to modernize the railroad plant. These are all long-time changes, for it is to be remembered that the units of railroad equipment are relatively expensive and their service life extends over many years. The problem of management is to know when it is economical to place a unit of equipment on the scrap heap that still has a number of service years in it.

It is interesting to note that the New York Central System has retired during the five-year period beginning with the year 1932, 1,600 locomotives, 65,459 freight cars and 672 passenger cars, where a careful study indicated that through either obsolesence or wear it was not economical to continue the equipment in service.

I have referred to long-range changes within the railroad plant itself. There have been changes from the outside — changes in public demand for transportation service. For example, there has been a demand for increased speed for both passengers and freight and the railroads have endeavored to meet this demand. Producers, wholesalers and retailers have quite generally adopted the principle of hand-to-mouth buying, resulting in the purchasing of smaller units by the distributive agencies to reduce their inventories and to increase the turnover of their goods. The rail carriers have sought to meet these demands. There has also been a tendency to relocate industry nearer to the source of supply of raw materials or consumption. The result has been a reduced demand for transportation. The railroads have had to face this change also. There has been the use of electric power instead of steam power or natural gas, with a consequent reduction in demand for coal. This change has had a serious effect upon the tonnage of rail carriers.

II

The most outstanding change in recent years has been the rise of new competitors. Whereas a few years ago transportation was almost universally considered as railroad transportation, today the railroads are only one of five great

transportation agencies. Highways, waterways, pipe lines and airways have developed. There is no longer a so-called monopoly in railroad transportation. The railroads must share the traffic of this country with other agencies. The effect of such a change in the position of the railroads is to create an entire series of new problems.

It should be noted that all of these new agencies of transportation have developed independently and almost wholly without consideration for the capacity and service of existing transportation facilities. We have largely kept each agency in an air-tight compartment of its own.

These five great agencies have been dealt with differently. From the period when railroads were the dominating and almost sole agency of transportation, there have come the restrictions and the burdens of regulation which remain in this period of changed conditions. Transportation by pipe line has very largely been left free to develop in response to a demand for specialized service on a basis of private management. Highways, waterways and airways have each been unrestricted, and largely unregulated, and each has had a government agency for its promotion.

The development of waterways has not been on a business basis but on the basis of politics. Congressmen have sought waterway projects for their districts, not for economic but for political purposes. The government agency through which waterways are promoted is the Corps of Engineers, United States Army. In seeking economic justification for waterway projects, they have felt, and have so stated publicly on numerous occasions, that their consideration should be focused solely upon an individual project and in disregard of all other agencies of transport. If they find that sufficient traffic can be diverted from existing agencies to a waterway, improved out of tax funds, to justify the project, it is open for recommendation.

In the U. S. Department of Agriculture there was established in 1893 the Office of Public Roads Inquiries. From the beginning it was a promotional agency and as originally created was intended to promote the improvement of the common road from the farm to the nearby market. It has continued since that time, and in recent years, as the Bureau of Public Roads, has grown in power and authority and has been the agency through which billions of dollars have been expended for the improvement of highways that duplicate and parallel main railroad trunk lines. The original intent of improving the farm-to-market road has been wholly obscured by the activities concentrated upon the main state highways. This movement has gone on without consideration for the capacity and the service of existing transportation facilities.

The promoting agencies for airways have been the Bureau of Aeronautics in the Department of Commerce, the Weather Bureau in the same Department and the Post Office Department with its mail subsidy. Commercial aviation has been promoted by these government agencies primarily for the purpose of having available, in time of war, plants for manufacturing airplanes of latest design, a large number of airplanes for active service and a trained personnel of pilots. Clearly, the promotion of a transport agency of this kind has not taken into consideration the effect upon existing transportation facilities.

One clearly-defined result of these uncoördinated activities is obvious today. As Professor Cunningham has pointed out, there is a surplus of transportation facilities. The greatest surplus is found along the lines of greatest traffic. Every agency has sought to share as much as possible in the traffic moving by other agencies. When a railroad has sought to abandon a branch line, communities have objected on the ground that loss of the rail line would leave them without adequate transportation facilities. In many cases, however, attempts to abandon such lines have resulted from the fact that a large amount of traffic has been diverted to a new agency which has been developed without any consideration of the effect upon a particular branch rail line.

Under the law railroads cannot abandon or extend their facilities and service without a certificate of public convenience and necessity from the Interstate Commerce Commission. Now it seems a sensible position to take that no great fixed investment in a roadway of a transportation agency should be made unless it is to be utilized. Therefore, it would follow that before large sums of public funds are invested in improved waterways or in the improvement of highways for commercial purposes, or in the extension of landing fields and lighted airways, consideration should be given to the effects of such agencies upon essential, existing transportation facilities. There is no requirement today for such a consideration.

III

This long-range change in the position of the railroads from the sole important transportation agency in the country to one among five has brought to the front another problem. The public apparently desires that there shall be some sort of smoothly-working relationship between all of these transport facilities, wherein each agency will get its just deserts, each will develop just so far as it should develop, the old will give place to the superior new, and there will be a continuous improvement in service at a continuously lower cost. All of these various ideas are bound together and expressed in one word " coördination ".

This vague and luminous phrase needs some consideration. It seems apparent that coördination is different from competition. Competition is necessarily a duplication of facilities. Coördination ought to be a working together for a common end. When railroads were attached end to end to make our great systems of today, they were coördinated. There was a common purpose so that operating practices, time schedules, rate adjustments, financial support and solicitation of business were all directed to the common end of making the system as a whole prosperous.

The public, however, seems to want competition retained. They fear monopoly. Competition may lead to an over-development of facilities. Coördination, if carried on without restraint, may lead to monopoly. So we may say that the public wants competition, wants coördination, does not want monopoly. This is a part of the changing position of the railroads.

Even under enforced competition with one another, the railroads have made some progress in coördination. Unproductive branch lines have been eliminated. More than 20,000 local stations have been closed due to the fact that the motor vehicle has a wider range of operation than the older agency, the horse-drawn wagon and truck. A package of freight may be loaded at any obscure station in the country for delivery to any other obscure station on the continent and, by exchange of traffic and cars, it will be carried to its destination. Twenty-five thousand miles of line are used jointly by more than one railroad. There are also thousands of joint freight and passenger terminals, shops and bridges and the like. There are those who are impatient about the rate of progress which the railroads are making in this coöperative effort but, generally, they are persons who do not have the responsibility of protecting the rights of the owners of individual properties.

There remains much to be done in this whole field of coordination. The problem is one which has arisen because of the changing position of the railroads but it must be clear that the changing position of the railroads calls for a change in public attitude to correspond to it.

The first requirement in a new public attitude is that there should be a comprehensive consideration of all transportation agencies. Each, it is said, has its own inherent advantages and each has its field in which it may operate most acceptably. These matters cannot be settled by focusing attention on a single agency. There must some time come an effort to evaluate the relative usefulness of agencies to meet the full public demand for transportation service.

A second requirement in this new public attitude is for consistent treatment of all agencies, at least so far as the government is concerned. There is today no consistency in treatment of these competing agencies. The future, however, is more hopeful. In 1935 Congress passed the Motor Carrier Act regulating highway operations. The reports of the Congressional Committee recommending this bill stated that it was a part of a general comprehensive program of regulation which would include all agencies of transportation and place them on an equality in this respect. This is a change in public attitude consistent with the change in the position of the railroads.

I have said that, as I see it, the object sought in the transportation field is to secure a smoothly-working relationship between all of these agencies. Is it not clear, however, that such an object can be attained only if there is coördination in facilities, in service and in regulation with respect to all of them? I have indicated the duplication of facilities. Service follows these facilities. Therefore, coördination in transportation can be had only on condition that we coördinate our attitude, our treatment and our development of these agencies. This coördination requires the application of the same economic

principles to each. It means that each shall stand upon its own economic basis, paying all costs, meeting all requirements and facing all tests of usefulness.

A subject much discussed in the recent past is that of passenger service and fares. Since June 1, when passenger fares were reduced, the discussions have become somewhat intensified, and some doubtful conclusions have found their way into print. It is true that there has been an increase in the volume of passenger travel on the railroads over the corresponding months of last year, and it is true also that, generally speaking, passenger revenues have been somewhat in excess of those revenues for the corresponding months of last year. I have no disposition to minimize the contribution of the rate reduction to this increase in passenger business. In all fairness, however, we should not overlook other contributing causes. In recent years the railroads have spent much, and done much, to make passenger travel on the rails more comfortable and more attractive. Train schedules have been speeded up; newer types of equipment have been put in operation; and air-conditioning has been provided, not only in large numbers of Pullman cars, but, as well, in coaches on many of the through trains. These improvements, although retarded in recent years by economic conditions, represent millions of dollars in the way of capital expenditures. Hand in hand with this improvement in the service has come a general pick-up in the business of the country and passenger travel has reacted, now as in the past, to the fluctuations in the country's prosperity. Lest we lose our sense of proportion, it is well to bear in mind the extent of this so-called pick-up in passenger revenue. On the New York Central, our passenger revenues for the month of September 1936 are still 51 per cent below those for the month of September 1929, although our freight revenues for September 1936 are but 36 per cent below those for September 1929. Our current passenger revenue is running at about the level of the spring of 1932, and we all know that we then thought business was pretty poor. The point is that railroad passenger business is not primarily, certainly not exclusively, determined by the rate of fare. True it is that the price is an element, but so also are the character of the equipment, the quality and comfort of the service, the speed of the trains, and the prosperity of the country. The railroads need a prosperous country, but also, and perhaps more so, a prosperous country needs the railroads.

IV

There is another element in the changing position of the railroads which should not be overlooked in any candid survey of the situation. I refer to so-called railroad labor questions. As is well known, the railroad brotherhoods are among the most efficient, active and articulate of any in the country. These organizations have in many ways, and over a wide front, served their membership faithfully and well. They have grown from small beginnings and against much in the way of odds, until now they have become powerful, politically as well as economically; and with this great power there has also come, in many respects, an insistence upon demands that are impracticable in operation and impossible in cost. Nowhere are the railroads subjected to more discriminatory regulation than in their labor relations. A multitude of regulatory measures are applied to them that are not applied to their competitors. An example of this is to be found in the pension legislation. It is not necessary that we consider the merits or demerits of old-age security legislation. It would seem fundamentally sound that whatever is set up in the way of old-age security for the great bulk of American wage earners should be applied also to the railroad industry; yet, we find on the statute books railroad pension legislation more burdensome in cost and more generous in provision for railroad workers than is the case under the general social security statute. I have never heard any argument in justification of this exceptional governmental consideration for railroad men. There is, of course, no social or economic reason for a preferential old-age scheme for railroad workers superior to that for other American citizens who also work and who also grow old. In the utmost candor, we must all accept, as the undoubted explanation, the greater efficiency and articulation of the railroad brotherhoods. Then, also, there are many proposals grounded not on economic propriety, but rather predicated on the desire to create more jobs. Among these are the train limit bills, bills requiring additional employees on trains and bills providing for the six-hour day on the railroads.

It seems to me no more than fair that we should ask, in the case of all so-called labor legislation not reasonably required in the interest of safety or efficiency, that there should be only such as is applicable generally to all wage earners, to the end that there may be no preferred class enjoying, at the hands of the law, bounties, privileges or advantages that are not equally applicable to all others similarly situated.

I have developed at some length the theme of the changing position of the railroads. Before closing, however, I want to make mention, not of the variables but of the constant element in the transportation situation. Through all the vicissitudes which the railroads have been forced to meet, the ups and downs of business, the disasters of drought and storm and flood, the imposition of restrictive regulatory measures, the competition of new agencies subsidized by government, railroad service has been demonstrated to be essential for the economic welfare of the country.

Let us fully recognize the value and usefulness of other forms of transportation. No one of these other forms of transportation, nor all of them together, can meet the demands of the commerce of this great continent. With the flexibility of the individually loaded car and the economy of mass transportation in trains, there is nothing to match the railroads that is yet in sight. It is our firm and constant belief, therefore, that the railroads will continue to be the essential transportation facility to meet the public demand throughout the land.

We in the railroad field hold the unanimous, steadfast belief that our industry is a solid, virile and an absolutely necessary one. We believe that ways will be found in the future, as in the past, to meet all changing conditions, economic or otherwise. We shall constantly continue our efforts to reduce expenses and increase our earnings. It may be that the railroads will never again hold the dominating position in the field of transportation that they once had. Nevertheless, under reasonable and average general economic and business conditions, well-managed and well-located railroad systems will continue to render safe, sure, satisfactory service to the public. They will make some return on the money invested by those who have reposed their trust in them. They will continue to be the essential backbone of the country's commerce through the coming years.

REMARKS BY THE CHAIRMAN

Hon. William L. Ransom: I am sure you will agree with me that the members of the Academy are indebted to Mr. Williamson for this keen analysis and forward-looking presentation of the position of the railroads in the national economy.

We turn now to the labor aspects of the railroad picture. It has been increasingly recognized that in a modern economy a first charge upon the revenues of industry must be the maintenance, in reasonable comfort and safety and health, of those who by hand or brain produce the service or the commodity which is supplied. The practical aspects of this just principle give rise to many grievous problems. Mr. Williamson has indicated the employer point of view with respect to some of them. The speaker whom we shall hear from concerning "Labor Relations in the Railroad Industry" is a New Yorker who was born in this city fewer than forty years ago. He achieved success at the bar but turned aside to the teaching of law. He served with distinction in professional capacities and as Chairman of the National Labor Relations Board, and returned by his own choice to his profession and work as Dean of the great Law School of the University of Wisconsin at Madison. He is a speaker who has, I believe, the confidence of American liberals and of American labor, and we are honored in the presence here of Dean Lloyd K. Garrison, of the Law School of the University of Wisconsin, who will speak on "Labor Relations in the Railroad Industry". Dean Garrison! (Applause)

LABOR RELATIONS IN THE RAILROAD INDUSTRY

LLOYD K. GARRISON
Dean of the University of Wisconsin Law School

LABOR relations in the railroad industry are determined by a complex of many factors: the experience of employees and managements who have lived together and dealt together for over sixty years; the craft structure and seniority principles of the twenty-one standard unions; the customs and practices of the industry; the character, intelligence and length of service of the employees; the calculations and policies of management and the hopes, fears and memories of the men; the pressure of new competition; the demands of shippers and security holders; and finally the nature of the laws and institutions set up to keep the peace and to promote justice. Of all these factors except the last, time will permit me to say little or nothing. Therefore my observations will have a certain distortion of emphasis, for which I hope you will make allowances. I shall speak primarily of laws and institutions simply because my experience has been in those fields.

The law of labor relations in the railroad industry is the most comprehensive and the oldest in the country. In its present form it derives from the 1934 amendments to the Railway Labor Act of 1926. These amendments are rooted in history. To understand them one must know their background. I shall try to trace that background, but I can do so only in the most summary fashion.

Prior to the World War only the train and engine service employees were strongly organized. Their four brotherhoods were generally recognized by the carriers, and contracts with these brotherhoods were in effect on most of the roads. The other crafts were for the most part weakly organized and, for the most part, not recognized. During the war period of governmental control and of active collaboration between the government and the unions, these other crafts built up their memberships to a point approaching that of the four brotherhoods, and entered into agreements with the government covering wages and working conditions. These agreements were abrogated after the return of the roads to private management, and, following the outlaw switchmen's strikes of 1920 and the disastrous shopmen's strike of 1922—the only nation-wide strike in our railroad history—the unions other than the four brotherhoods lost most of the ground they had won during the war.

The policy of nonrecognition was, rather widely, returned to; many of the carriers set up "system associations" or company unions designed to wean and keep the men from the standard unions; and some of the roads also exacted so-called "yellow-dog" contracts from their men, under which the latter contracted, as a condition of their employment, to refrain from joining labor organizations. These tactics were continued by certain carriers down to 1934, despite the improved relations between management and labor which set in after the shopmen's strike and which were typified by the cooperative plan worked out on the Baltimore & Ohio, and by the liberal labor policies of some of the other roads.

The amendments of 1934 defined more exactly than before the obligation of management to refrain from interfering with labor's choice of representatives. The amended law specified that these representatives included labor unions—a point which had been previously disputed by certain carriers; prohibited carriers from lending financial support to company unions, or inducing employees to join or remain in such unions; outlawed "yellow-dog" contracts; and attached criminal penalties to the violation of these provisions. The law also gave to the new National Mediation Board, which it set up, not only the traditional functions of mediation—functions which its predecessors had exercised since 1898—but also the duty of ascertaining the choice of representatives by employees in cases where such choice was disputed. The choice was to be ascertained by taking a secret ballot or by other appropriate methods. Previously many carriers had refused to deal with unions—excepting the four brotherhoods—for want of evidence satisfactory to the carriers that these unions actually represented the men. In some cases also the carriers were bedeviled by rival organizations, each claiming jurisdiction over a certain

class of employees and each claiming the right to deal with management. Now by the device of a secret election under government auspices these disputes could be cleared up.

In the first year of its existence (1934-35) the new Mediation Board (a three-man impartial body) determined the choice of representatives in 96 cases. Eighteen of these were jurisdictional quarrels; 45 involved a choice between a company union and a standard union, the latter winning in 86 per cent of the cases. Unless all signs fail, the company unions, of which there are still a considerable number, are on the way out. Experience has shown, here and elswhere, that in most cases the employees will select a bona fide labor union in preference to a company union whenever they have a free choice. The law now assures them a free choice—as it should, for satisfactory relationships cannot be built upon any other basis.

The Mediation Board has been active in other disputes, growing out of desired changes in wages or working conditions. During the year 1934-35 it mediated in 70 cases, 24 of which terminated in written agreements of settlement. Including the representation cases just described, the Board in its first year acted in 166 disputes involving over 100,000 employees on 117 different railroads. All of these disputes terminated without open conflict. The figures for the past year, not yet published, will probably show an even greater activity. The Board is performing a useful function with great ability and success. When it fails in mediation, as of course it often does, the law provides a method of voluntary arbitration. If the parties cannot be induced to arbitrate, the matter is dropped unless a serious interruption of commerce is threatened, in which event the President may appoint an emergency board to investigate and report. During its investigation and for thirty days after its report the *status quo* must be maintained. After that nature may take its course. These provisions for mediation, arbitration and investigation, particularly the first two, are based upon a long experience and a long legislative history. They are sound and have proved their worth.

They relate, however, only to conflicts which are not justiciable in nature—demands for an increase or reduction of wages, changes in rules and so on. These conflicts generally end in compromise. But there are other conflicts which are justiciable in nature—disputes about the meaning of particular clauses in written agreements. These disputes call for judicial interpretation and decisions, not conciliation and compromise. Now experience has shown that you cannot successfully combine judicial and mediatory functions in one body. We tried it with the United States Railroad Labor Board, set up after the war, and the result was a memorable failure. Congress, therefore, in creating the new Mediation Board, gave it no judicial functions. These were assigned to another new agency, the National Railroad Adjustment Board.

The Adjustment Board interprets and applies written contracts between carriers and unions, handing down decisions which are reviewable and enforcible in the federal courts. It does nothing else. It sits in Chicago and consists of 36 members, 18 selected by the standard unions and 18 by the carriers. The board is divided into four bipartisan divisions, constituting in substance four separate boards. The first division adjudicates disputes involving train, engine and yard service employees. This is the busiest division of all, and its cases generally involve the most money and have the most far-reaching effects. The third division is the next busiest: it deals with a number of crafts of which the clerks, telegraphers, station employees and signalmen have had the most cases. Both of these divisions are constantly in session throughout the year. The other divisions, particularly the fourth, have relatively little to do and meet only from time to time.

The law provides that when a division deadlocks, it shall call in a referee to sit with it and make the award. If it cannot agree on a referee (and it almost never can) the National Mediation Board in Washington appoints the referee. Thus every case ultimately gets decided.

One may ask, is it necessary to maintain such elaborate machinery for the interpretation of agreements? The answer is yes, and, as I shall attempt to show, the machinery is not quite elaborate enough. There are in existence on the 859 carriers covered by the Railway Labor Act over 3,000 separate agreements with labor organizations, of which over 2,300 are on the Class I railroads. Each of these agreements consists of many clauses and thousands of words, defining, in language

not always clear, jobs, duties, hours, overtime, seniority rights, discipline procedure, leaves, vacations, wage rates and so forth. Disputes are constantly arising: what does this particular clause mean as applied to this particular set of facts? Or, if the meaning is clear, what are the facts which give rise to this particular claim? Sometimes both the meaning and the facts are in dispute. There may be precedents but they too are often in dispute.

Some one has got to decide these disputes, after they have been handled all the way up to the top of the carrier-union hierarchies and no agreement has been reached. They cannot be left to fester. There are too many of them and the stakes are too great. Law courts are not the answer. There must be tribunals specially adapted to the requirements of the industry, and able to work swiftly, simply and expertly. I think everyone will agree to that. But there is disagreement as to the kind of tribunal which the situation calls for.

The unions, after the junking of the United States Railroad Labor Board in 1926, sought the establishment of national tribunals patterned upon the boards set up during the war period. The carriers refused, preferring local boards, if any. The law left the matter to mutual agreement. As a result no national boards were set up. In their stead were created some three hundred regional and single-system boards—chiefly the latter. By no means all the carriers joined in setting up even these local boards. The amendments of 1934 gave to the employees what they desired; and nearly all the local boards, except the Pennsylvania's, thereupon faded out of existence.

The details of this controversy need not here be discussed, since the matter has become academic. I can only express my own personal view that since many of the rules in the agreements are standard upon some or all of the carriers, it seems logical that there should be a national body to interpret them. Otherwise a particular craft on one road will, as has happened in the past, get better treatment under a particular rule than the same craft under the same rule on another road; and this can only lead to friction and confusion.

There are two changes which I think should be made in the present set-up. In the first place, the law puts no time limit on claims presented to the Adjustment Board. A number of awards have been made requiring restoration of wages or penalty payments from as far back as 1930 or 1931, when the claims arose, to the date of the awards. In at least some of these cases the finding that a rule was violated was based upon a prior decision of the Board interpreting the same rule upon the lines of another carrier, although the local practices in the one case may not have been the same as in the other. I think the Board is right in interpreting a standard rule consistently, and in disregarding local practices except when they are so clear as to amount to an agreed-upon interpretation, for otherwise there will be no certainty and neither carriers nor employees will know where they stand when decisions relating to the same rules upon other roads are handed down. But this policy will result in much hardship unless there is some time limit on claims based upon such decisions.

In still other cases the particular application of a rule has never been passed on; it comes up to the Board as an original proposition; there are no precedents, the rule is obscure, and the question might almost be decided either way. In such cases it seems unfair to penalize the carrier for having done innocently some years ago what the Board now finds for the first time to be a violation of the rule. On the other hand, there have unquestionably been cases where the carrier, at a time when no tribunal was available for the protection of employees, deliberately flouted a clear rule in order to save money at the expense of the men. I should think the law might feasibily lay down a reasonable time limit, with authority in the Board to waive it upon a persuasive showing that the violation was deliberate.

The second change I would suggest is that in place of the present referee system three impartial full-time men, appointed by the President and confirmed by the Senate, should be attached to the Board to adjudicate deadlocked cases. I have served as a referee with both the First and the Third Divisions, sitting upon nearly a hundred cases, and what I suggest grows out of that experience. The views here expressed are my own; I speak for no other member of the Board. As matters now stand, the referee in deadlocked cases is the sole judge.

Some of these cases are trivial and the decisions have no significance; others, though important, are so clear that any

reasonably intelligent outsider could decide them with confidence. But there are still others which are so difficult, so closely balanced, so technical and so far-reaching that—speaking again for myself alone—I am satisfied that the responsibility is too great to be cast upon one lay referee who comes to the board for a temporary assignment, with no background, no feel for the intangibles, and no fellow judges to consult with.

I know that the employees are skeptical of full-time neutrals, for if the appointments are unwisely made there is no escape; and the unions have bitter memories of the Railroad Labor Board of 1920-26, whose public chairman was regarded as actively hostile. But both sides must take the same chances, and I am persuaded that in the long run, given moderately good initial appointments, both sides will be better off with three full-time neutrals on the Board than with a succession of single, temporary referees.

The selection of referees who are both qualified and available is apt to become increasingly difficult with the mounting number of deadlocked cases. The use of referees, moreover, is very time-consuming, for they are not called in to sit with a Division until *after* the cases have been argued by the parties before the Division. When the referee appears, though he does not hear the parties, the Division must waste precious days rearguing the cases for his benefit. The Third Division is barely abreast of its work and the First Division is far behind. In the last fiscal year the First Division received 1,294 new cases, heard 891 and decided 862 (of which 303 were decided by referees). The net carry-over of undecided cases (making allowance for some which were withdrawn) was 356; and if we add the cases carried over from the previous year we get a total of 1,461 cases docketed and undecided.[1] These figures demonstrate the pressure under which the Division is working and the need of some relief. Full-time neutrals sitting with the Board in all cases would not need to hear rearguments in those which were deadlocked, and would thus save the Board an enormous amount of wasted time.

One word more and I am done.

The railroads are facing an unprecedented competition. To survive and prosper employees and management must coöperate

[1] About 1200 cases were inherited from regional boards in existence when the Adjustment Board was set up.

as never before. For the sake of their own future, which depends on the prosperity of the industry, there is much that the employees should give up in the way of burdensome rules, uneconomic make-work legislative programs, and opposition to needed coördination of facilities and terminals. But these things are not likely to be given up for the asking. They are symptoms of a deeper hunger—the hunger for security.

With the post-war development of larger locomotives, longer runs, the closing of many terminals, and the growing use of labor-saving devices, the employees watched their numbers dwindle from 1923 to 1929 by nearly 200,000, though the gross-ton mileage of freight and passenger car movement increased in that same period by 31 per cent. In the next four years the employees' numbers were further cut by nearly 700,000, of whom not many have been reëmployed. The seniority principle, which has given to the carriers the most experienced, conservative and faithful labor force of any major industry, has operated also to give it an undue proportion of elderly and aging men.

There is fear of old age, fear of unemployment—fears based upon the solid realities of what has happened in recent times. These fears explain in part the obstinate clinging to outworn rules, the drive for make-work programs. I do not condone these policies. They are bad for the industry, and in the long run bad for the men. But I doubt if you will end them by saying they are bad, or by talking about the long-run interests of men, when round the corner are immediate perils. I do not know the answer, but I cannot help but feel that there is enough statesmanship on both sides to yield what should be yielded and to grant what should be granted. The agreement of last May between the standard unions and the principal carriers, providing allowances for men displaced by consolidations, was a most hopeful sign.

If in seeking the revision of rules, allowances might similarly be proposed for men losing work as a result of the revision, much could surely be accomplished; and if in the same spirit the other problems of security could be approached, the fears which help to perpetuate short-sighted legislative policies might soon be dissipated. Let us hope for the sake of all that by some such process of give and take, of mutual understanding and forbearance, the industry may move forward.

REMARKS BY THE CHAIRMAN

HON. WILLIAM L. RANSOM: Dean Garrison, we are indebted to you and thank you for coming here to give us this sympathetic presentation of the labor relations problems in the railroad industry.

Chief among the patrons of the railroads are manufacturers and those engaged in trade and commerce and other American industries. The next speaker will discuss the interest of industries in the railroads. Mr. Virgil Jordan has had a useful career as an economist and in the field of accumulating statistical data and the conclusions in behalf of American industry. He has been for some years the President of the National Industrial Conference Board. I present Mr. Virgil Jordan, who will speak concerning "Industry's Interest in the Railroads". Mr. Jordan! (Applause)

INDUSTRY'S INTEREST IN THE RAILROADS

VIRGIL JORDAN
President, National Industrial Conference Board

MY part in your discussion this morning is short and simple, like the familiar annals of the poor, among whom the railroads certainly must be included for most of the period since the war. I shall first describe what I believe to be the substance of the interest of other industries in the railroads, and then offer a few observations as to how those interests are likely to be influenced by developments affecting the railroads in recent years and in the future. In what I shall say, of course, I am speaking only as an investigator of facts underlying the prosperity of all those engaged in industry and in the railroads, and not as a proponent of the special interest of any group in either field. We have come to recognize that interdependence is one of the primary facts of prosperity in our present social organization, and the railroads, with all who are involved in their work, are an inseparable part of the whole organization for producing goods and services upon which the prosperity of all rests.

The people of this country who depend upon American industries for their support and security, which I think includes everybody, have three principal points of interest in the situation of the railroads. First, they are concerned to secure efficient, dependable and adequate transportation service at the lowest total real cost. Second, pay rolls and employment in a large number of important industries are vitally affected by the ability of the railroads to purchase equipment and supplies for the maintenance and improvement of their service. Third, workers in all industries and businesses are concerned with the consequences of governmental policies toward railroads with respect to labor, operation, taxation, finance and competition, which affect their earnings and costs and which will ultimately determine the continuance of the railroads and, consequently, of other industries, as private enterprises.

With respect to these three points, the prospects over the next few years are not very hopeful for workers in other industries. During the past year there has been some improvement in the position of the railroads which has enabled them to make some progress in improving equipment and service and lowering costs. This has been helpful to workers in some of the heavy industries. Further progress in this direction is certainly possible, and far-reaching programs are now in preparation.

Unfortunately, underlying tendencies in economic and political conditions will probably prevent or greatly retard the realization of these programs. These tendencies, which have been in operation for many years, must either materially increase railroad transportation costs and depress the purchasing power and employment of workers in all other industries, or they must cripple the financial position of the railroads during the next five or ten years.

As this process continues, and probably beginning by 1940, private investment in the railroads will gradually be dissipated or expropriated and replaced by public investment, and they will be absorbed in some form of government ownership or operation. This outcome will greatly increase the real cost of rail transportation and the general cost of living, putting a heavy burden upon workers in every industry, directly or indirectly, for inferior and unprogressive service.

The railroads remain, and must remain, of course, to use the very trite phrase, the backbone of our transportation system for the movement of heavy commodities over the enormous area of this country. Highway and water transportation facilities are not and never will be anything but accessories to the railroads. Measured in ton-miles, the railroads provide at least ninety per cent of the commercial freight transportation of the country, and in tonnage, they carry at least half of the products moved in the United States. Our railroad system must always, therefore, be depended upon to transport and distribute by far the largest part of the commodities produced and consumed in this country, and there is no doubt that they can provide this transportation service at lower real cost than any other facilities, if all costs, direct and indirect, are taken into account in the comparison.

This cost could and would be considerably lowered, and the service improved with new types of equipment now being developed, if conditions were encouraging to private initiative and the investment of new capital in railroads. Workers in every industry and occupation have a direct interest in these conditions, because the cost, efficiency and adequacy of railroad transportation are definite elements in the cost of living and, therefore, in the purchasing power of every person in the United States.

In the case of railroad transportation, as in that of taxation, it is impossible to measure the incidence of transportation costs in relation to the price of individual commodities and services, but the fact that they are not measurable in specific items, of course, does not mean they are not there. Whether or not the theory of general diffusion of taxes as an element in the cost of goods and services is valid, there is little question about the relation of transportation costs to the values and services of commodities produced. Part of that value is contributed by the transportation process which enters into production and distribution at all stages, and the relative importance of this service and of its cost can be broadly measured by the proportion which the net realized income of the transportation industries forms of the total realized national income.

For all transportation industries combined, this ratio has averaged close to ten per cent in the past ten years of prosperity and depression, with little fluctuation from year to year; that is to say, the total direct cost of all transportation service provided for sale in all forms, not including such part of the cost paid indirectly through taxes used for the support of highway, waterway and airway transportation, amounts to about ten cents of every dollar's worth of goods and services privately produced in this country. Of this the steam railroads account for slightly more than half, or fifty-one per cent, at present as compared with nearly sixty per cent in 1929. In other words, direct over all railroad transportation costs amount to about five cents of each dollar's worth of the goods and services produced in the United States. Measured in this inclusive way, railroad transportation costs may seem to be insignificant, but they are decisively important in the case of specific commodities and industries. In the aggregate, they

constitute a formidable total, and the changes that are taking place and are likely to occur in them are of great interest not only to the railroad industry, but to those in other industries as well.

For the steam railroads, the total net realized income from transportation service declined forty-four per cent between 1929 and 1935, a drop from $3,875,000,000 to $2,187,000,000. This is more than a reflection of the decline in volume of railroad traffic due to the depression. During this period, the realized income from water transportation fell thirty-one per cent, that from commercial motor transportation only ten per cent, and that from air and pipe line transportation only five per cent.

Here is a clear indication of the familiar diversion of the nation's expenditure for transportation service from the railroad to other facilities. This is further emphasized by the fact that while in 1919 about two cents of each dollar's worth of goods and services privately produced were accounted for by the direct cost of purchased motor transportation, this ratio had risen to nearly three cents in 1935. This increase was about matched year by year during this period by a corresponding drop in the ratio of steam railroad transportation costs, the other forms of transportation showing no substantial change in their proportion of the total.

Summarizing these trends, it may be said that while in 1935 the country was still paying for purchased transportation service in all forms about ten cents of each dollar's worth of goods and services produced, as it did in 1929, it was paying only five cents for railroad transportation in 1935, as against six cents in 1929, and the remainder went to other forms of transportation. If public expenditures on waterway, airway and highway facilities could be included in the comparison—which, as Professor Cunningham has said, is impossible at present—the change certainly would be more striking still.

These changes have meant a large loss in wages and salaries to workers in railroad transportation, which accounts for about sixty-two per cent of the total labor income from all transportation service. Salaries and wages in steam railroad transportation declined by more than $1,400,000,000, or nearly fifty per cent during this period, while all other forms of transportation showed a drop of only about one third. The effect of these changes on the situation of the railroads, however, has a much greater significance than merely in its relation to their own employees. Workers in a large group of industries producing railroad equipment and materials have a special and direct interest in the financial position of the railroads, as it affects the railroads' ability to make capital expenditures for maintenance and improvements and to raise new capital for this purpose. These industries play an important part in the general employment situation and in the purchasing power of workers generally.

Unemployment and reduced purchasing power of labor have been concentrated chiefly in these heavier industries during the depression, and they have been affected over a longer period by the financial difficulties of the railroads.

The extent and duration of this influence are indicated by the fact that the capital expenditures of Class I railroads for equipment, roadway and structures were somewhat more than a billion dollars in 1923, and less than two hundred million in 1935. This decline has meant an enormous loss of employment and purchasing power to workers in all of the industries producing railroad equipment and materials. It probably accounts directly or indirectly for the unemployment of a million men each year since 1932. When the losses in employment on the railroads themselves, which Professor Garrison has referred to, are taken into account, it is hardly an exaggeration to say that their unfavorable situation during recent years has caused the disemployment of at least two million persons and a corresponding loss of purchasing power to the community.

Certainly no more important contribution could be made toward alleviation of unemployment and expansion of purchasing power in this country at the present time than the restoration of our railroad system to financial health and vigor. It is clear that without such restoration a large sector of our unemployment problem must remain unsolved, save by the painful process of time which may absorb displaced labor into other occupations.

The outcome in this respect now depends wholly, of course, upon the policy of government, which has had the railroads in some degree under its regulation for nearly fifty years and

now carries the full responsibility for them in its hands, as it does indeed for the survival and prosperity of those engaged in every other industry in this country today. Whatever may be the result of this assumption of responsibility for the support and security of those engaged in other fields, in the railroads, where it has been exercised most fully for half a century, the consequence has been the progressive paralysis of private initiative and enterprise and the enforced dissipation of railroad capital, which, taken together, have laid heavier burdens of transportation costs upon the community than it would have otherwise had to bear. Today these consequences are reflected in a lower general living standard than would otherwise be possible and in acute accentuation of the unemployment problem.

In the early stages of railroad development, regulation helped to remove many evils which burdened the public, some of which would doubtless have disappeared in the course of time anyway; but in later years government has served mainly as an instrument for advancing special and local group interests, at the expense of the national interest in efficient, adequate railroad transportation service. Government policies with respect to railroad labor, operation and finance have tended for a number of years, and particularly since the World War, to increase operating costs in the face of inflexible rates and to weaken the financial position of the railroads. Lack of coördinated policy in regulation of competitive government-subsidized forms of transportation has contributed to this result.

Although the fixed indebtedness of the railroads as a whole is not excessive by economic standards, and has not tended to increase for many years, their financial position has been so strained by these conditions that more than a quarter of the total mileage has been forced into receivership, and the ability of the railroads generally to raise new capital for cost-reducing improvements has been materially impaired.

Individual roads, which were so fortunately situated that they could do so, have been aggressively pushing forward cost-reducing and traffic-increasing improvements. In the railroads as a whole, there are in progress intensive research activity, experimentation and the development of long-term plans for improvement of motive power, for application of new materials and new principles of design to lighten the weight of rolling stock and increase the comfort of passenger trains, and for the use of new methods and materials in track laying and roadway construction. All this activity has already proceeded to the point where it can be said that a spectacular revolution in railroad transportation is around the corner. This would mean immeasurable benefits to the public in lower transportation costs and improved service. It would mean very specific and measurable benefits to workers in other industries through increased employment and purchasing power; but these benefits will not be realized so long as present tendencies in governmental policy toward the roads continue to paralyze their initiative and sap their financial capacity to carry their programs through.

Improved traffic has lessened and will further lessen the strain on many of the roads, but there is little prospect of fundamental change for the better in the underlying situation. Pensions and other projected policies affecting railroad labor will enormously increase costs, and security market conditions are certainly not favorable for raising the new capital necessary to carry through any large part of the cost reduction program in process of development.

The political atmosphere is certainly not favorable for any substantial increase of railroad rates under private management, even if this were in itself desirable, which is questionable. Government work programs are rapidly increasing the surplus of transportation facilities in competitive state-subsidized forms. These tendencies, combined with the general social and political philosophy of the period, are clearly converging toward a situation in which the ability of the railroads to render adequate low cost service will be impaired, and agitation for government ownership of the railroads will again become active. It is probable that definite steps in that direction will become a political issue—or rather an administrative program, since we no longer have political issues in this country—within the next four or five years.

I said in an address two years ago that we might expect to see the definite beginning of the absorption of the railroads in some form of government ownership by 1940, and the current situation makes this forecast seem conservative.

All our economic and social policy in this country is now definitely and deliberately designed to bring about the dissipation of private capital investment and its gradual replacement by state capital in every major field of production through the progressive crippling and paralysis of private initiative and enterprise. This program now has more than unanimous approval, one might say about 150 per cent approval, and may be expected to be carried through fairly rapidly in the course of the next eight or ten years. Since the railroads have been subjected to the processes involved for a very long period, they are now near the head of the list of candidates for collectivization. In fact, since the announcement last week that the banking system had been nationalized by making the member banks of the Federal Reserve System the instrumentalities of the federal government, the railroads may in fact be at the top of the list at the present time, unless the utilities slip in ahead of them.

Of course, very few of those interested will be aware of the event till after it has actually occurred. Before and after its culmination this process will, of course, entail higher railroad transportation costs and ultimately poorer service. This will mean not only higher living costs for workers generally, but will materially affect the position of private enterprise in other industries, since government ownership of the railroads will be an entering wedge and an invincible instrument for establishing state capitalism in other fields. As such an instrument it stands on a par with nationalization of the banking system and public ownership of utilities. With railroad transportation, power and credit in the hands of government, private enterprise cannot survive in any field in this country.

Even if the form of socialization ultimately chosen for the railroads should be that of a public corporation, as in the case of the London Transport System, with shares held by the public under government operation, the consequences I have just mentioned would still follow. Those engaged in railroad transportation as workers or investors, and the consumers of railroad transportation service, will be out of luck, and providentially they probably will never know what they have missed.

So if, among the workers and investors in other industries and the consumers of railroad service generally, there should remain any who have an interest in the potential benefits of private enterprise in this field, they would do well to give serious and sympathetic attention to the situation of the railroads and lend what aid they can toward the development of national policies designed to strengthen their capacity to serve the public effectively. The present position of rail transportation presents a very definite and direct challenge to all other industries, which demands that in their relations with the railroads they put aside considerations of immediate self-interest and bear in mind the common stake which all industries have in the preservation and development of efficient and adequate railroad transportation under private initiative and enterprise.

Remarks by the Chairman

Hon. William L. Ransom: Mr. Jordan, in behalf of the Academy, I thank you.

We come now to another interesting, and often lively, part of our program, by way of discussion of the subject and of the addresses and papers to which we have listened. It is our practice to have the discussion opened, and then to throw the meeting open to a brief period of discussion from the floor.

Some of you may have noticed, by checking your final program today with the one which you first received, that we expected another speaker this morning in the person of Mr. William Green, the vigorous President of the American Federation of Labor. Mr. Green accepted our invitation, and his name was included in our first edition of the program. Unfortunately, the convening of an important meeting of the Executive Council of the Federation compelled him to withdraw his acceptance. When I talked to Mr. Green on Monday evening, he expressed very keen regret that he was unable to attend this meeting of the Academy.

Turning now to the discussion—the discussion will be opened by one who has had a wide experience in this field from the public point of view.

Professor Daniels was a Professor of Political Economy at Princeton, and later a member of the New Jersey Board of Public Utility Commissioners. President Wilson appointed him a member of the Interstate Commerce Commission of which he was later chairman, and in 1923 he resigned to become Professor of Transportation at Yale University. Now he is Professor Emeritus of Transportation at Yale. The discussion will be opened by Professor Daniels, under the ten-minute rule. (Applause)

DISCUSSION: RAILROADS AND THE NATIONAL ECONOMY

WINTHROP M. DANIELS
Professor Emeritus of Transportation, Yale University

I ASSUME that the unfortunate absence of Mr. Green absolves me from doing more than making one or two points with reference to the parts of the previous papers that have not concerned themselves with labor regulation. I shall, therefore, confine myself to one or two qualifications that I would make in the suggestions offered by Professor Cunningham and by Mr. Williamson. I think it is fair to say that both of these gentlemen agreed that we have at the present time a very considerable oversupply of transportation facilities. That view of course is often readily suggested by the very obvious and dramatic growth of certain types of transportation facilities. I think it was Will Rogers who said that it would not be long before we had a good hard-surfaced highway leading to every poorhouse in the country, and that is only one illustration of the excess of transportation facilities with respect to the corresponding demand.

It may well be that there is such a partial excess of provision as against requirement, but the first point which I should like to suggest is this, that you cannot estimate appropriately the so-called excess provision of transportation facilities by simply looking at the balance sheet investment in those facilities. After 1920, the railroads began their large program of additions and improvements, amounting to almost thirty-three per cent of their previous total investment, and yet it is questionable whether in usable, physical apparatus, there was any such enlargement of our rail transportation facilities.

The truth is that a great many of the facilities whose cost was written into the asset side of the balance sheet, where that cost very largely remains, represent equipment whose earning power has become zero and whose liquidating value is zero also. In

other words, the excess of transportation facilities is not going to be measured accurately by figures upon the asset side of the balance sheet, but by a very intensive physical inventory of the apparatus that exists as contrasted with the demands put upon that apparatus.

As a matter of fact, I think it is true that the operators of many individual transport lines, if asked whether they have an excess of immediately available facilities, will, if they are candid with you, disclose the fact that they are not anxious concerning their oversupply, but fearful lest certain needed facilities in the immediate future prove insufficient for the requirements.

One of the most experienced operating men whom I know said to me recently that, if industrial development proceeds at its present upward trend, he will be surprised if there is not a shortage of open-top and other equipment within six months' time. Now, that does not look as though in that very basic line we had such an overwhelming oversupply of transportation facilities.

Your draft is always limited by the obstruction in the neck of the bottle. I would like to ask some of the operating gentlemen in this vicinity how adequate they think the present supply of car floats in and about the harbor of New York is. I wish someone would tell me where you could rent or buy ten pier floats tomorrow. I am told on very good authority that they are not available. Consequently, I am inclined to admit that we have had an unparalleled growth of transportation facilities, but to deny that the excess supply, if such there be, can be determined by looking at the delusive figures on the asset side of the balance sheet.

Hundreds of the specific assets have long ceased to be physical aids in transportation. You might just as well write them out. If you eliminated the obsolete items in all your transportation facilities, you would be relieved in large part of this incubus of a huge oversupply.

That is the first qualification, and almost the only qualification, that I would venture to make concerning the excellent papers which were presented by Professor Cunningham and by Mr. Williamson.

They both agreed in one other point: namely, that some central control over these five different avenues or methods of transportation was necessary. We ought to have a glorified and omnipotent Interstate Commerce Commission, which would determine what the railroads, the water carriers, the pipe lines and the highway carriers were to do. I agree that it would be highly desirable, if it were possible, for some central controlling agency to determine and allot to each of these five agencies the field for which each was best and most economically fitted.

I cannot help feeling, however, that considerations other than economic considerations governing transportation are likely to interfere seriously with the realization of any such project. The airplane, for example, is not only a commercial instrument; it is a potential military instrument, and I doubt whether Congress will ever surrender to any administrative board so full a control over airplanes as to jeopardize the Congressional appraisal of the necessity of developing that particular carrier as a military instrument. That may be unfortunate, but I think it is one of the hard realities which we must face. Then, too, I confess, I am almost as pessimistic as my friend, Mr. Jordan, not about things in general, but about this one thing, that we shall ever induce the people of the country to believe that the natural waterways are not a donation by nature or by heaven whose improvement must inevitably be of national and popular advantage. When the matter is reduced to dollars and cents, I think this is a pervasive and profound delusion, but I despair of ever inducing my fellow citizens generally to abandon their belief that natural waterways should become transportation facilities.

I have a vivid recollection of being in St. Louis about ten years ago. There, along the waterfront, green grass actually was growing in the streets, and a few old hulks were tied up along the shore. I was talking with a railroad vice president (I was working for a particular railroad company at that time), and as we passed along, he bemoaned the fact that this natural artery was apparently devoid of any commerce whatever, that this heaven-provided and costless waterway was being allowed to flow by the vacant docks and wharves. He bewailed, also, the useless expenditures being made by his own company and other companies in wasteful provision for transportation by rail.

I leave with you, then, two suggestions. In the first place, I am not so much alarmed as some of my friends about the present oversupply of actual and immediately usable instruments of transportation, particularly as against rising demand for transportation service; and, in the second place, while I devoutly subscribe to the ideal desirability of some central control that should allot to each of these services its proper field and restrict it thereto, I am bound to say that I regard it as an ideal whose realization I am not very likely myself ever to see.

I appreciated the scholarly and illuminating paper presented by Dean Garrison, and I was immensely entertained, and only slightly depressed, by the comprehensive world survey that we had from Mr. Jordan. (Laughter and applause)

Remarks by the Chairman

Hon. William L. Ransom: I thank you most heartily, Professor Daniels, for this characteristically delightful review of the addresses.

In presenting Professor Daniels, I omitted to say that I believe he is in very close touch now with the problems of railroad administration, because by designation of the Federal Court, he is the trustee of the New York, New Haven and Hartford Railroad, in receivership.

This meeting is now open for a brief period of discussion from the floor. That discussion will of necessity take place under enforcement of the five-minute rule. If any of you have anything you wish to submit or add to this symposium of views, the floor is yours, with the restriction that you keep within five minutes.[1]

1 Space limitations make it impossible to print in these Proceedings the interesting discussion by several members who spoke from the floor under the five-minute rule.—Ed.

PART II

THE RAILROAD SITUATION CRITICALLY ANALYZED

INTRODUCTORY REMARKS *

ELIOT WADSWORTH, *Presiding*
President, Boston Chamber of Commerce
Former Assistant Secretary of the Treasury

THE subject this afternoon is "The Railroad Situation Critically Analyzed". I do not know whether that "critically" means with criticism or with great care, but I suppose we will all have suggestions to make. What has appealed to me about the railroads is their apparent lack of a selling department. The railroads began with a monopoly of all heavy traffic. They are now confronted by increasing competition. It has seemed to me, as an outsider looking on, that they have overlooked what is one of the most essential agencies in any modern business—whether it be telephone service or automobiles or drugs or anything else—and that is, a systematic effort to sell their commodity, namely, transportation.

The railroads began in a market in which the only competition was the distance an ordinary individual could walk on his legs or travel with a horse and buggy. Gradually they have come into a market where the average individual has a car standing at his door, which will go as fast as most railroad trains, and where the manufacturer, who has freight to ship, has a very energetic and tactful truck dealer trying to sell him trucks, or a truck owner trying to sell him transportation. The development in that field has come about very rapidly.

The automobile people have developed perhaps the greatest technique in selling that exists in any field, and my impression of the railroad technique in selling is that it has not kept pace with that of its competitors.

* Opening the Second Session of the Fifty-Sixth Annual Meeting.

I had occasion to get some figures which relate to this competition in connection with a case that we had in the Boston Chamber of Commerce some two or three years ago. Of course, up in New England we are the great center for truck business. Our distances are short, our roads are good, and the truck is at its very best there in carrying on short haul business. The railroads have suffered perhaps there as much as anywhere else in the country.

There was a formal proceeding before the Interstate Commerce Commission and the Chamber wanted to develop information as to the movement of truck traffic between New York and Boston. Investigators made three checks at a point on the old Boston Post Road just east of the Connecticut line, during several periods of forty-eight hours. Their statistics disclosed that 4,873 trucks, or an average of more than 100 per hour, passed the point where the check was made. We then consulted six of the big truck companies to get an idea of what the average load of those trucks might be, and they estimated that it would be from eight to ten tons. We allowed only four tons to a truck, taking an average of 100 trucks an hour. That would mean 400 tons per hour, 9,600 tons per day, 2,880,000 tons each year of three hundred working days. Estimating the tonnage in terms of railroad cars carrying twenty tons each, it is the equivalent of 144,000 loaded freight cars. These figures are for only one highway leading into New York from the New England district, but they indicate why the railroads report that their freight business has been reduced 30, 40 and 50 per cent in the last few years.

I would suggest as an important factor in dealing with this phase of competition, the creation by the railroads of a more energetic sales department, in order to compete directly with the trucking and other interests which are so active in soliciting business.

In meeting the problem of individual automobile competition the railroads really seem to have made some progress. They certainly have on the Boston & Maine, where the new gasoline train running to Bangor has become so popular that many persons who formerly drove their cars into Boston now go down to the city by rail, avoiding expense, discomfort and the parking problem. I have been told by the representatives of the Boston & Maine that the low fare and the fast train, with its comfortable arrangements, have apparently turned the tide in favor of the railroad.

Our first speaker this afternoon will discuss rates, wages and taxation. He is by profession a lawyer and has advanced far in the railroad business through the legal departments. I will not read all the positions which he has held since he began the practice of law in Mississippi. He specialized in legal matters connected with railroads, serving as General Counsel for the Illinois Central Railroad and then as Vice President and General Counsel of the Association of American Railroads, which office he has held since November 1, 1934. I take great pleasure in introducing Mr. Robert V. Fletcher. (Applause)

RESTRICTIVE LEGISLATION, RATES, WAGES AND TAXATION

ROBERT V. FLETCHER

Vice President and General Counsel, Association of American Railroads

I AM sure that all of us identified with the transportation industry are deeply grateful to the Program Committee of the Academy of Political Science for devoting this fifty-sixth annual meeting to the vital subject of "Transportation Development". Just as there are important aspects of production and consumption that call for study by those who are giving attention to the evolutionary processes in the domain of economics, so there are many phases of transportation, having to do with distribution, which challenge our earnest attention. This program deals with a variety of questions of interest to every student of the general problem — questions which call for careful thinking by informed and serious minded students of our political and economic system.

I mention the political side of the subject because it cannot be ignored in any practical or worthwhile consideration of the topic. Without making the slightest pretension to being an economist, I think I am safe in saying that the laws of economics are never permitted to operate in a vacuum, certainly not outside of the pages of some fanciful romance after the manner of Plato or Sir Thomas More. We must approach our consideration of the topic assigned to me for discussion with due regard to the structure of our government and the quality of our thinking upon questions that are essentially political. I am proceeding upon the hypothesis that, in spite of recent world developments and tendencies, we here in America are still devotees of the democratic principle. This should mean, as applied to the subject of this address, that our people will not tolerate a policy that fosters or even permits what true democracy chiefly abhors, the exercise of special privilege. This is the very foundation stone of democracy and here we may safely plant ourselves.

A policy that steadfastly refuses to recognize the right of special privilege to exist, by the same token, insists upon equality before the law as a cardinal working rule. This familiar truism no one will dispute. The difficulty, of course, lies in its application. For due regard for equality does not preclude the right to classify or, in other words, to consider dissimilarity of circumstances and conditions in determining a particular course of conduct. No one would contend, for example, that every citizen of the United States should pay exactly the same amount toward the necessary expenses of government, irrespective of ability to pay, or regardless of the quantity of governmental protection.

This leads us to a brief consideration of the nature of our transportation agencies and their place in any well-arranged economic system. It is easy to understand that in primitive society, the distribution of goods and the transport of persons did not call for the services of public carriers. But as the organization of society became more complex, as the boundaries of neighborhoods were extended, and the mental horizons of the people were widened, there was an increasing tendency toward specialization, with the consequent necessity for exchange of commodities and the increasing need for improved transportation facilities. It is not difficult to comprehend the distinction which arose in the public mind between the business of transport and the business of production and sale. Almost anyone, however limited his means or outlook, could engage in farming or small factory production or merchandising, without great difficulty. But when it came to sending products for considerable distances, it was obvious that relatively small producers and merchants were driven to collaborate in employing carriers expert in the business of transport and for whom a full load need not be provided by one person. As trade expanded, those therein employed became almost wholly dependent upon these carriers for their markets and supplies.

Not unnaturally, there arose an insistent demand that these carriers should not be left free to refuse service, or charge unreasonable prices, or act arbitrarily in fixing charges as between competitors. And so, in order to exercise a certain measure of control over these essential transport agencies, while at the same time leaving ordinary industry undisturbed, there was

invented the convenient and ingenious phrase " affected with a public interest ", to furnish a basis for public regulation and for the enforced assumption of certain obligations to the public. The fact that the carriers were few in number and their patrons numerous and smarting under common grievances made easy the task of fastening upon the carriers a legal status from which they have never been able to escape. In most of the countries where the democratic principle has found no permanent recognition, this status, for one reason or another, has developed into government ownership and operation of the railroads as the most important agencies of transportation. In the great democracies of Great Britain and America, the principle of public control has gone no further than to provide for a system of regulation of rates and practices in the public interest, leaving the ownership of the property and the risks of the enterprise in private hands.

Here in the United States, as may have been expected under our dual system of government, where for the first seventy-five years of our history the authority of the states predominated, the initiative in regulation was taken by the states in that period when the Granger legislation was popular. That legislation varied in range from statutes in some so-called conservative states (I might mention Massachusetts) aiming only at publicity, to statutes in other states actually prescribing rate schedules. For a time, the Supreme Court of the United States seemed inclined to the view that such statutes were of legislative rather than judicial concern. And what is even more remarkable, that great tribunal for a time seemed disposed, even with respect to interstate rates, to leave the states unrestrained in their power to regulate, in the absence of Congressional action.

Ultimately, however, after some hesitation, the commerce clause and the Fourteenth Amendment to the Constitution were so construed as greatly to restrict the power of the states in the matter of rate regulation, particularly interstate rates. Thereupon, Congress, in order that the field might not be left unoccupied, enacted, in 1887, the original Act to Regulate Commerce, creating the Interstate Commerce Commission and giving it power to prohibit unreasonable and discriminatory rates. It may be interesting to inquire at this point why, in accordance with the democratic principle of equality, Congress did not, at this time, extend regulation to forms of transportation other than railroads.

Of course, there was then no considerable commercial transport on the highways, none through the air and little, if any, by pipe line. But traffic on the waterways preceded the dawn of authentic recorded history and there was certainly some competition in 1887 between water craft and railway trains. But at that time, the Panama Canal was no more than a dream, the self-propelled barge was unknown, and navigation on the Great Lakes, especially as to package freight, was largely under railroad control. Congress could not visualize a situation in which the construction of the Panama Canal, the enactment of the Panama Canal Act, prohibiting railroad control of water lines, the subsidizing of water transport by the United States Government, the establishment of the Federal Barge Line, the expenditure of huge sums in waterway improvement and construction, and the operation of the long and short haul clause made rigid by amendment would so alter the situation as to make the water lines real, militant competitors of the railroads. Whatever the motivating impulse, the original Act of 1887 limited the regulation of water rates to those established by carriers partly by railroad and partly by water when both are used, under a common control, management or arrangement for a continuous carriage or shipment in interstate commerce—a limitation that has survived through the entire fifty years of regulation.

The original Act, in the light of later amendments, impresses the reader as being ultraconservative. Some of its language was borrowed from the English Railways and Canal Act. It suggests the theory that the ends sought could best be accomplished by publicity, rather than by the imposition of penalties. It contains the classic inhibition against rates that are unreasonably high and unjustly discriminatory. It contains a long and short haul clause, but the prohibition extends only to rates where circumstances and conditions are similar. The Commission created by the Act is given authority to apply to the courts for injunctive decrees to enforce its orders. Carriers were required to file tariffs showing all charges, which could not be changed except upon ten days' notice. This initial

venture into the field of federal regulation remained substantially unchanged for sixteen years.

In this period, largely under the guidance of a truly great thinker and jurist, Judge Cooley, there were announced certain fundamental principles of rate regulation, some of which happily survive; others, unfortunately, have been discarded, under pressure from groups clamoring for reform. In 1903, in the administration of Theodore Roosevelt, the original Elkins Act was passed, making it a criminal offense, punishable by fine, to deviate from the published tariffs or to grant rebates. In 1906, this punitive statute was amended by providing prison sentences for railroad officers or shippers who granted or received rebates. By this same Act, the grant of free passes, with certain exceptions, was prohibited and the Commission was given authority to establish maximum rates. These were the changes recommended by the President and the regulation of the railroads was thought to be complete.

On the whole, and in the light of experience, there is ground for belief that regulation should have stopped just there. (May I say that this paper was written as an expression of my personal views. I have no authority to speak for any railroad, for the railroad industry or for the Association of American Railroads.) It is doubtful if the numerous drastic and far-reaching amendments of later years have operated in the public interest. That a certain measure of regulation of transportation agencies is desirable, few students of the question now deny. Certainly no one of consequence would advocate a return to the era of rebates and uncensored rate making. Such a state of affairs would be beneficial to neither the patrons nor the owners of the railroads. But the Act to Regulate Commerce and the Elkins Act, as they stood after the amendments of 1906, probably contain every provision that is essential to the protection of the public interest. The legislation as it stood then represents that happy medium which avoids, on the one hand, the evils of extreme restrictive legislation, with its paralyzing effect upon managerial initiative, and, on the other, the evils of unrestrained and often short-sighted and narrowly selfish individualistic policies.

Most of the important changes since 1906 have been in the direction of strengthening bureaucratic control, at the expense of efficiency. Particularly have these amendments been at the expense of that flexibility so essential to the adaptation of the machine to changing conditions.

I should like to examine a few of the so-called reforms that came subsequent to 1906. In 1910, the Commission was given authority to suspend proposed changes in rates and hold them in suspense for seven months. As a practical matter, the Commission has, not infrequently, requested the carriers voluntarily to extend the period of suspension beyond seven months, pending investigation, and such requests are almost invariably complied with under fear of a summary adverse decision. If the Commission were gifted with that prescience which would cause only unjustified rates to be suspended, there could be no quarrel with the suspension statute. But it is obvious that if a rate change is justified and necessary to meet changed conditions, whether of competition or of some other nature, the end sought is too often defeated by the long period of delay. The desired traffic has gone elsewhere, or the needy carrier has been weakened by lack of nourishment.

Likewise, in 1910, the long and short haul clause was amended by omitting the all-important phrase "under similar circumstances and conditions". It is difficult to exaggerate the adverse effect of this significant amendment. Theretofore, carriers had been permitted, within reasonable limits, to meet competition where they found it, in accordance with a familiar economic principle, recognized and practiced by every manufacturer, merchant, farmer and moving picture operator in the country. Subsequently, the railroads were restricted in their efforts to meet competition by a rule so artificial and irrational that it might well have been designed deliberately to handicap the railroads in the competitive race. The result has been to penalize the interior, wholly dependent upon rail transport, and to create an unnatural monopoly, utterly at variance with any sound competitive theory.

I think it can safely be said that the consolidation plan found in the Transportation Act of 1920 has proved an almost complete failure. But for certain rather incidental sections of the law which, sensibly construed, has permitted some important leasing arrangements, nothing significant would have been accomplished. The failure of the plan to consolidate the rail-

roads of the country into a few large systems is in no way attributable to the Commission, which has labored long and arduously to make practicable a scheme condemned by its own artificiality and additionally hampered by standards which no one can observe.

Then, too, nothing of real value has been accomplished by the Valuation Act of 1913. Its cost, to both the railroads and the taxpayers, has been enormous, in the expenditure of both money and effort; but out of it has emerged little except dreary volumes of statistics that are now largely obsolete. So far as I am informed, the findings of the Commission as to railroad values have never been adopted as a basis for making rates, or for approving a consolidation, or for authorizing the issuance of securities. Indeed, the integrity of no single railroad valuation has ever been established by any court of final or competent jurisdiction.

That near kinsman of the Valuation Act, the recapture statute, has been abandoned as utterly futile and unworkable. Hailed in 1920 as a panacea for all railroad ills, and as life-giving nourishment for the weak sisters, it proved ineffective, partly because it depended for support upon the broken reed, the Valuation Act, and partly because it assumed the existence of a quality in human nature of which only the altruists dream. In 1933, it was relegated to the shelves of the museum upon which repose a fine collection of legislative curiosities.

Of course, something can be said for the value of the statutes giving the Commission control over the issuance of railroad securities and control over the supply of transportation by making it necessary to secure authority for construction and abandonments. I am not, however, convinced that the public and the transportation industry have been benefited more than they have suffered by the exercise of these powers, conscientiously as the Commission has endeavored to discharge its duty. In the matter of abandonments, it has always seemed to me that the enlightened self-interest of the carrier can be trusted not to give up an operation which holds out any reasonable prospect of business; and without such prospect, how can real public necessity exist? As to improvident issuance of salable securities, some control may be desirable for the protection of investors, but this is not an aspect of the problem peculiar to corporations engaged in transportation. One's views of the wisdom of these regulatory measures depend upon his general attitude toward the function of government in relation to business.

Another recent excursion by the government into the domain of management was the Transportation Act of 1933, with its provisions for coördinations under the patronage of a coördinator. This unique legislative measure, ostensibly designed to eliminate competitive wastes, failed of its principal object, not because it was not wisely administered, but because it ran counter to certain qualities of human nature which cannot be ignored. As yet, so powerful is the democratic tradition that the rôle of the autocrat is a difficult one, however justly, patiently and temperately he may play his part. This is particularly true when the law he is instructed to administer exalts an economic abstraction, sound enough in theory, above the inclinations of the owners, the users and the employees of the property. The refusal of the Congress to continue this Act in effect is one of the most hopeful signs of the times.

If we could turn back the clock to the legislative status that existed after the 1906 amendments, we would greatly simplify the important process of putting all forms of transportation upon an equality in the matter of regulation. It has been forcefully argued that it is absurd to subject a single truck or a single tow boat to the cumbersome, intricate rules and regulation to which the railroads must conform. Opponents of equality in regulation paint vivid pictures of the plight of the small operator, confronting the maze of federal requirements and bewildered by their ponderous machinery. But his difficulties would be greatly reduced if he were required to do no more than was exacted of the railroads in 1906. Surely he could file reasonable and non-discriminatory rates, contained in tariffs which he could easily observe. He could comply with reasonable accounting rules and make such reports as the Commission might, in its discretion, require. These rather simple restrictions, if they may be so called, would fairly well represent the measure of his regulation.

We have all about come to the conclusion that common justice, as well as economic stability, calls for equality in the matter of regulation, where the transportation agencies are

competitive, as in the case of the railroads, the highway vehicles and the water carriers. Some insist that the water lines must be regulated as are the railroads, the busses and the trucks. Others advocate removing all regulation from rail and highway transport, so that all competitors may have a free-for-all fight, with no favors asked and no quarter shown. Others favor removal of some of the restrictions resting on the rail and highway carriers and bringing water carriers under the same modified form of regulation. I enroll myself with those who find themselves more comfortable on middle ground and I respectfully suggest that in the matter of regulation of rates and practices the year 1906 furnishes a good example of that moderation which is most conducive to safety and success.

I turn to a brief consideration of the restrictions imposed upon the rail carriers in the matter of their relations to their employees. The classic attitude of organized labor is one of settled opposition to legislation with respect to wage scales and rules controlling working conditions. Union labor has always favored the plan of settling controversies over these vital questions by processes of negotiation, influenced in some cases by the exercise of its economic power, as it euphemistically refers to the right to strike. Indeed, upon only one occasion has Congress undertaken to deal directly with the delicate question of what shall constitute the sum to be paid for a given number of hours spent in the service of a railroad.

I refer, of course, to the Adamson Act of 1916, enacted by Congress as an emergency measure and as such upheld by the Supreme Court. Previous to that time, there had been enactments passed in the interest of safety and humanity, such as the Safety Appliance Act and the Hours of Service Act. The Adamson Act, applying only to men engaged in train operations, and for the first and last time fixing wages by legislative fiat, was passed at the behest of the President, rather than at the request of organized labor. It was temporary in its operation and, as the Supreme Court subsequently declared, it went to the very limit of Congressional authority.

When the Transportation Act of 1920 came to be written, with its many innovations, there were included provisions creating the Railway Labor Board, with power to fix wages and settle controversies over working conditions. As a result of one of its decisions, there was, in 1922, a nation-wide strike of mechanical workers. The effect of this serious labor disturbance, perhaps the most serious in the railroad industry since the Pullman strike in 1894, was sufficient to lead, after considerable delay, to the repeal of the Act creating the Railway Labor Board, with power of decision as to wage scales, and to the substitution therefor of the Railway Labor Act of 1926, to the terms of which men and management finally agreed.

Under this law, as amended in 1934, arbitration is encouraged but not made compulsory; fact finding by a presidential committee is provided for, if arbitration is not agreed to; and boards of adjustment, with a neutral referee in case of disagreement, are created to deal with disputes as to the proper interpretation and application of working rules. The Act further encourages the organization of workers into groups, for the purpose of collective bargaining, and condemns the exertion by management of any influence in the setting up or conduct of such groups.

The Emergency Transportation Act of 1933 went very far in prohibiting the discharge or demotion of men as the result of the coördination of railroad facilities, but that Act is not now in effect. The protection which it afforded to labor is, in some degree, accomplished by the agreement of 1936, under which unemployment benefits for a generous period are agreed to be paid to those displaced by coördinations. The controlling act, at the present time, therefore, is the Railway Labor Act, with the incidents which have been mentioned. On the whole, it can be safely said that few fields of endeavor of the magnitude of the railroad industry have been for so long a time free from serious disturbances.

The policy of adjusting controversies by negotiation and arbitration, rather than by government tribunals with authority conferred by law, has not operated to the disadvantage of railroad workers. This is shown by the fact that the average hourly compensation of railroad employees has increased from 28.3 cents in 1916 to 68.6 cents in 1935, an increase of 142.4 per cent, while in the same period the cost of living has increased only 26.8 per cent. Translating these hourly wage figures into terms of yearly compensation, we find that whereas the average annual pay of railroad employees in 1916 was

$892, the figure has grown in 1935 to $1,653. It is true that this growth in unit labor costs, coupled with decline in business, due to the depression and the diversion of traffic to competing forms of transportation, advantaged by government subsidies, has led to a marked decline in the number of persons employed, the decrease being from 1,647,097 in 1916 to 994,371 in 1935.

Such a result is the unavoidable consequence of economic laws which all of us are powerless to repeal. Charged with the obligation to avoid waste and extravagance, the railroads have been forced to reduce employment as business declined in volume. Furthermore, as unit labor costs steadily rose, it was necessary to increase the productivity of the men employed. Railroad statistics reflect the operation of this inevitable law. Freight cars per train have grown from 38½ in 1921 to 46¼ in 1935; gross ton-miles per freight train hour from 16,500 in 1921 to 28,750 in 1935, while at the same time freight and passenger train schedules have been speeded up nearly fifty per cent. In this period, 1921 to 1935, the rate level, both passenger and freight, has steadily fallen, the decline in the freight rate level being 23 per cent and in the passenger fare level 38 per cent.

It can be confidently asserted that there are hopeful indications of an increasing tendency toward adjusting by conference and agreement controversies between men and management as to conditions of employment in the railroad industry. It is generally recognized that railroad labor in the United States tops the list in the matter of wages, reasonable hours of service and conditions of employment generally. It is likewise true that railroad employees rank very high in the scale of intelligence, social standing, economic independence and political influence.

The great problem that remains unsolved is that of unemployment, a problem, however, that is not peculiar to the railroad industry. Indeed, it is a problem that is well-nigh universal and which taxes the resources of statesmanship in every part of the world. I have neither the time nor the ability to discuss it here. I can only express the hope that the railroads of the nation, manfully struggling toward recovery, will not be selected for exceptional experimentation along a course which has not been fully charted or indeed adequately explored.

At the outset of any discussion of taxes, we are confronted with the disagreeable fact that whereas, in 1916, the railroads paid in taxes 4.4 cents out of every dollar of revenue received and 13.1 cents out of every dollar of net railway operating income before taxes, in 1935, these ratios had grown to 6.9 cents and 32.2 cents, respectively. I am not prepared to say that this mounting burden of taxation is out of line with what is paid by industry generally, although in certain taxing jurisdictions unfair discrimination could easily be established. But the railroads do have a legitimate cause for complaint in the fact that they are required to pay out seven cents for every dollar taken in, while their competitors on the highway pay out about three cents and their competitors on the waterways next to nothing at all. Here lies an opportunity to correct an inequality and an injustice which should challenge attention.

In the matter of federal taxation, the railroads are in accord with the protest forcefully presented by all corporations of any magnitude against the unfair and illogical theory of imposing income surtaxes upon a progressive scale, measured by net income, without reference to investment. Every student of taxation recognizes that such a system penalizes the man who happens to have an investment of a certain amount in a large corporation as against his neighbor who happens to have the same amount invested in a small corporation. A scheme of surtaxes which ignores the ability of the stockholder to pay has no support in reason or justice.

The current law imposing heavy taxes upon undistributed income operates with special hardship in the case of the rail carriers. This results from the peculiarities of their accounting practices, as prescribed by the Interstate Commerce Commission, practices which are designed to give a true picture of investment, without reference to questions that may arise in connection with taxation. For example, if an ordinary business corporation finds it necessary to replace an outworn structure or device, it may charge the entire cost of such replacement to operating expenses, without reference to the cost of that which is displaced. But if a railroad company spends $15,000 to replace a structure which cost $10,000, it may

charge to operating expenses only the cost of the abandoned property, with a consequent addition of $5,000 to capital account, thereby adding a purely fictitious amount to the sum total of its taxable profits. Not only do railroads suffer by their enforced adherence to such accounting rules; the law checks, if it does not wholly prevent, the accumulation of sinking funds to retire indebtedness, a policy which has been urged upon the railroads from very high quarters indeed. The railroads join with industry generally in an appeal to Congress so to modify this experimental legislation as to permit corporations to pay their debts and enlarge their plant through capital expenditures.

Conscious of its obligations as a quasi-public servant, the railroad industry, ready and anxious to serve, hopeful of the future as America goes forward, asks only that the hand of government be not so heavily laid upon it that it may not utilize the energy, the initiative and the enthusiasm of those who have devoted their lives to its welfare.

Remarks by the Chairman

Mr. Eliot Wadsworth: I am sure we feel very grateful to the last speaker, Mr. Fletcher, for explaining at least some of the phases of the maze in which the railroads operate. That word has been used before in this meeting. We must all sympathize with the railroad people themselves in trying to find their way through the restrictions under which they operate. And now I take pleasure in introducing our next speaker, who is known to everyone who has ever taken an interest in the railroad problem, for his extraordinarily interesting writings and speeches. He has had a varied experience in business in Wall Street and with the Wall Street Journal. He served as a member of the Interstate Commerce Commission for a number of years, and still is associated with the Wall Street Journal. It is a great pleasure to introduce Mr. Thomas F. Woodlock, who will speak on "Competition, Within and Without". Mr. Woodlock! (Applause)

COMPETITION WITHIN AND WITHOUT THE RAILROAD INDUSTRY

THOMAS F. WOODLOCK
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Former Member of the Interstate Commerce Commission

LIMITATION of time compels me to treat my subject in bare outline. I shall avoid statistics. What I shall try to do is to show you that what we may for convenience call the "public mind"—in that phrase I include the public itself, the Congress and the Interstate Commerce Commission—has from the very beginning been considerably confused in dealing with this matter of competition in the railroad industry, and that this confusion is still one of the main ingredients in what we call the "railroad problem".

It is always helpful in discussing anything to begin with a clear concept of the thing about which we are talking. That thing is competition. In the first place, quantitatively considered, competition is synonymous with waste — waste of energy, material and money. It necessarily implies at least two persons, two plants, two aggregations of capital or money standing ready to do one thing or perform one service, which can be done or performed by either of the competitors. Next, in all competition there is a winner and a loser. We profess to distinguish between competition which is useful and competition which is wasteful, but that distinction is qualitative. It is apparently based on the assumption that trial and error is the law of what we call "progress". Competition is the form in which the process of trial and error expresses itself and we say competition is useful when it produces progress and wasteful when it does not. It must, however, not be forgotten that the path of progress is strewn with casualties. As David Cushman Coyle has neatly put it, "a country can stand as much progress as it can stand bankruptcy."

Competition and economy are incompatible notions—something that I beg you to bear in mind during this discussion, for

failure to realize that fact is an important source of the confusion in popular thinking to which I have referred.

Competition between the railroads, as we all know, first concerned itself with railroad building. I need do no more than refer to the tremendous rush of competing companies to occupy our gigantic territory, which began at the close of the Civil War, and in the span of one generation or so gave this country half the railroad mileage of the world. All our people joyfully acclaimed and eagerly encouraged the advent of the rails—frequently with gifts of land, town sites, and even money. Capital invested in a railroad is irrecoverable. Immense sums of capital were sunk by its owners in this way and enormous losses were suffered by those owners. The country as a whole was temporarily overbuilt, both competitively and absolutely, hence the losses suffered by original investors, but the losses were concentrated on a few and benefits were enjoyed by the many. There was in the operation as a whole abundance of bankruptcy, but at least an equal abundance of progress.

The real competition between the railroads, however, was to come, and it came the moment that trains began to run on the new rails, in the shape of a struggle for business. You are all so familiar with the facts that I need only refer to the growth of the rate war and the rebate, as the weapons with which the railroads fought each other. As soon as this started there came a fundamental change in the public attitude regarding railroads. They ceased to be public benefactors and began to assume the rôle of public enemies. Out of that change has come the railroad problem, as we have had it for two generations and still have it today.

The farmer was the first to lay his woes at the door of extortionate rates charged by the railroad, and the Granger movement of the seventies was the first of the pressure groups which afterwards became so numerous. Out of the Granger movement grew the state railroad commissions and the beginning of public regulation. All these bodies were a combination of policeman, prosecuting attorney and magistrate—at least in psychology. Meanwhile, synchronously with this inception of regulation came at least a partial realization on the part of the companies that competition in rates meant destruction of all, and the railroad "pool" was born, as a cure for the rate war.

I take it that you are sufficiently familiar with the history of that institution while it lived, and I merely note that as soon as it proved to be an effective remedy for indiscriminate rate cutting—as it did under the managing genius of Albert Fink—the public rose in opposition to it, and the "monopoly" specter appeared on the political scene. State regulatory commissions did their part in fomenting the public alarm and the result was the prohibition of pooling by the Interstate Commerce Law. By this time the notion that competition was an indispensable requirement in the railroad industry had firmly established itself in the public mind, from which it has never been dislodged.

The last really important rate war—the trunk line war of 1884—just antedated the Interstate Commerce Act, but that war was mainly the outcome of an important piece of purely competitive railroad construction—the building of the West Shore Road. Notwithstanding, however, the legal prohibition of pooling, rate wars became relatively fewer and smaller following the Interstate Commerce Law. The instinct of self-defense by coöperation had crept into the railroad manager's consciousness and there grew up traffic associations, the object of which was to obtain some kind of common action to maintain rates. It was supposed, for a time, that these were within the law, but in the middle nineties they were declared to be in violation of the Sherman Anti-trust Act, and the sacred principle of railroad competition received a further boost.

It is interesting to observe that the Interstate Commerce Commission was at least partly alive to the problem thus presented, and in its report to Congress in 1898 it pointed out that while every other nation in the world at that time regulated railway rates, none enforced competition between railways. It had, moreover, in the previous year repeated its suggestion made in 1894 that under strict regulation it might be safe to permit pooling. Again in 1901 it said: "In justice to all parties we ought probably to add that it is difficult to see how our interstate railways could be operated with due regard to the interest of the shipper and the railway without concerted action by these associations"—that is, the traffic associations already mentioned. And in 1900 it said: "Competition is wasteful. Owing to it transportation by rail actually costs

more than it ought. To eliminate that competition will be to work an actual saving in the cost of the service and this should redound to the benefit of both the carriers and the shipper." This was very sound doctrine, no doubt, but without any perceptible influence upon either the public or the Congress.

One reason for this was, undoubtedly, that by this time the railroad managers had themselves entered upon a policy of self-defense, which proved effective enough to arouse fresh alarm in the public and the political mind, and utimately in the mind of the Commission.

Largely under the lead of President Cassatt of the Pennsylvania Railroad, the managers had gone a long way in accomplishing three things, all in the nature of self-defense, the effect of which was to make the monopoly ghost still more terrifying to the public—or at least to the politician. By the later nineties the general freight rate level had reached what proved to be the bottom. President Cassatt undertook a vigorous campaign among railroad managers to exterminate the rebate and to raise the rate level. In both he was succesful, so that by the time the Elkins Act of 1903 was passed—largely, by the way, on the initiative of railroad managers themselves — outlawing the rebate, the rebate itself had largely disappeared. Also the freight rate level had been lifted quite appreciably. It was about the turn of the century that the "community of interest" phrase appeared in print, and upon its heels came that series of purchases by one railroad of the stock of another, which culminated in the Northern Pacific panic of 1901 and the formation of the Northern Securities Company, ultimately condemned as in violation of the Sherman Act. The effect of all this was naturally to fix more firmly than ever in the public mind the belief that competition between railroads must at all hazards be preserved. Also it gave a tremendous impetus to the passage of the Hepburn Act of 1906, which for the first time gave the Commission some real power to determine rates, which power, four years later, was made plenary by the Mann-Elkins Act of 1910. Furthermore, the series of important cases of 1911-12, brought under the Sherman Act against several so-called "trusts", and the passage of the Clayton Anti-trust Act gave the "competition idea" fresh vigor.

It may be helpful here to pause for a short analysis of the contents of the competition idea as then entertained by what, for convenience, we call the public mind. Probably, for most people, it was a combination of instinct and vague hope. The instinct of "anti-monopoly" was always universal in our people—is today—and is readily comprehensible. The hope was that if the railroads were forced to compete, rates would come down—also a simple and natural emotion. But it is quite certain that the full logical implications in the notion of competition were not then and are not even now generally recognized and accepted. The history of the fourth section of the Interstate Commerce Act will give us a demonstration of that fact. That section contains the so-called "long and short haul" clause, the principle of which is so well known that I need do no more than mention it.

The second and third sections of the Interstate Commerce Act condemned all forms of discrimination, undue prejudice and undue preference by railroads in the treatment of their customers. The fourth section is nothing more than a specific prohibition of a special kind of undue prejudice or preference, which was already covered by the preceding sections of the Act, and it was, therefore, pure surplusage. As originally stated, it was simply and accurately enough expressed in the principle of the preceding sections. It prohibited the charging by a railroad of any greater compensation in the aggregate for the transportation of passengers or of like kind of property *under substantially similar circumstances and conditions* for a shorter than for a longer distance over the same line in the same direction, the shorter being included within the longer distance. Please note the phrase "under substantially similar circumstances and conditions", for it is vital.

If there are two lines between two points, one line being longer than the other, and if the two lines touch only at these two points, it is evident that the "circumstances and conditions" surrounding these two points differ from those surrounding all other intermediate points on both lines, inasmuch as the said two points have direct alternate transportation service between each other, which is not available to any of the intermediate points on either line. The rate between these two points is necessarily made by the shorter line. Consequently on a strict mileage

scale of rates, the rate of the longer would necessarily be higher between these points than is that of the shorter line, and might be a good deal higher depending on the difference in distance. If, then, the longer line wishes to share in the business moving between the two points, it must meet the short line rate. This rate will be less than it charges to an intermediate point. But this entails no discrimination against the intermediate point, for the simple reason that that point would be in no way benefited by its carrier refraining from this competition. If it is not benefited by its carrier refraining from meeting competition at the more distant point, it cannot be hurt by this competition being met.

So far as I am aware, in every country other than the United States, the long and short haul question has always settled itself on these simple lines—that is, by the presence or absence of competition at one point as compared with another. But not so here. Indeed, for the first ten years of its life the Interstate Commerce Commission declined to recognize the competition, which I have just described, as necessarily differentiating circumstances and conditions and consequently justifying relief from the fourth section of the Act, but in 1897 the Supreme Court forced it to do so. The Court's decision led to amendments of the section in 1910, one being of a highly significant character. This was the deletion of the all-important phrase concerning "similar circumstances and conditions". As you no doubt perceive, this amendment struck at the heart of the whole principle of the thing, and separated American theory from that universally accepted elsewhere.

Another amendment in 1910 provided that whenever a railroad secured permission to reduce the long haul rates to meet water competition, it could not afterwards increase them, unless it could justify the increase on grounds other than the elimination of water competition.

Next, by the Act of 1920 another amendment was enacted which further separated the law from the principle. This was the addition of the so-called "equi-distant clause". The new provision required that whenever the Commission granted relief from the fourth section, merely because one line was longer than another, higher rates than those of the competitive point might not be charged by the longer line to intermediate points further distant from origin than the length of the short line to the competitive point. What logic there might be in this provision I have thus far been unable to discover. It was the Commission's own invention, apparently, for that body seemed to think that there was some necessary mathematical distance-relation of a competitive to a noncompetitive rate (46 I.C.C., 712-748). By the same Act, moreover, the Commission was prohibited from permitting the establishment of long haul rates that were not " reasonably compensatory ". It was further provided that relief from the fourth section of the Interstate Commerce Act might not be granted on grounds of potential water competition.

I have gone into these details because they show in a striking way the various aberrations of the public mind in connection with this matter of competition. In the first place, the Commission declined to recognize the elementary principle expressed in the phrase "under substantially similar circumstances and conditions" until the Supreme Court forced it to do so. Then Congress struck that phrase from the law. Next, at the instance of the Commission, Congress enacted the so-called " equi-distant " clause. Finally Congress undertook to hobble the railroads in competing with water routes. As a result of these actions we have on the statute book a law on the long and short haul question for which no match can be found anywhere else in the world. It is literally a mass of inconsistencies. In the last session of Congress a bill was introduced, known as the Pettingill Bill, which correctly and succinctly stated the principle which should govern in the matter. It failed of passage, and I note the fact that the Interstate Commerce Commission did not give the bill, in all particulars, its approval.

When the Act of 1920 was passed the new highway competition had not definitely shown itself. The law still contemplated an essential railroad monopoly requiring regulation. It did, however, provide for a consolidation of systems into a limited number of large reasonably self-contained entities, but it also laid down the principle that in forming these consolidations and unifications, competition between the resulting systems was to be preserved, so far as was found possible. As you know, consolidation has made little progress. Several important proposals have been considered by the Interstate Commerce

Commission and rejected. In practically all cases disapproval was based, at least mainly, on the fact that these combinations seemed likely to restrict competition. Apparently the theory of the matter was that all the important centers in the three great districts should have at least two railroads serving them. Inasmuch as direct competition in rates was excluded, it must have been assumed that the railroads would compete in service. At the same time, however, the law in the famous section 15A, dealing with fair return, required honest, efficient and *economical* management. The legislation of 1933, establishing the federal coördinator of railroads, contemplated economy by extending the principle of joint ownership of facilities and terminals in large cities. Thus, the two opposing principles, competition and economy, were brought forcibly face to face with each other with the result that the basic antinomy in the situation became plainly evident. Notwithstanding the most earnest efforts of the coördinator, Mr. Joseph B. Eastman, little or no progress toward this kind of economy has been found practicable.

I digress for a moment to pay my tribute of admiration to Commissioner Eastman's performance of his task, as coördinator. It is not his fault that more progress in economy by coöperation has not been secured. Circumstances were too strong for him, and the law tied his hands in the most important respect, that of economy in labor. One thing can assuredly be said of the job that he has done: he has given the country, the railroads, their competitors and the public a mass of information concerning the facts which could have been secured in no other way. It is a particular pleasure to me to salute him as a master of his subject. (Applause)

So much for the public mind in its conception of competition within the industry. I might offer other instances of the attempts of the Commission to deal with the basic antinomy in the matter. For example, its effort to persuade Congress to broaden its powers, so that it could prescribe through routes and joint rates upon competing railroads, without regard to short hauling, is clearly an invasion in principle of a fundamental right of a carrier as a competitive railroad. I think, however, I have said enough to show that at no time from the inception of the railroad industry has public thinking on the subject been clear. What that thinking has always seemed to contemplate was a constant effort to "preserve the best features of both" opposing principles. The trend of opinion has generally been against the carrier's own interest as a competitor.

Before touching the question of competition external to the railroad industry, it is well to consider the manner in which railroad management has dealt with its competition problems. I have no hesitation in saying that railroad managers, during the years following the Transportation Act of 1920, conducted a competitive campaign for business that went to extremes for which no rational excuse can be offered. The phrase "car-crazy" originated as a description of the efforts made by individual railroads to divert business from rival lines to their own. To such a length had these practices grown that managerial proposals were made to establish some semblance of order and reason by placing over the heads of the competing roads an authority to be known as "Czar". One of the wasteful results of this sort of competition has been the hauling of freight—as the phrase goes—"around Robin Hood's barn". It was a not unnatural result of conditions created by the general public policy toward the industry itself. While this may be an explanation of the situation, it cannot be regarded as an excuse for excessive competition.

It was about the time of the passage of the Transportation Act of 1920 that the railroads began to suffer from competition from external sources which has now become so acute as to require legislation. The motor industry has made practically its entire growth as a competitor with the railroad in the years since 1920. So far as passenger transportation is concerned, the tremendous inroads made by the highway upon railroad business have resulted from strictly private as contrasted with common carrier operations. If it had been only busses that the railroads were to meet, it is very doubtful whether railroad reports would have carried anything more than microscopic traces of lost revenue. As a matter of fact, out of 110,000 busses in service in this country not more than 60,000 are common or contract carriers in serious competition with the railroads. It is the private motor car, of which we have 23,000,000 in the country, that has bled the railroads white so far

as passenger transportation is concerned. When we come to freight the situation is not very different. Out of about 3,500,000 motor trucks in the country a scant half million are common or contract carriers subject to public regulation. The remainder are privately owned trucks, carrying owners' freight, which are constitutionally free from any regulation other than that of the police power having regard to public safety. The new regulation undertakes to control common carriers and contract carriers of passengers and freight. We do not yet know to what extent it will be effective. But I should like you to note that, judging from the controversies already in progress, the highway operators seem to have the curious idea that, while they are entitled to compete with the railroads, the railroads are not entitled to compete with them! The present controversy between the trucking interests in the eastern district and the Interstate Commerce Commission is quite illuminating as to this curious warp in their concept of competition.

The fact, however, is that we now have a competition between railroad and highway transportation of an extremely acute kind, under which practically every sort of commodity that moves in carrier transportation is moving somewhere in the country by highway, where it formerly moved by rail, and everywhere in the country many commodities, which used to move by rail, are now moving by highway. Transportation is, in short, an acutely competitive industry. Furthermore, we have yet another form of competition in freight transportation; namely, that of the artificial inland canalized waterway upon which barges and trucks operate free of tolls. I have no hesitation in characterizing the attitude of the public mind—remembering what I mean by that phrase—toward this particular kind of competition as having been grossly unfair, from the very inception, or rather the reappearance, of water transportation. We have now had for the best part of twenty years the shocking spectacle of government itself operating trucks and barges upon the Mississippi and Warrior rivers in direct competition with privately owned railroads, using some $23,000,000 of the public's money in the enterprise. At least ten times as much public money has been poured into these streams to make them navigable, and upon this investment there never has been earned any sum to represent an appreciable return. Not only is this so, but the Congress by the Denison Act fastened these water lines as parasites upon the privately owned railroad systems by forcing the latter to accord through routes and joint rates with the water lines, thus extending the latter's scope of operation over an enormous territory to the direct detriment of railroad net revenues. Finally, with all the railroad rates subject to the strictest kind of regulation, the port-to-port rates on the water lines are still entirely immune from any public control. Could anything more clearly demonstrate that the public mind has come to regard its railroad servants as public enemies, notwithstanding the fact that they are strictly bound by a system of regulation controlling every single important activity of their owners?

I shall not attempt to settle or even argue the question of whether the cars, trucks and busses traveling the public highways pay their way directly or indirectly so far as public money is concerned, or whether they are in fact heavily subsidized. There can, however, be no debate concerning the subsidization of artificial inland waterway transportation. The situation is indefensible under any considerations of equity; that it reflects a definite and considered policy to which the public mind has given and still gives its assent is what, I think, justifies me in characterizing it as nothing short of a scandal.

In concluding this necessarily brief and very imperfect presentation of the matter of competition in transportation, I will venture to state what seems to me to be the only fair course for the public regulating authority to pursue. Since practically *all* commodities are now moved under competitive conditions in railroad, highway, waterway, pipe line or air transportation, and since *all* regions of the country are reached by one or another of these competing facilities, it is manifest that need for the strict regulation of railroad rates under section 1 of the Transportation Act of 1920 is rapidly approaching the vanishing point. Competition will provide regulation, so far as practically all the important rate structures are concerned. If anybody is curious to know what competition has already done to many of these structures, I may say that one of my last duties on the Interstate Commerce Commission was to readjust the rates on cotton moving by rail between all points

in the United States. In 1930 a schedule of rates east and west of the Mississippi River, prepared under my general direction, was approved by the Interstate Commerce Commission. Hardly had it gone into effect, when the motor truck commenced to tear it to pieces. A comparison of cotton railroad rates as they exist today with those laid down in the readjustment of 1930 would tell a surprising tale. Speaking broadly, and with all allowance for exceptions, my deliberate opinion is that the time has come to permit the railroads to readjust the entire structure of rates, as fast and as far as they can do so, to bring them into some kind of relation to the competitive highway and water rates.

No doubt there are places, and there are commodities, where outside competition has not completely infiltrated railroad business, and where it would be possible for railroads to exact unreasonable rates. What is perfectly clear to me, however, is this: that where railroads go to the Commission asking for higher rates, the Commission cannot logically reject them as more than maximum reasonable rates on the ground that they will not move the business. With all the foolishness attributed generally to railroad managers, it is hardly sensible to suppose that they will propose rates—or keep rates in force—without the expectation that the rates will move traffic, and if the rates *do* move traffic in competition with highway or water, how can they offend under section 1? In any event, a theory of rate regulation originally based upon the concept of the railroad as a monopoly is clearly out of place in dealing with railroads subject to the most acute competition that they have ever experienced. Whatever else we need, we need a complete change in psychology, for without it the thing that we call the "railroad problem" will continue insoluble. Furthermore, if any other reason were needed for turning the railroads loose to meet their competitors, it would be found in the fact that quite apart from common or contract carrier competition, we have 23,000,000 *private* carriers of passengers and 3,000,000 *private* carriers of freight. It is surely time for us to begin to think clearly and act fairly in the matter.

Remarks by the Chairman

Mr. Eliot Wadsworth: I am sure we all realize, after listening to Mr. Woodlock, what a rate expert is and why every big corporation and shipper has to have at least one rate expert on the staff. Our next speaker will discuss the subject of "Management and Financial Policies". He is a gentleman who has been in finance and banking in New York ever since graduating from college. He is a director of various corporations, representing both railroads and shippers. I am greatly pleased to introduce Mr. Henry S. Sturgis, Vice President of the First National Bank of New York. Mr. Sturgis! (Applause)

RAILROADS—MANAGEMENT AND FINANCIAL POLICIES

HENRY S. STURGIS

Vice President, First National Bank of the City of New York

A CRITICAL analysis of railroad management and financial policies seems to be called for in view of the general subject of the afternoon's discussion and the topic assigned to me. One who has many friends in the railroad industry is perhaps taking some risk of losing them by embarking upon such an analysis, particularly if the conclusions are likely to be critical. On the other hand, one may possibly do so if he admires, as I do, the very great accomplishments of railroad men in the face of conditions which would have discouraged and broken men less strong than they.

It is reported that over sixty million people, nearly half of our population, have a direct or indirect financial interest in the railroads. My friends in the railroad world will, perhaps, forgive me if I attempt an analysis of their attributes, both good and bad, when I assure them that it is done in a spirit intended to be wholly friendly and with a view toward contributing something to the solution of a problem of such great importance to the national economy.

I am taking the liberty of reversing the order of my topic, and of discussing first matters having to do with financial policy. Since several volumes could be written on this subject, I must limit myself to certain phases which strike me as having great importance at this time.

Commentators on railroad finance have had much to say in recent years about excessive debt, high interest charges, and sinking funds for the reduction of both. The railroads have been criticized for failure to reduce their debt and have been urged to resort to sinking funds for that purpose. But this argument for sinking funds is in my judgment specious and fails to recognize the fundamentals of railway financial necessities.

Railroad capital, like Gaul, can be divided into three parts. One part represents that which is obtained from those who are willing to take a low return in exchange for safety. A second part represents that which is contributed by those who are prepared to take a risk for a potentially larger return. The third part consists of equipment trusts representing an investment in a wasting asset.

The first two categories represent the investment in fixed property and working capital. Their combined total cannot be reduced. The railroad industry is not a dying or contracting industry; it is still an expanding industry. Therefore, it is generally agreed that more, instead of less, capital will be needed to meet the conditions presenting themselves. The crux of the matter lies in the ratio between the two parts which constitute the whole of fixed capital. It is raising a smoke screen to say that railway bonded debt is excessive and to go no further, for attention is thereby diverted from the real cause of the trouble. In relation either to earning power or to property values, the total of fixed debt was not excessive when it was issued. It has become excessive—if it is excessive—not for lack of sinking funds, but because of the decline in net earnings. And it is important to note that the decline in earning power results not only from a great depression, but from governmental and managerial policies going back well before 1929.

And there is some evidence that it is improper to say that taken as a whole the debt of the railroads is a real burden. In a report recently issued, The National Industrial Conference Board states that " no evidence exists to support the theory that business is saddled with too great a burden of private debt ", and as to the steam railroads the report says that problems of debt have developed " where specific policies of individual companies created difficulties."

Since the total capital in the railroad business cannot be reduced, sinking funds are not the answer to this financial problem. Any reduction of debt by a sinking fund is purely temporary and merely means that when new capital is required, the earnings used for sinking funds, instead of for capital expenditures, will have to be replaced and more new capital will have to be obtained than would otherwise be the case, with

attendant added financial costs to the roads. The only possible way to reduce railway debt in substantial amounts — except through the bankruptcy courts—is to change the ratio between debt and equity, that is to say, to transfer debt to equity. And this means that the equity must be made attractive. Sinking funds do the reverse, and reduce rather than enhance stock values. The cure of the debt situation is to attack the cause of the trouble—increase railroad net earnings, not only enough to make secure the fixed debt that exists, but sufficiently so that holders of indebtedness may be induced to exchange their obligations for stock and thus prepare for the next depression.

The worst feature of railway debt is that maturities, set many years ahead, often fall at most unfortunate times. Those who advocate sinking funds would do the railroads a greater favor, were they to recognize the fixed character of railway capital and advocate the issue of railway bonds as perpetual debt with no maturity except that which would come through failure to carry out the terms of the indenture. The injection of sinking funds can only be justified on the basis that the capital thus temporarily retired can be replaced at lower rates. That does not seem to be a probability at this stage of the bond market. Railroad management has been much too acquiescent in the present clamor for sinking funds, and should have done more to resist this pressure on them than to fall in with the demand for such a form of debt retirement.

The second item under financial policies that interests me has to do with reorganizations, of which several are pending. Railroad managements generally, particularly of those properties which have avoided financial difficulties, should be taking a greater interest in these reorganizations.

It is unfortunate that the new Bankruptcy Act makes it the duty of a debtor to propose a plan of reorganization. Obviously, the debtor is going to save all he can for himself from the wreck. He can do this only at the expense of the creditor. The Bankruptcy Act was intended to enable creditor and debtor to treat with each other and to hasten reorganizations, and thus reduce the costs of these proceedings. Instead, an attempt is being made to use the Act to preserve the interest of the debtor, all at the expense of those who loaned the money. This has led to delaying reorganizations instead of hastening them. But far worse, it is destroying what little remains of railroad credit.

The railroads, in their own protection and for the preservation of their credit, should take a strong position that reorganizations must preserve the priorities. Stockholders of railroads which cannot meet their obligations are entitled, like any other debtors who have pledged their property for the payment of their debts, only to that which remains after the creditors have been satisfied as nearly as possible in full, or to such position as the creditors find it in their interest to give the stockholders, either for new money or for some other definite consideration. Any other view, if adopted, will further contract an already contracted market for railroad securities, and the railroads will need to go often to the money market in the years to come. Railroad management might very well advocate some changes in the Bankruptcy Act looking toward more realism in reorganizations. As it is, they promise to take endless time and to be more costly even than before.

Let us now turn from the capital structure to the earning statements of railroads. Here not only may be seen the dire effect of railroad policies, both governmental and management, but here also is hidden away one of the great causes of railroad financial troubles going back over many years. I refer to a cause of trouble to which very little attention has been given—the failure to include adequate reserves in the expense account.

In railroad expense accounts, reserves for bad debts are almost nonexistent. Such losses are very small, but such as they are, they are usually charged to surplus and not provided for in earnings. Obsolescence, of which so much exists, is completely unrecognized. A few roads set up some reserve for depreciation of structures, but very few. Reserves for contingencies hardly ever appear. All, however, set up a reserve for depreciation of equipment, but a reserve that is pitiably inadequate.

Many railroaders will smile at this statement. But let us see what are the consequences of insufficient reserves for depreciation of equipment. If there are serious consequences to an inadequate reserve that is recognized by the railroads, then there must be even more serious results from the complete

absence of other reserves generally accepted as proper by sound business.

Obviously, small reserves reduce the published expense account and thus increase the announced profits. That is pleasing to a speculator or to those interested in obtaining wage increases or rate reductions. The first direct effect, however, is the payment of more income taxes than would otherwise be paid. This means an outlay which is a definite cash loss to the stockholders. The second effect is to play into the hands of those who would claim that the roads are earning too much and that wage increases or rate reductions are in order. These low reserves have made an opening for greater pressure on the rate structure than would otherwise have existed, and have made the roads more vulnerable under demands for higher wages. The third effect is, by encouraging dividends, to reduce the amount of cash income available for investment in the property and thus lead to the issue of more securities. And finally, and of the most importance, through failure to write off inefficient equipment as promptly as necessary, low depreciation reserves lead to keeping in service cars and motive power that could be replaced with substantial reductions in operating costs. This seems to me to be unbusinesslike, backward, and contrary to the interests of creditors, stockholders or the public.

An engineering firm of high repute, after a study, has determined that it is uneconomical to rebuild freight cars from sixteen to eighteen years old. Locomotives over ten years old are far less efficient than new and are fast becoming obsolete. And yet the roads write off their cars and locomotives on the basis of a life of from twenty-five to thirty years and keep them in service that length of time. That is one reason why over half the locomotives in the country are over twenty years old, and while quite able to run, are inefficient and costly as compared to modern engines.

If any industrial concern reserved such inadequate sums for depreciation as do the railroads, and almost completely ignored other reserves, it would become insolvent and go out of business in a very short while.

Furthermore, these unbusinesslike low reserves are shortsighted in the public interest. The aim of the railroads and of the Interstate Commerce Commission must be to give the best service at the lowest possible cost. This, we assume, is the goal of any public utility, or, in fact, of any farsighted enterprise. It can be attained only by the expenditure of money, looking toward cost reduction. The money can better be obtained by proper reserves in the income account than through the capital market. In other words, low transportation costs for the public will more surely and safely be secured in the end by rates now which will permit and encourage proper reserves, plus dividends to the stockholders, than by rates which are immediately low and make the reserves impossible. The American Telephone and Telegraph Company furnishes a fine example of how sound financial principles will lead ultimately to the best service at the lowest possible rates.

It will be said that the Interstate Commerce Commission recently set the rates for depreciation of equipment and that management is not responsible. That is true. But our railway managements have long been charging too little for depreciation and nothing for obsolescence or contingencies, and are far too complacent with the recent order of the Commission.

Let us turn now to a discussion of management. Two men of my acquaintance, each of whom attained eminence in his chosen field, have told me that if they had their lives to live over they would be railroad men. There is a fascination about railroading which attracts to the industry hard-hitting, two-fisted men. And no man can long survive the struggle and earn his way to the top who does not combine fine mental qualities with his fighting instincts.

These men, whom we call railroad men, have gone through a training which builds strong characters. They have been prepared at any hour of the day or night to contend with all kinds of weather, to meet emergencies of fifty-seven different varieties, and to carry a heavy burden of responsibility. They have done it, and have put the trains through. Anyone who would spend a few days with a division superintendent would come away with the distinct impression that here is a job which can be filled only by a man with physical stamina, courage, and a high degree of ingenuity.

This is the training which most, but not all, of our railway executives have had. Naturally, they too are hard-hitting men with high intellectual capacity. And the route over which

they have come to their present positions gives them a deserved pride in their organizations and makes them kings so far as their particular properties are concerned.

Any analysis of railroad management and its background must also take into consideration the fact that the railroads constitute, with few small exceptions, the only public utilities in this country which do not have territorial monopolies. Not only has competition naturally existed among the railroads, but it has been fostered by governmental policy. In other words, our executives received their training not only in competition with nature and the elements, but they have come to their present positions during a period when intensive competition with each other has been a part of the daily routine. It is useless to say that the railroads are no longer a monopoly, that they now have outsiders with whom to compete, and that they should coördinate their efforts against the common competitor. The fact remains that habit and training keep the railroads at each other, even though their lack of territorial monopoly, coupled with intensive regulation, makes coöperation between them more a necessity than in any other business.

Having become chief executives, these men find themselves directing their properties through a maze of unfavorable legislation, onerous regulation, and other handicaps. They are told what their revenues shall be, what wages they shall pay, how many cars their trains shall haul, and how many men shall man a train. They are overburdened with a variety of other hindering, tantalizing, maddening limitations on their efforts to operate successfully. Is it any wonder that their initiative has been deadened?

In spite of these things, subsidized competition, and a great depression, they have given this nation the best railroad system in the world. Surely this is proof enough of their capacity, and evidence of the inherent vitality of the industry. Yet our railroad friends are sometimes accused of doing less than they might have done to put the industry on a sound financial basis. Is this so? And if so, what is lacking?

It seems to me that the charge is a fair one. The shortsightedness of certain of the financial policies has been described. The lack of coöperation between the roads is evident to everyone, including the railroad men themselves. The competition between the roads has probably had as much, if not more, unfavorable effect upon their net operating income than the competition of motors and waterways. And this intra-railroad competition is assuming more disastrous proportions today than it ever has. It consists largely of taking tonnage from each other, and then taking it back. No one gains any advantage, and all lose in such a stupid performance. Every executive can tell you what is wrong and what needs to be done, but too little has been done. Pride in their own organizations seems to prevent them from using the experience or advice of those outside the industry. There does not exist a planned program looking to the future of the railroads as a whole over a period of years. The railroads constitute the finest illustration in the world of the adage that " what is everyone's business is no one's business."

Now, why should this be so? The explanation lies, I think, in those very characteristics of our executives which have made it possible for them to give us such a perfectly operated transportation plant. These men have had fighting careers. Their background is essentially one of competition. The railroad problems of today are fundamentally economic and financial. The solution of these problems requires coöperation, tact, statesmanship, and broader business and financial training than most of our executives have had. The solution requires an ability to look at the situation as a whole rather than at the situation as it bears upon some one property. Those of us who complain of railroad management are the ones who have been stupid—not the railroad men—for it is expecting the impossible that they should suddenly revive the initiative so long repressed and immediately develop the compliant natures and coöperative thinking necessary to cope with the existing situation. Furthermore, the men who head our railroads are much too busy with the problems affecting their own particular systems to give the time that is required for attention to national problems.

Under the circumstances, what should these executives do? I am convinced that they should call to their councils a group of men with wide business and financial experience, and obtain their assistance in dealing with those problems which have to do with the economic and financial aspects of the railroad situation as a whole. Railroad men are beginning to see the necessity

for a closer look at the industry from the national point of view. When they obtain the coöperation of the type of men suggested, their problems will in some cases gradually disappear through the development of greater coöperation with each other, and other important national problems will be more quickly brought to a solution.

Some will surely say that because of increasing earnings the railroad problem is vanishing into thin air, and nothing needs now to be done. To brush aside trouble is an easy way to postpone the inevitable. That is the attitude which existed in the decade of the twenties. If the railroads, and those interested in the railroads, take the easy way and do not soon plan and work for their better economic and financial future, the next depression will topple over more and stronger roads than have fallen by the wayside since 1929.

Remarks by the Chairman

Mr. Eliot Wadsworth: Mr. Sturgis has given a very strong endorsement to the management of our railroads. In spite of all the difficulties outlined here, under which the railroads must operate, we certainly have the best railroad system in the world. Our next speaker was to have been Mr. Thomas I. Parkinson, President of the Equitable Life Assurance Society. Unfortunately, he has been called out of town and he has asked the General Counsel of the Equitable Life, Mr. Sterling Pierson, to speak in his place. It is a great pleasure to introduce Mr. Pierson. (Applause)

THE INVESTORS' INTEREST IN THE RAILROADS

STERLING PIERSON
Counsel, Equitable Life Assurance Society

WHEN one has stopped to consider who the investors in railroads really are, he must thereafter approach the discussion of this subject with some degree of humility. As a general rule, we tend to think of investors as falling within three large classes, namely, individuals, incorporated institutions, and estates; but upon more careful consideration we come to realize that the ultimate investor is always an individual: either a stockholder in a corporation, a depositor in a commercial or savings bank, the beneficiary of a trust or a policyholder of an insurance company. We also come to see how difficult it is to appraise the preëminent interest of such individuals, for the policyholders of our insurance companies are at the same time taxpayers, bank depositors and, in many cases, stockholders. As such, they are seldom aware of the interrelations of, and the conflicts between, their various interests. However that may be, they are the individuals who supplied the funds which have been invested in railroad securities by various agencies, acting on their behalf. Although they may not realize the fact, the financial side of the railroad problem affects them directly in many ways.

Strangely enough, the investors' interest was probably more clearly recognized four years ago than it is today. At that time because of a spectacular decline in the market value of railroad securities, and in railroad earnings, it was generally recognized that the financial position of the railroads was a matter of common concern. The invitation extended by various organizations interested in railroad securities to the gentlemen who were to become the members of the National Transportation Committee put this phase of the matter as follows:

> This situation touches every citizen. It affects directly the security of wage and employment of the 1,500,000 railway workers. It affects equally the many and important industries supplying railway equipment

> and supplies. It touches the financial problem of local, State, and National government, to the support of which the railroads contribute over $300,000,000 annually in taxes. It has given rise to a severe decline in the value of the $19,500,000,000 of railroad obligations and shares, and has occasioned concern to institutions which hold such obligations among their assets, representing in part the savings of that thrifty portion of our population which is to be found among the policyholders of insurance companies and the depositors in savings banks. The relief that the present emergency has made it necessary to grant to the railroads is a drain on the Federal treasury, and any ultimate loss will constitute a burden on every taxpayer.
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> We, the undersigned organizations, representing many of the interests concerned, believe that there is no more important present task than a thorough and satisfactory solution of the railroad problem, as an integral but the most urgent part of the entire transportation problem. We beg that you examine all phases of the problem and recommend a solution which, with due regard for the public interest, will ensure an opportunity for the railroads of this country to operate on a business basis, to the end that there may be a stabilization in employment of wage-earners and in the values of investments made in behalf of insurance policyholders and savings bank depositors, and a general enhancement of the prosperity of the country which to so great a degree depends upon the prosperity of the railroads and of the many lines of business which in turn depend upon them.

Furthermore, President Roosevelt said in his October 1932 speech at Salt Lake City:

> Now there is no reason to disguise the fact that the railways as a whole are in serious difficulty. And when so large a part of the American people have a direct cash stake in the situation, I take it that our job is neither to howl about a calamity nor to gloss over the trouble, but patiently and carefully to get to the bottom of the situation, find out why the trouble exists, and try to plan for a removal of the basic causes of that trouble.

To that end he proposed

> the preliminary development of a national transportation policy with the aid of legislative and administrative officials and representatives of all interests now deeply concerned with the welfare and service of railroads, including investors, labor, shippers and passengers.

Today, notwithstanding the fact that the market values of some railroad securities have risen, we stand just where we did four years ago, so far as any plan for removing the basic causes of the railroads' difficulties goes. If anything, there is more uncertainty about the financial future of railroads than there was then, and because of this uncertainty I doubt that many of us, acting on behalf of the ultimate investors of whom I have spoken, are now ready to make long-term commitments in railroad securities, or that we shall be ready to do so until many of the existing uncertainties with regard to the future of railroads are disposed of. In this connection, I may add that we regard the task of eliminating the existing difficulties as primarily that of management, and not of the investors or of the government. We can lend the managers some support, but it rests with them to decide whether they wish to have further access to private funds, and, if so, to create the conditions which will be persuasive to the private lender.

For the present, I think it may fairly be said that, with few exceptions, the primary concern of investors in railroad securities is the administration of their existing investments, rather than taking on further commitments in this field.

As we survey the existing volume of railroad indebtedness in the light of what has taken place within the past few years, we are forcefully reminded of the necessity of keeping constantly in touch with changes in the services which railroads are rendering, and their accompanying effects on earning capacity. These are days when the needs of communities and institutions shift much more rapidly than in the past, and these changes are likely to be accompanied by significant variations in the earning capacities of the railroads which serve them. Accordingly, while it once may have been a respectable investment practice to buy a good bond maturing 75 or 100 years hence, and put it away in the vault until maturity, we know now that such a practice is apt to lead to difficulties for the investor.

By keeping close to the facts which underly statements of current earnings the individual investor can get some measure of protection in selling out before the adverse trend becomes generally apparent. But this does not solve the problem for investors in the aggregate or for the railroad which has issued the bonds. It has contracted an indebtedness, derived substantial benefit from its proceeds, and ought in good conscience to meet this indebtedness, notwithstanding the fact that the value of the property into which the proceeds of the indebtedness have gone may have diminished. Such an instance pre-

sents a general problem of railroad credit which we now see ought to have had more consideration by investors, railroads and regulatory authorities alike. It clearly suggests the desirability of the creation by debtor railroads of sinking funds for the retirement before maturity of at least a portion of their funded debt, or the application to the railroad funded debt generally of the serial maturity principle commonly accepted in the equipment trust field.

The experience of the last few years, likewise, points us to more studied consideration of the relationship of cyclical fluctuations to our investments. The forces responsible for cyclical fluctuations may be counted upon to assert themselves in the future as in the past, and presumably with greater intensity in view of the progressive increase in society's dependence upon capitalistic methods of production. Investors, and especially those who are charged with the responsibility of protecting the investor, must hereafter evaluate conditions with greater emphasis upon the prospect of continued cyclical changes. The incurrence of debt cannot be sanctioned solely on the basis of conditions characterized by plentiful earnings at, or near, the crest of a cyclical upswing. Capital expenditures can be justified only on the basis of earnings in the long run, and mortgages upon such property retain an investment character only so long as earning capacity is sustained and protected against such hazards as extreme optimism resulting in excessive declarations of dividends.

We come now to the extremely difficult problem of administering the investment in securities of railroads in bankruptcy or receivership proceedings. The magnitude of this problem was brought out only yesterday by Commissioner Mahaffie, who stated that 26.5 per cent of the total mileage of American railroads, and 22.4 per cent of the total capitalization, are now in receivership or undergoing reorganization under section 77 of the Federal Bankruptcy Act. This section, which was originally put forward for the ostensible purpose of expediting reorganizations and simplifying their administration, seems to have accomplished neither of these objectives. On the contrary it has thus far operated in such an unsatisfactory way as to constitute a real source of concern to investors who are interested in expediting the reorganization of railroads in trouble

There are several reasons for this. In the first place the section, both in its original and amended form, contains a number of ambiguous provisions which have been and probably will be the source of extensive litigation. I have in mind, for example, such provisions as that contained in section 77 (b) (4) which requires that a plan "shall provide for fixed charges . . . in such amount that, after due consideration of the probable prospective earnings of the property in light of its earnings experience and all other relevant facts, there shall be adequate coverage of such fixed charges by the probable earnings available for the payments thereof." Second, it has had the effect of requiring debtor railroads to produce plans of reorganization which would obviously not merit the serious consideration, let alone the approval, of any substantial part of the security holders. Third, by giving to the Interstate Commerce Commission such broad powers to deal with reorganization plans, it has put creditors in the frame of mind of trying to guess at the probable requirements to be applied by the Commission in determining whether to approve a plan of reorganization. Consequently, much time that might profitably be spent in trying to arrive at a basis of reorganization, which will be acceptable to substantial groups of creditors, is spent in debating such points as whether the Commission will or will not favor the issuance of fixed interest obligations in a particular instance; whether it will sanction income bonds or will require preferred stock; whether it will or will not sanction cumulative features, and, if so, what kind; what, if any, sinking fund features it will require, etc., etc. Meanwhile, although the Commission through its examiners has been holding hearings on various plans of readjustment, no clear-cut precedents have yet been developed as to what tests will be applied to a proposed plan in determining whether it shall have the Commission's approval.

This is an unhealthy situation. As Commissioner Eastman long ago pointed out: "The bankers and lawyers and security holders by whom reorganization plans are evolved ought fairly to have, in the process of their bargain and trade, some guide as to what we will or will not approve."

Without expressing any opinion as to the soundness of the general framework provided for under section 77 of the Bankruptcy Act, the time appears to have come to raise the question

whether, if reorganization plans proposed under that framework are to be scrutinized by some independent body before being submitted to the court having jurisdiction of the reorganization proceeding, it would not be better to create some quasi-judicial body other than the Commission to perform this duty. If the problem of reorganization under section 77 is as tremendous as it is generally conceded to be, it would seem that it might well be made the concern of some quasi-judicial body which could devote its entire time to the consideration of the problem.

Irrespective of whether this is done, however, it seems that the creditors are going to face a difficult problem in establishing to the satisfaction of any body the justification for their claims in reorganization proceedings. Already circulation is being given to the idea that the creditors are what one of my academic friends recently referred to as the "meanies" in the reorganization proceedings, because they have thus far turned up in opposition to the plans proposed by the equity holders, plans which for the most part propose to exact sacrifices from senior security holders, while substantially preserving the position of the equity holders. Before any such general condemnation is visited upon the heads of the creditors it would be well to recognize the difference in the position of the bondholder and the equity owner prior to bankruptcy. The former chose a limited return in exchange for what he regarded as a more secure position in event hard times should come knocking at the door. The latter assumed a junior position, in order to obtain what in most instances was the very real privilege of enjoying a rate of return substantially beyond that received by the bondholder. Perhaps if the bondholder could be made whole for this relative difference in return during the fat years, he would be more willing to consider sharing sacrifices in lean years. Beyond this it should be recognized that the claims of some classes of creditors are based upon something more fundamental than this idea of relative equity in rate of return. Here I have in mind particularly the life insurance companies.

The life insurance companies do not differ from the railroad companies in having to meet fixed charges. Under the terms of the contracts with their policyholders, they guarantee over long periods to create reserves with which to meet future claims. These so-called reserves differ from the reserves of commercial enterprises in that their amounts are determined by law and are based on a fixed rate of interest specified in the contract of insurance. Each year the value of a life insurance policy increases by this interest increment. The aggregate of these items for all the outstanding policies becomes the fixed charge of the life insurance company. We thus see that a most important requirement of the life insurance company's investment is stability of income. For this reason, it is essential that our investment portfolios consist as largely as possible of securities which either produce a steady rate of return or obligate the debtor to compensate us for any temporary lack of return by payments made out of greater earnings in subsequent years. Accordingly we cannot cheerfully acquiesce in the suggestion that all interest on income bonds issued in reorganizations be made noncumulative.

Another problem which is one of our concerns is that of management. We are interested in management, but we have no desire to become the managers of railroads. Our interest in the problem of management is sharpened by the fact that as we look back over the years we come to see that very often the statistics upon which we relied reflected the activity and enthusiasm of a man or group of men, rather than a basic condition in a particular territory. Accordingly we have come to realize that no matter how good the economic conditions in a region served by a railroad may be, the results obtained on that road can always be made better if it is operated by men who bring to the job experience, energy and enthusiasm. This viewpoint is emphasized, too, by our relations with the railroads in trouble. It is a most disheartening experience to have to deal with managements which, while cash is low, assure you that their hearts bleed for the creditors, and that their roads are adequately maintained, so that if gross revenues increase they will undoubtedly be able to pay something, only to find that just as soon as gross revenues and available cash increase, those same managements come forward with programs for extensive improvements, which are then described as absolutely essential. Such a situation can easily provoke an investor to the point of thinking that, if his interests are to be protected, he

ought to become an operator. Notwithstanding such provocations, we have wisely, I think, refrained from trying to assume any such position.

In conclusion, it may be said that the investor is today more keenly aware, than he was a few years ago, of how many problems are involved in the railroad situation. He realizes his inability to jump in and solve them all by himself. He sees that the situation calls for greater coöperation than ever before between all of those who have a stake in the present and future of railroads. He would like to continue to have an interest in railroads, but whether he will feel it possible to do so depends upon the creation of a more satisfactory condition in the railroad industry generally than is now apparent.

Remarks by the Chairman

MR. ELIOT WADSWORTH: I am sure we appreciate very much this discussion of the attitude of the investor who, after all, was the founder of our railroad system over a long period of years. We now have just a half hour left of this meeting, according to the schedule laid down by the Committee, for brief remarks under the ten-minute rule. I am going to ask Dr. Carson S. Duncan, who has had wide experience both here and abroad in the railroad field, and who is now the economist of the Association of American Railroads, to give us his opinion of the papers presented at this session. Dr. Duncan! (Applause)

DISCUSSION: THE RAILROAD SITUATION CRITICALLY ANALYZED

DR. CARSON S. DUNCAN
Economist, Association of American Railroads

THERE is no reason why I should know more about these papers than any one of you, for those who read them refrained from having advance copy available. Therefore, I can only comment upon certain points which particularly interested me as I listened to the speakers.

Concerning the first paper, may I say that the fundamental question certainly is: How far shall we permit laissez faire to control our attitude toward transportation management? If we turn the clock back to 1906, as was proposed, we shall have to repeal many legislative enactments, all of which were originally proposed in the name of public interest. Each one, therefore, should be tested, on the basis of our experience, to determine whether its continued enforcement is in the public interest.

The rate controversy is a perennial one. There is no formula by which a just and reasonable rate can be determined in every case. Questions arise concerning individual rates, combinations of rates, and general rate levels, but none of these questions can be answered unless we know whether the sum total of rates applied to the traffic volume will result in an income sufficient to support the transportation agency. That is about as far as we can go.

I think that we can all agree that wages should be fair. We can also agree that there should be an adequate return in service for a fair wage, and that there should be no disruption of essential transportation service because of disputes over wages. But who shall determine what constitutes a fair wage? How can it be determined so that both parties, the payer of the wage and the receiver of the wage, will accept the verdict?

Certainly, I am convinced that there is valid objection to making one agency of transportation an experimental labora-

tory for social reform, so long as its competitors are exempt from such experimentation.

With the views set forth in the paper on competition, I am in substantial agreement. Competition, of course, means a duplication of facility. What has been called the "public attitude" during recent years may be summarized very briefly: the greater the competition in the transportation field, the more reasonable the rate. And yet, competition, if unrestrained, will inevitably lead to too many facilities.

The suggestion has been made that there should be coördination which, as was explained this morning, means that all agencies of transportation should work together for a common cause. If coördination is not properly guided, however, it will lead to monopoly, which the public will not tolerate. Therefore, as I see it, what is needed is a combination of competition, without wasteful duplication, and coördination, which stops short of monopoly.

I am convinced that regulation might achieve fair competition within a given transportation agency, if the terms of regulation are just. The difficulty, however, is that competition from outside will remain unfair and unjust until regulation is applied so that it reaches down to the right of way—what I call the grass roots—of every agency.

There is much to be said, in my judgment, in favor of the accumulation of adequate reserves by the railroads, but, obviously, in these lean years the time is not right for such a policy. I have frequently suggested that the railroads came too early. Management had not yet conceived that ingenious idea which was later applied to our public utilities, whereby the telephone company, for example, fixes a minimum rental, while the phone is disconnected during the subscriber's summer vacation. With gas and electricity the same "standby charge" is used. If the railroads had come at a time when such a charge could have been made, they would have had a basis for reserves. They came some years too early.

I want to say only a word with respect to another feature. I hope that this great Academy will at some future meeting permit some railroad executives to speak of the problems they see in the financial management of other industries, and then we will get both sides of the picture. (Applause)

What is the investor's interest in the railroads? Of course, as an individual, or as an institution, the investor is interested in security and a fair return. I assume, therefore, that institutional investors, whether banks, insurance companies, schools or other institutions, will have in their portfolios, side by side, railroad bonds, and bonds issued by states, cities and counties, and that some of those government bond issues will represent the construction of highways paralleling and competing with the railroads.

In 1932 there were over one and a quarter billion dollars' worth of state highway bonds outstanding. In 1931 more than one and three-quarters billion dollars were invested in county and bridge bonds, and in 1932 there were over one and a half billion dollars' worth of city street bonds outstanding, a total of more than four and a half billions of dollars.

The investor in an individual security of a railroad is interested in its earning power. The investor in a government bond is interested in the taxing power of that government unit. Therefore, behind this financial problem, as the situation is today, stands the competition between private credit and government credit, and it is my contention that private credit, for fixed investment in the highway, has been dead since the last toll road, and for investment in waterways, has been dead since 1882, when the last toll was removed.

PART III

TRANSPORTATION PROBLEMS AND SUGGESTIONS TOWARD A CONSTRUCTIVE SOLUTION

INTRODUCTION

THOMAS W. LAMONT
Of J. P. Morgan & Co., *Presiding*

FIRST of all, I want to say one word in tribute to the memory of the late George A. Plimpton. From the foundation of this Academy, and till the time of his death, he was the treasurer of this Academy, one of the leading citizens of this city, a noble man, without whose coöperation the upbuilding of the Academy could never have attained its present level.

Next, I want to express the thanks of the Academy to these distinguished men on either side of me, who throughout the morning and afternoon sessions today have given us of their effort in the fine papers which they have presented. They have left their offices, they have left their professorships, they have left their several callings, and have brought to us new light on this problem of railroad transportation in America.

Third, if you please, I should like to take you into my confidence, and to explain that shortly before the election, the "High Command" of the Academy asked me to throw a light note into the proceedings of the dinner. They explained that the dinner would fall very shortly after the election, and that they feared that a number of those present might be feeling a sense of gloom. As a matter of fact, I have never faced, it seems to me, a less gloomy audience. The reason is that we are all agreed, as I think, that we have every confidence in the sobriety, industry and common sense of the American people and in the destiny of this country. (Applause)

Now, Mr. Eastman, I don't know whether or not in Washington they ask you to throw a light touch into your deliberations, but I can assure you that it is a disconcerting request. It reminds me of a recent experience in London, where I attended a banquet of considerable size. They had been kind enough to give me a seat on the dais, and toward the end of the speech-making, the chairman arose and said, "We wanted to call on our American guest for a speech tonight, but we didn't give him time for preparation, so, all we will ask you to do, Mr. Lamont, is to arise and tell us a droll story." (Laughter)

Perhaps I may be permitted now to drop back into the slow and stodgy talk that bankers are famous for the world over, and, if I may, I should like to allude to three forms of transportation which I utilized in a recent trip to South Africa. That is a land of great beauty and great delight, full of thrilling experiences, a land that reminded me much of the America of years ago in its earlier days. As you approach Capetown, eighty miles at sea, you see Table Mountain looming up, and then you come into the beautiful harbor and take that Blue Train northward to the Transvaal. Before doing that we motored over the lofty mountains which almost completely surround Capetown, with the Indian Ocean on one side and the Atlantic Ocean on the other. Going over one of those high mountains I was impressed by the excellence of the engineering. The road had taken advantage of every possible slope and contour of the mountain. It was beautifully done, and I turned to my host, who was driving me, and said, "Who were the engineers of this highway?" His reply was: "This is the old elephant trail. We simply took the elephant trail that dated back a thousand years and enlarged it into the highway." Well, we have no elephants here, but to our American railway engineers I can commend the elephants in their wisdom as wonderfully equipped for finding the best way over difficult mountain passes!

We took that Blue Train, not like the Blue Train that goes from Calais to the Riviera, but still very comfortable indeed, and landed in Johannesburg, where our host, General Smuts, met us. Up to that point, the railroad transportation had been excellent, but from that point on the schedules were very slow. I found that we should not have a chance to view the beautiful

Victoria Falls of the Zambesi unless we hastened on our way. So I succeeded finally in chartering a large airplane and invited General Smuts and his family to accompany us on that two-thousand-mile trip to the Victoria Falls and back.

I had a little misgiving, to tell the truth, about flying in South Africa. I had not flown in America. It seemed curious to start my career in a strange land, so I asked a business friend in Johannesburg to be good enough to check up behind the scenes and ask about the safety devices, landing places, and so on. He called the manager of the airways and said, "You know you have quite a valuable cargo, both General Smuts, member of the Cabinet, and his family, and the Lamont party. We want to be sure that there is no danger." Whereat the manager indignantly retorted: "Danger! Danger! Do you think we would risk a £20,000 airplane if there were any danger?" (Laughter)

So we went to Rhodesia, a land named after that great man, Cecil Rhodes, who, despite all his faults and mistakes, had a great spirit that still broods over South Africa. We can picture him in his dying moments, as he sat in that house of his on the slopes of Table Mountain, overlooking the Indian Ocean on the one side and the Atlantic Ocean on the other, saying with almost his last breath: "How little done, how much left to do!"

Thus we tested transportation by rail and by airplane. The third form was by motor car, when General Smuts took us to the Kruger National Park where all the wild animals of Noah's Ark roam in their native habitat. The trip was a unique experience! Perhaps the most interesting and thrilling part of it was at night, after the Kaffir boys had finished cooking our supper in their very excellent way, when we would sit down by the campfire under those southern constellations, with the lions roaring outside the stockade and the hyenas snarling under the river bank. Then General Smuts would talk to us of war and peace, of art and love, of botany and anthropology and geology, and everything that was interesting in the world. He was a man of great spiritual force, who had performed great deeds for his country and for the British Empire. He was one of those who believe that even if right be worsted, wrong will not triumph. In the present condition that confronts the world, he felt and said that though fear and hatred seemed to be enthroned on many of the high seats of the mighty, nevertheless, good will and coöperation would finally prevail and right would come into its own.

Our first speaker this evening is Mr. Joseph Eastman, a graduate of Amherst College, which has mothered so many brilliant sons, among others, George A. Plimpton, whose lamented death we have noted, Calvin Coolidge and Dwight Morrow. It was through my friend and partner, Dwight Morrow, that I first heard of Mr. Eastman, and was first drawn to notice the qualities that have brought him so far. Some years after his graduation Mr. Eastman became a member of the Public Service Commission of Massachusetts, where he had a notable career. Later he was called to Washington, and became there a leading member of the Interstate Commerce Commission. There has been no man more indefatigable in his efforts to solve the complex railway problem than Mr. Eastman, no man who has worked so hard or has shown quite so much ingenuity as he has in gathering the masses of facts that have to do with the administration of his office, no man who in the office of Coördinator—and I must voice the feeling of a great many, Mr. Eastman, when I say that we are very sorry that the office lapsed—could possibly have accomplished as much as he did, crippled though he was in so many different directions by laws that were rather narrow, and by labor problems that were insoluble at the time.

We appreciate very much his willingness to speak to us this evening, and we give our most cordial greeting to Mr. Joseph Eastman of the Interstate Commerce Commission. (Applause)

TRANSPORTATION PROBLEMS AND SUGGESTIONS TOWARD A CONSTRUCTIVE SOLUTION

JOSEPH B. EASTMAN
Member of the Interstate Commerce Commission
Former Federal Coördinator of Transportation

THE subject which I have been asked to discuss is rather appalling. " Transportation problems " cover an enormous territory. For instance, I have a profound conviction that human legs are not used as a means of transportation to the extent that they should be, and at the other end of the scale scientists are now actively working on transportation to the moon. For these problems I am to suggest a " constructive solution ". I confess that I have come to dislike the word " constructive ". It has become the accepted means of answering criticism, when all other means fail. The critic is " destructive " and not " constructive ". Yet long ago it was discovered in the Ten Commandments that the best solution for many human problems is purely " destructive ". In short, cease and desist. (Laughter)

The fact is, also, that for many of our problems there is no real " solution ", and transportation is no exception. Conditions will not stay put long enough to give the remedy a chance. The problem is continually shifting and changing form. It is like trying to solve the weather. Nevertheless it is right to work on these problems. We may not solve them, but we can at least do something to curb abuses, promote healthy growth, and keep change moving in what we deem to be the right, instead of the wrong, direction.

The magnitude—perhaps " enormity " is the word—of the subject is alleviated by the fact that my knowledge of it is limited. I speak from the point of view of a government official, neither blessed nor afflicted by private enterprise and initiative, who has lived at the expense of the taxpayers for a long time and has been trained in the school of regimentation. You can take what I say accordingly. (Laughter) I should say, also, that I speak for myself. I am not undertaking to voice the opinions of the Interstate Commerce Commission, or of any member of that body except myself. Furthermore, in the course of my remarks I shall have occasion to make various categorical statements which lack of time will not permit me to support. However, I stand ready and willing to provide the necessary support, whenever occasion may require.

Of course the government always has been a great factor in transportation, and properly so, for the well-being of the community is wedded to transportation. Our Supreme Court indeed has said that railroad companies perform a "function of the State". Although the actual carriage has been left to private enterprise, public funds in tremendous amount have gone into transportation facilities, including the vast system of streets, roads and highways; canals, waterways and harbors; airports and airways; urban subways; and even ships and railroads. The total runs into many billions of dollars. In the early days many of the railroads could not have been built without public aid. Our wonderful system of highway automotive transportation was made possible by the great governmental expenditures on public roads. Much the same is true of a large part of our water carriage. Our system of airways, which is developing so splendidly, was initiated by the federal government and is still dependent on public aid. At the last session of Congress an act was passed providing for a system of public subsidies to build up our merchant marine.

We owe a great deal to private enterprise and initiative in the development of the transportation which we now enjoy, but I suggest that we owe a great deal to public enterprise and initiative as well. The wish is often expressed that the government would keep its hands off business, but in the transportation business no one really wants that wish to come true, at least not when the hands are loaded with funds. During the recent depression, it was public funds which kept many railroads out of receivership and bankruptcy, and which enabled many to carry on with construction and maintenance work. Most, I think, of the new stream-lined or electrified passenger trains would not now be running, if it had not been for the timely aid of public credit.

But, as you know, the government does not stop with financial aid to transportation but undertakes to do, as well, some regulating. We did not start off that way, and it is important to understand how it came about. In the early days, the idea was to encourage the building of as many railroads as possible and depend upon competition to do the regulating. The men who ran the railroads were typical American entrepreneurs. There were a few men of genius, many of excellent capacity and force, some with public spirit and principle, others not strongly characterized by these qualities, and a substantial percentage of poisonous rascals. It was quite common to regard government as a necessary evil, to be brought under suitable control, the end justifying the means.

It was found that this system did not work over well, and it brought trouble both to the railroads and to the public. The states began to try regulation and eventually, fifty years ago, the federal government created the Interstate Commerce Commission. Perhaps the greatest trouble was that uncontrolled competition worked very unevenly. The major benefits went to the big communities and shippers that had the most traffic to offer; lesser communities got lesser benefits; and the little communities, unfortunate enough to have no competition, got what the railroads called "normal rates". It was the day of rebates and all manner of special rates and concessions, continually changing, and no man knew what his competitor was paying. At the same time the railroads were cutting their own financial throats in the process.

The first evil which the government undertook to eradicate, therefore, was the evil of unjust discrimination, and incidentally the evil of exorbitant charges to those not favored with competition. While the primary purpose was protection of the shippers, a secondary effect was protection of the railroads. As time went on, other abuses were attacked. It was found that competition and the financial necessities of weak roads, coupled with some unscrupulous managements, made it difficult to secure the uniform introduction of air brakes, automatic couplers, and like safety devices. The strong hand of the government was used to bring this about. It was found that many unnecessary roads had been and were being built, to the damage of all; that constantly recurring car shortages could or would not be cured without government help; that it was a too common practice to extract profits through financial exploitation, instead of operation, and that government control was needed to protect both investors and the general public from the resulting damage; that the laws designed to preserve competition to the last degree ought to be relaxed, but in favor of supervision over the process of unification.

This is by no means an all-inclusive summary, but it indicates how the system of public regulation gradually expanded, not arbitrarily, but because of known evils and at the behest of public opinion. At first the railroads resisted this expansion, but it is a matter of much interest to me that when the culmination was reached in the Transportation Act, 1920, it had, on the whole, the support of the railroads and the financial interests of the country. If you think that the culmination was not reached until 1933, in the Emergency Railroad Transportation Act, you should remember that that Act was conceived by a group of investors in railroads and received the support of the railroad managements, at least until the labor amendments were added. It is of equal interest that a stronger demand for federal regulation of motor carriers, provided for in 1935, came from the railroads and even the motor carriers themselves than from the public served.

Until 1920, or thereabouts, the railroads dominated the transportation scene, and transportation problems were very largely railroad problems. But the scene has shifted, and very greatly. You know of the extraordinary development of competing forms of transportation, by highway, by water, by air, and underneath the ground, a development which is continuing with accelerating rapidity. It has changed our transportation problems, in important respects, very radically, and we have all had to stop and take note.

In my judgment there is something, by way of a "constructive solution", for the carriers to do, and also something for the government to do. Perhaps I ought to speak only of the part to be played by the government, but with apologies to Mr. Bledsoe I shall say a word about the carriers' part too. Let me get that off my mind first.

In view of the great growth of competition and the frequent oversupply of facilities, the market for transportation has become distinctly a buyers' market. There has in the past been a tendency, I am afraid, to regard it as a sellers' market, in which those served had to take what was offered at whatever price was set, and this tendency was strengthened by public regulation. Until very recently, many apparently believed that the only thing which set a limit to railroad earnings was the Interstate Commerce Commission. This was particularly true of investors and in the New York financial district. It was not true in general of the active managers of business enterprises, or even of many of the railroad officials who were in closest touch with the service. The latter were at times impelled, I think, by the sentiment emanating from above to act contrary to their better judgment.

Discussion centered around the Commission, on the theory that all railroad ills could be cured if only the prices for their services were made sufficiently high. The Commission was the devil that stood in the way. It was not even appreciated, until long after 1920, that the unforeseen factor which was eating into earnings was the rapidly progressing slaughter of the passenger traffic by the automobile and the more gradual invasion of the freight field by the truck. The Commission itself was slow to recognize the facts.

As matters now stand, and are likely to stand for some time to come, the railroads and the other carriers are more nearly in the situation of ordinary competitive business. They must cater to the consumer, study his needs and wishes, and try to give him the service which he wants at the price which he is willing to pay. Success will go to those who can create new traffic by giving continually better service at lower prices. The fact is that there is no fixed amount of transportation to be performed, but instead an amount whose limits are dependent only on the facilities afforded and the price of service. The practical problem for the carriers is to tap the huge reservoirs of potential traffic and swell the volume of their business.

It is no more than all business must do, if we are to solve the problem of unemployment. The hope of averting disaster, as science marches on in the creation of labor-saving mechanisms, lies in using them to reduce costs and prices in the way which will greatly expand the consuming market. In no other way can the ability to consume keep pace with the ability to produce. If labor-saving mechanisms cannot be so used to increase consumption, they might better be thrown on the scrap-heap at the outset.

The task for the railroads and the other carriers, therefore, is to fit their service and their prices to the needs, desires and purses of their present and potential patrons. They must be eternally on the alert to improve operation, service, equipment and rates, take advantage of everything that modern science has to offer, and cut waste out by the roots.

For three years it was my duty, as Federal Coördinator of Transportation, to examine into the operations of the railroads, with particular reference to waste. My efforts were not wholly appreciated by the executives or by the employees, but I know they were conscientious, and I think they were useful. Of three things I am certain. One is that railroad service, equipment and rates have not, in many respects, been well adjusted to the new conditions, and that there are large opportunities for gains in traffic and revenue, as and when they can be better adjusted. Another is that each type of carrier can do certain things better than the others, so that in many situations they can be used to great advantage to complement or supplement each other. The third is that the railroad industry, as now organized and conducted, does many things uneconomically and wastefully, because of the great number of separate companies and their frequent failure to work together where their real interests are not in conflict.

My thought has been that the industry should be organized much like the United States, so that the larger matters of common concern could be dealt with by centralized and concentrated effort, leaving the individual managements a free hand with local matters; and also that the federal government could lend valuable aid in promoting such coördination. The Association of American Railroads reflects a somewhat similar thought, with the federal aid left out. There are others who believe that the results desired can be had only by concentrating railroad properties into a very few hands, through consolidation or union in some other form. I doubt that this can be done without compulsion by the government, and whether its power should or will be so used. However, those who are persuaded that this is the only practicable plan should not hide their light

under a bushel, but come out into the open with concrete proposals.

Let me add a word or two of caution. The carriers must know and give heed to the costs of their services. It will not do to slash rates regardless of costs to meet competition, on the old theory that somewhere and somehow other traffic can be made to carry the load. The idea that it is good business to take competitive traffic at a margin over so-called out-of-pocket expense is dangerous and delusive, if extended beyond narrow limits. Various reductions in rates are much to be desired, but the vital thing is to get costs which will justify the reductions.

The best hope that employees can have for a transportation system that will continually employ more men lies in one which will, through better service and lower costs and prices, continually build up the volume of business. It does not lie in artificial means of making more work which will add to costs, stand in the way of better service and lower prices, and stifle traffic. Make-work schemes will in the end be suicidal for the employees themselves.

Investors, particularly in bankrupt properties, should bear in mind that good credit is essential to railroad success. They have more to hope from a reorganized property which can face the future with good credit prospects than from one which gives greater paper recognition to their claims at the cost of a sound financial structure.

So much for the carriers. What are the things which the government should do? I have shown you how and why public regulation of the railroads developed. Similar reasons now exist for regulating all of the carriers. The extraordinary growth of competing forms of transportation brought with it the old, familiar evils. There were the same cut-throat competition, the same instability and uncertainty of rates, the same secret discriminations, the same threat to responsible operators from those who were unprincipled and irresponsible, the same difficulty in protecting working conditions and the public safety, and the same tendency to multiply new operations beyond any public need to the damage of all. Looking ahead, there was the same danger of financial exploitation as larger systems were put together capable of issuing securities which could be sold to the public.

A good start in rounding out the system of public regulation was made in the Motor Carrier Act, 1935, and I hope that the same thing can be done for the water carriers and the air carriers. Many of them recognize the need. Plainly, also, the way to secure equal, impartial and well-coördinated regulation of each type of carrier is to give a single commission the same duties and responsibilities with respect to them all.

This brings up one of the difficulties and defects of public regulation. It is a cumbersome, time-consuming process, often exasperating in its delays and in the expense of its procedure. The carriers and their lawyers are in part responsible, because they seize every opportunity to secure a court review of adverse decisions. The commissions must protect themselves against such appeals by careful judicial procedure, the making of full and open records, the writing of detailed and explicit opinions, and the avoidance of anything that savors of arbitrary action. This lesson has been learned by harsh experience.

Nevertheless, procedure can be improved, and one of the essentials is the best possible organization and system of administration. If the Interstate Commerce Commission is given duties and responsibilities with respect to all types of carriers, this will become a matter of much moment. My belief is that the Commission will have to be reorganized to do the job right, and I have proposed a definite plan. My plan may not be the best, yet I am confident that some plan will be necessary.

It is often said that the railroads are hog-tied by regulation and deprived of initiative in management. This is far from the fact, but I agree that regulation should be held to the minimum which the public interest requires. If the railroads, or anyone else, can show that some of the present regulation serves no useful purpose and is an unnecessary nuisance, it ought to be abandoned. This afternoon I heard Judge Fletcher discuss two features of the Transportation Act, 1920, the consolidation plan and the recapture clause, which he condemned rather strongly. Neither one of them came from the Commission. I think that they came from the investors. The Commission recommended the repeal of the recapture clause, and it was repealed in 1933. It also recommended repeal of the consolidation plan provisions, but without success. When I was Coördinator, I asked the railroads for a specific showing

as to unnecessary regulation, but what I got was not impressive. Their requests for relief were surprisingly few. Now they are seeking freedom from the qualified prohibition against charging more for a shorter than for a longer haul over the same line or route. I think that what they ask would be a reversion to the jungle, but such concrete issues are to be welcomed in contrast with the usual generalities about the hardships of regulation without specific proposals for their alleviation. Doubtless, there are instances where regulation should be eliminated or modified. Let us have the specific proposals.

The great problem which public regulation faces arises out of the competition between the different types of carriers. Each has its points of superiority and inferiority. If a single management were in charge of all transportation, it would use the various means according to their economic merits. I am satisfied that the country does not want any single management, and that it wishes reasonable competition to be preserved. The government must see to it that competition does not take on unfair and destructive forms, and that the operations of the various types of carriers are combined and coördinated where that will serve the public interest best. No one save the government can do this.

Modern science is developing means of transportation so fast, and the government has so great a stake in transportation, even financially, that it should, I believe, deal with transportation problems in still another way, in addition to the present system of regulation. The Interstate Commerce Commission is distinctively a tribunal, set up to deal with controversies and specific matters, and its time is fully occupied by this quasi-judicial and administrative work. There is need for a department, not so engrossed, which can keep in close touch with the transportation situation, watch developments, study the larger problems, foresee dangers which are impending, promote the cause of coördination, and advise both the President and the Congress in regard to transportation policies. Many countries, notably Great Britain, have a Ministry of Transport which functions in this way and also performs strictly administrative duties with respect to transportation which are scattered in our own government among a large number of bureaus. The establishment of such a Department of Transportation here is worthy of consideration. My own inclination is to prefer a nonpolitical, independent agency, associated with the Commission. However it may be worked out, the general idea has, I believe, much merit.

You may be anticipating, in view of my past record, a word on public ownership and operation. I hope to see the time when that subject can be discussed as the purely practical question which it is. Railroads perform a public function, as the Supreme Court has stated, and we would not be embarking on Communism if our government took over that function directly, as many other countries have done, instead of entrusting it to private enterprise. It is only a question of the practical way to get the best results. After many years' experience in government service and opportunity to observe some large branches of private enterprise rather closely, I do not doubt the practicability of running the railroads as a government enterprise under men of excellent character and capacity and without political corruption. There would be danger of ill-advised legislation affecting the enterprise, but no more so than now. The divided responsibility and cumbersome character of the system of private ownership and management combined with public regulation have inclined me toward direct public ownership and operation with responsibility concentrated in the government.

The staggering difficulties of taking the properties over on terms fair to both the private owners and the government and the fact that the railroads are now only one of the important means of transportation are complicating factors which justify doubt as to the wisdom of public ownership and operation under present conditions. I am not now urging it. It is not impossible, however, that the time may come, as it has come in other countries, when the system of private ownership and management will break down for reasons beyond control. It is not unwise to give some thought to that possibility, at least to the extent of considering the best possible plan for public ownership and operation, if it should become necessary.

Let me say in closing that I feel that the carriers—all of them, railroads, motor carriers, water carriers and air carriers—are now showing a general disposition to grapple boldly with

their problems with commendable zeal and enterprise. The free advice which I have volunteered in these remarks has been tendered in no critical spirit. We are all working for a "constructive solution" of transportation problems, and I have only been offering a contribution to that end for what it may be worth.

Remarks by the Chairman

Mr. Thomas W. Lamont: Thank you, Mr. Eastman. I am sure that we have all noted with satisfaction that the representative of the Interstate Commerce Commission has a sense of humor and a sense of proportion. I wonder whether those qualities in public office do not transcend in importance many other qualities. Fortunately Mr. Eastman also possesses the others in great abundance.

As our second speaker, I am going to introduce to you Mr. Samuel T. Bledsoe, the head of the great Atchison, Topeka and Santa Fe Railroad.

I do not know whether the Santa Fe was built by the entrepreneurs to whom Mr. Eastman has referred, but if it was, they did a good job eventually. It covers a vast territory, traversing thirteen states, and upon Mr. Bledsoe's shoulders rests a great responsibility, which he has discharged with consummate skill. He is a native of Kentucky, and he knows the whole region of the Mississippi Valley, and the Southwest, through his early experiences there as a lawyer and his later career as a railroad official. He has long been prominent in the councils of the railway executives. There is no more welcome figure in New York than that of Samuel T. Bledsoe, whom I have the pleasure of presenting to you. (Applause)

CONSOLIDATION AND COÖRDINATION PROBLEMS

SAMUEL T. BLEDSOE

President, The Atchison, Topeka and Santa Fe Railway Company

I HAVE selected for discussion certain problems arising in connection with consolidation and coördination of railroads, and particularly those relating to coördination of railroad terminals.

Coördination of railway properties and facilities commenced almost with the beginning of railroad construction. The elimination of different gauges and the adoption of standard gauge for tracks represented coördination. The establishment of every one of the many thousands of freight and passenger stations, which serve more than one railroad, was an act of coördination. The great railroad systems of the country, without exception, were created through the coördination of a large number of small, independent railroads. Coördination historically has been the fruit of the business judgment of railroad management. In many respects it has been accomplished with the aid, but seldom under the pressure, of public authority. In fact, in many respects it was impeded by restrictive statutes of the states and by federal statutes relating to trusts and monopolies.

During the period of federal control there arose a theory that the railroads of the nation should be consolidated into a limited number of great systems. As a result Congress, by the Transportation Act of 1920, required the Interstate Commerce Commission to plan such systems and to allot all railroads to them. To facilitate the preparation of a tentative consolidation plan, the Commission employed Professor William Z. Ripley of Harvard to prepare and submit to it a suggested grouping of the railroads, and caused his report to be published, with some modifications, as a tentative plan for the consolidation of all the railroads (63 I.C.C. 455). The comments of the several members of the Commission indicated clearly that the tentative plan was submitted only as a basis on which to make a full

record upon which a final plan could rest, without prejudgment of any matter which might be presented in that record.

Hearings on this plan were completed December 4, 1923. The record consisted of almost twelve thousand pages of testimony, much of which was conflicting. The Commission found the difficulties involved so great that instead of proposing a final consolidation plan it recommended to Congress in 1925 that it be relieved of the duty to prepare such a plan. It repeated the recommendation in 1926, 1927 and 1928. It was not until 1929 that, obviously realizing that such relief would not be forthcoming, it adopted a nineteen-system plan, subsequently (in 1932) reduced to eighteen systems.

It should be realized that the Commission's plan was little more than a mere gesture. In reporting it the Commission stated:

> Section 5 (5) provides that after we have adopted a plan, as we here do, we may, either upon our own motion or upon application, reopen the matter for such changes or modifications as in our judgment will promote the public interest. Such applications will afford opportunity for further consideration upon adequate and recent records of the various parts of the plan.

One of the commissioners, in a separate concurring opinion, said:

> Although I do not approve of it in important respects, I concur in the adoption of the consolidation plan above outlined because it has many good features, because it is necessary under the law to adopt some plan, and because it is not very important, after all, whether or not it is the best plan that could be devised. We may modify it at any time hereafter, and no consolidation for which it provides can be accomplished until we have found, after full hearing, that the public interest will be promoted thereby.

It will be observed that from the passage of the Transportation Act of 1920 until the announcement by the Commission of its consolidation plan, on December 9, 1929, the law forbade the consolidation of railroads in the United States into single systems for ownership and operation. The announcement of the Commission's plan, therefore, did not remove the statutory bar to such consolidations until after the financial crash of 1929, and no consolidations under the Commission's plan have been effected. It is a matter of mere speculation as to what would have occurred had the Commission's plan been announced during the so-called boom, and at a time early enough to permit the formulation and completion of consolidations before the October 1929 crash. It can be stated with some confidence, however, that even had the crash not occurred, many of the specific consolidations prescribed by the Commission's plan would not have been favored or attempted by many of the railroads which would have been affected. Some, probably all, of the eighteen systems included railroads with demonstrated lack of earning power, and many included lines that really should not be consolidated with any system, but should be abandoned. I have not been able to discover in connection with many of the proposed systems what benefit they promise to strong lines in exchange for the permanent and continuing sacrifices which their adoption of lines known to be valueless would involve.

The Transportation Act required that in the grouping of the railroads competition should be preserved as fully as possible; wherever practicable, existing routes and channels of trade were to be maintained; and the several systems were to be so arranged that the cost of transportation between competitive systems, and as related to the values of the properties through which the service was to be rendered, should be the same. As theory this of course is attractive, because one assumes that the process is one of equalization of cost through increase in economy. It should not look to equalization through increase of cost, yet ordinarily such an increase will be the natural result, if major lines in stronger earning position are to be burdened with the difficulties of the weaker lines.

I would hesitate to say that no such system will be created in the relatively near future, and while under present conditions the Commission's plan as a whole certainly could not be consummated even if it had the supporting confidence of the Commission and that of the industry, both of which it seems to lack, yet it must not be forgotten that Congress adheres to its policy favoring some broad consolidation scheme. Indeed, Congress expressly reannounced that policy in 1933 by amending section 5 of the Commerce Act so as to forbid acquisitions of control not in harmony with the Commission's consolidation plan.

The Transportation Act of 1920 drew a distinction between consolidations of railroads into single systems for ownership and operation, on the one hand, and acquisitions of control of one carrier by another by lease, stock purchase or otherwise. It forbade consolidations, as I have stated, pending the adoption of a nation-wide consolidation plan by the Commission. It did not forbid acquisitions of control but facilitated them by affording means to escape the impediment of restrictive state statutes and federal anti-trust laws, providing that neither should prevail against public convenience and necessity found and certified by the Interstate Commerce Commission.

Such acquisitions of control occurred frequently during the period following the enactment of the Transportation Act of 1920. During the ten-year period 1923 to 1932, inclusive, certificates of public convenience and necessity were granted by the Commission in a multitude of cases affecting nearly forty-one thousand miles of line, or more than 16 per cent of the entire mileage of road owned in the United States. The fact that during ten years the control of so large a part of the entire mileage of the country has been rearranged in such proceedings indicates that in the industry there is continually under way a natural process of coördination. It also leads to the serious thought that the industry will respond to its own needs and take advantage of its own opportunities, under the supervision of governmental authority for the protection of the public interest, with more certainty than can be expected as the result of a more ambitious nation-wide plan under which the industry is to be planned in advance and adjusted as a whole, rather than piecemeal. I do not wish to be understood to oppose the more ambitious plan in its entirety. Time may demonstrate the wisdom of much of what it proposes. I simply utter the word of warning that its wisdom as a whole has not been demonstrated, that the Commission itself is not wholly committed to it, and that the theory that such a plan will largely solve all railroad problems in all likelihood is fallacious.

Personally, I doubt whether the broad scheme for consolidation of all railroads into a limited number of systems will ever be carried into effect. I know, however, that there are some who may differ with me as to this, and of course the creation of some consolidations, less than all, can be visualized much more easily. Perhaps, therefore, extensive unification of terminal facilities, especially at great cities, should be approached cautiously until the outcome can be better known.

Most of the important terminal unification plans involve the abandonment of much property which would have to be surrendered at substantial sacrifice of value, and which, if surrendered, could not be retaken for railroad use except by the expenditure of almost prohibitive sums. Most of them require the assumption of great contractual obligations which could not easily be escaped or which could be escaped only with great injury to other railroads dependent upon them. Practically all of them involve substantial dislocation of, and consequent continuing obligation to, labor.

Indeed, it seems obvious that consolidation of units of railway service or facilities cannot be undertaken intelligently without according some recognition to the necessities of the railroad systems to which such unifications would be appurtenant, if the policy demanding the creation of such systems is to be taken seriously.

On June 16, 1933, there became effective the Emergency Railroad Transportation Act, one of the purposes of which was to encourage and promote or require action on the part of the railroads designed to avoid duplication of services and facilities and to promote the joint use of terminals and trackage incident thereto or required therefor. The Act created the office of Federal Coördinator of Transportation, divided the carriers into three great regional groups, and prescribed the establishment of regional coördinating committees representing the carriers of each group, with the duty to carry out on their own initiative the purposes of the Act, in so far as they could be voluntarily accomplished by the carriers. The Act further provided that in the event of the inability of such committees, legally or otherwise, to carry out such purposes by voluntary action, they should recommend to the Coördinator that he give appropriate directions to the carriers by order. The Act undertook to authorize the Coördinator in such cases to issue and enforce such orders, if he found them to be consistent with the public interest and in furtherance of the purposes of the legislation.

Section 7 (b) of the Act provided that the number of employees in the service of a carrier should not be reduced, by reason of any action taken pursuant to the authority of the legislation, below the number of employees in service during May 1933, after certain deductions, and also provided that no employee should be deprived of employment such as he had during the month of May 1933 or be in worse position with respect to his compensation for such employment, by reason of any action taken pursuant to authority conferred by the Act.

At the time of the enactment of this statute there were organizations of railway executives in each of the three regional groups engaged in studies of the same general character, in the main, as those prescribed by the Act, though not nearly so extensive as those subsequently undertaken by the Coördinator. While the express language of section 7 (b) indicated its applicability only to action pursuant to the authority of the Act, on August 7, 1933, the Coördinator addressed a communication to the regional coördinating committees, in which he agreed that it was not the intent of section 7 (b) to interpose obstacles to economies which carriers might be able to accomplish in the ordinary course of management, but declared it to be the clear intent of the Act that its labor restrictions should apply not only to economies resulting from action by the Coördinator but also to economies resulting from "the impetus given by the Government in the Emergency Railroad Transportation Act, 1933, to collective carrier action through the agency of the Regional Coördinating Committees which the Act created." Declaring further that the committees which were in existence when the Act was adopted bore the earmarks of a device to avoid the provisions of section 7 (b), he announced that he assumed jurisdiction over, and that he thereby made subject to the provisions of section 7 (b), all projects for joint action by two or more separately operated carriers involving unification or joint use of facilities of every sort, including terminal facilities.

Shortly thereafter, in a communication addressed to the Executive Secretary of the Southern Regional Coördinating Committee, under date of August 21, 1933, the Coördinator asserted his power, and his intention by his communication of August 7, 1933, to bring within the range of the labor restrictions of the Act all the projects to which that communication referred, including "future joint projects which might be accomplished without any resort to collective action by the carriers of the region through such organizations as the general committees and sub-committees working therein."

However serious the legal question as to the validity of this action of the Coördinator, the practical result was that, whether lawful or not, it prevented the possibility of early completion of any such proposed coördination. The effect of the labor provisions themselves was to confine the activities of the Coördinator to those incident to investigation and studies, and his action to which I have referred made it impractical for the carriers to proceed independently.

In his first report the Coördinator made the following statement with reference to this situation:

> It had the further result of bringing within the range of Section 7(b) practically all coordination projects involving labor-saving economies. Because of this situation, no orders have been issued and the Coordinator's work has largely assumed the character of research into the possibilities of coordination. (Appendix I, Coördinator's Report, June 16–December 31, 1933.)

There may be a general misapprehension of the nature and results of the researches which the Coördinator conducted. I shall discuss them briefly, not in a spirit of criticism but only for the purpose of pointing out that they have led to an exaggerated idea of the possibilities of economies that may be accomplished through coördination of terminal facilities. There seemed to arise the general belief, which still obtains in some quarters, that the Coördinator discovered and announced opportunities for enormous economies available to the carriers, if they were only willing to seize them. It was not, and probably is not now, generally understood that these studies were without finality and, as I shall point out presently, were largely speculative. Even high officers in other departments of the government fell into the common error of attributing to these studies the finality and credibility which they lacked. The then Solicitor General of the United States and other representatives of the Department of Justice, in a brief filed March 1935 in the Supreme Court of the United States, referred to the studies as "highly practicable opportunities for coordina-

tion" by which "economies of as much as $50,000,000 a year can be effected by coordination of terminal facilities alone", and distinguished these studies from "other large savings which have not yet been definitely computed." [1]

No doubt these studies do contain much information that may prove useful, and quite possibly many of them make proposals which might be discovered to be practical. But fundamental error underlies all of them with which I am familiar and discredits their promise of economies. To illustrate this I shall refer to the very important matter of the proposal for the unification of the Chicago terminals, studies as to which were conducted under the direction of the Coördinator's Western Regional Director. I am sure, however, that the Coördinator did not personally participate in the details of the coördination groupings.

The coach yard of a railroad should be close enough to its passenger station to avoid extensive switching, in order that promptly upon the arrival of trains passenger train cars may be placed in such yards to be cleaned, inspected and made ready for further service. Moreover, passenger train consists for the same trains differ on different days; frequently it is found necessary to add one or more cars of various types after a train is made up, to take care of an unexpected number of passengers or to take care of delayed or unexpectedly large quantities of mail or express.

The Chicago plan contemplates that the service and repair of the passenger power and cars of a certain important Chicago line, which are now performed at a location close to its own present tracks and depots, would be performed at a point remote from its present tracks and facilities located on another railroad some five miles distant. This would involve at least one hour of additional time and four additional miles of movement each way for every train. It would deprive this line of its present valuable flexibility in meeting emergencies in changing or adding to the consists of trains and in respect to bad order cars; it thus would seriously impair its service to the public; and it would substantially increase operating costs. I should add that the line under discussion would be required to

[1] Reply brief for Petitioners, Railroad Retirement Board *et al.* *v.* The Alton R. R. Co. *et al.*, No. 566, October Term, 1934, pp. 22-23.

operate its passenger trains over a route, already badly congested, into a station which even now is not well able at all times to take care of the business which it undertakes to serve.

It is very desirable that forwarding and receiving freight stations be at a single location. Freight train yards usually are located as conveniently as possible to the freight station, ordinarily in or adjoining the industrial area served. Thus loaded cars may be set promptly for unloading and empty cars may be moved promptly for loading. The inbound and outbound freight houses of the particular line I have mentioned are now conveniently adjacent to each other in the business district of Chicago. The Chicago plan proposes that these be so relocated that the inbound freight house would be about eleven miles from the outbound freight house, despite the impracticable and difficult and expensive operating situation which would result. The proposal would also involve the rerouting of that line's freight trains in the terminal in such fashion as to require several miles of excess switching over that now required to serve various team tracks, freight houses and industries. The Chicago plan further contemplates the rerouting of freight trains of the line in question for a considerable distance outside Chicago, making necessary an expenditure of over two million dollars to provide the necessary handling facilities.

It is not necessary that I discuss the Chicago plan in greater detail. It is a major proposal, of course, and naturally it gives rise to a greater number of objectionable features than do such proposals at points of lesser importance, but I believe some one or more of the objectionable features displayed by the Chicago proposal will appear in practically every terminal unification study, small or great, which I have considered.

In my opinion it is sufficiently apparent that individual interests have been largely disregarded. This is not accidental, nor does it arise from deliberate desire to put any line to disadvantage or expense. In great measure it is the natural consequence of the fundamental error, which underlies not only the Chicago plan but also every other terminal unification plan, with which I am familiar, resulting from a study conducted under the direction of the Coördinator.

This fundamental error lies in the fact that all these studies with which I am familiar were made upon the basis of the assumption that private ownership by the several railroads of their several facilities and properties should be disregarded in framing the projects, and in estimating economies to be expected therefrom. It was the specific direction of the Coordinator's staff that this course be followed by the railway executives assigned to this work by the regional coördinating committees, and these directions were obeyed.

I have been informed that the Coördinator believed that studies of this character would avoid the necessity that a substantial amount of time be given them by the chief executives of the railroads, and believed that such studies, when completed, would afford a basis upon which the Coördinator and the interested chief executives could give consideration as to how the matter of coördination could best be handled. While I think this approach to the problem was a mistake, I do not wish that statement to be construed as criticism of the Coördinator. He had a large matter to deal with, and no beaten trail to follow. Nevertheless, in my opinion this disregard of ownership, and disregard of the right of railroads to compensation for the use of their properties, created an unworkable standard, enhanced estimated economies, and resulted in conclusions, which could hardly be intelligently rectified by adjustment for the erroneous assumption on which they were made. Certainly, if ownership was ignored in order to facilitate further study by chief executives, the studies cannot be treated as credible till someone rectifies them.

In addition to this fundamental fault there are other reasons why the plans presented by these studies lack practicability. According to my observation, it was very seldom, in connection with such proposals, that there were any benefits accruing to one railroad to offset the loss of property abandoned, or to reimburse it for the use of its property by another railroad. I would add that lands acquired at substantial prices because of the desirability of their location for railway facilities would be of little value following abandonment.

Public convenience does not permit that scheduled hours of arrival and departure of either freight or passenger trains at important points shall be uniformly distributed throughout the day. Most travelers prefer to arrive early in the day and leave in the late evening, thus traveling at night. Most recipients of freight prefer to receive their shipments early in the day in order that they may be available for distribution on that day's market. The result is that during the early and later hours of the day there is a peak of traffic which must be handled in a terminal. This situation is made more difficult by the fact that both express and mail move on passenger trains and must be handled at the same peak periods. All of these facts seem to be overlooked or not taken sufficiently into account in some of the studies for coördination of terminals at important points.

The studies were based on traffic analyses confined to short periods, sometimes two months, sometimes one month, sometimes three days, two days, or one day. From such analyses hypothetical traffic volume and characteristics were computed or assumed. In my opinion it is doubtful whether the true situation can be arrived at in this way. Moreover, these studies were made at a time when business was at a very low ebb. Even the partial revival of business which has occurred since the studies were announced serves to disclose that the unified facilities proposed in some instances would not suffice to take care of the combined business which it is proposed they should handle. In 1933 freight car loadings of Class I railroads in the United States were only 56.6 per cent of those of 1928. This means that a terminal unification designed to take care of 1933 traffic volume would be subjected to a 76.7 per cent increase in service demand, if traffic volume of 1928 should be restored.

There are many other defects. Some relate to cost, some to expense, some to uncompensated surrender of property values, some to unreasonable competitive disadvantage. I shall not attempt to recite them. My purpose will have been served, if what I have said, and the illustration I have given, sufficiently emphasize the point I am making; namely, that one of the largest of the problems which stand in the way of terminal coördination is the difficulty of clearing the public mind of the belief that it is a field already fully explored, in which rich possibilities are already appraised, requiring nothing more than a willingness to do the things which it is erroneously believed the Coördinator has shown can and should be done.

My comments are not intended as criticism, unless criticism is to be implied from frank recital of the facts.

The situation cannot be depicted correctly without some further reference to the attitude of railroad labor. Railroad labor was quick to realize that savings resulting from coördination of facilities and unification of railway activities in large measure would be due to reduction in number of railway employees. Since section 7 (b), to which I have already referred, was temporary legislation which might expire on June 16, 1935, labor caused to be introduced at the last session of Congress proposals designed to assure permanent provision for dismissal wages or other allowances to employees displaced or disturbed by coördinations accomplished by the railroads under private management.

This demand went considerably beyond the relief accorded by section 7 (b). Many railway executives felt that there was merit in the principle underlying it, although I think it can be said they felt that it went farther than either principle or practical necessity would justify. However that may be, on May 21, 1936, an agreement was reached between labor and practically all the Class I railroads, establishing fixed rules for the treatment of labor so disturbed or displaced. I shall not go into the detail of this agreement further than to state that it provides, under stated formula, for alternative forms of what I may call, perhaps inexactly, coördination allowances.

While this agreement does not facilitate the coördination of terminals and terminal trackage—or, for that matter, any other coördination—it at least clarifies the situation by specifying the price which the railroads must pay labor for the privilege of coördination, and in that way makes intelligent study of terminal coördination easier.

I believe that there are opportunities for the betterment of the railroad situation by unification of some and perhaps many terminals. Whatever the errors which underlie studies made by or for the Coördinator, those studies have resulted in railroad management seeing terminal unifications more objectively and giving thought to them more earnestly and more concretely, which, quite probably, was one of the important things at which the Coördinator aimed. Railroad management is more alert to the possibilities of benefit along this line. The problem of the effect on railroad labor, while possibly not wholly solved, at least has been brought down to earth and stated, so that railway management may know what to expect.

I, therefore, believe that the opportunities which lie in this direction are more readily discoverable, and will be more freely taken advantage of, than a few years ago. Consideration of such proposals should not be postponed or put aside and forgotten. I wish to emphasize, however, that each unification problem is a separate problem. It is not only individual as to the project but it is individual as to each railroad a party to the project. Each case must be considered on its merits by each railroad, and no case should be hampered by the belief that because it is a proposal for unification it necessarily is meritorious. No railroad should be expected to suffer a substantial loss in order that other railroads, parties to the same project, may gain thereby.

Remarks by the Chairman

Mr. Thomas W. Lamont: You have listened to these two admirable addresses, and I shall take only a few minutes to supplement what they have said by giving you one or two additional aspects of the problem.

ASPECTS OF THE AMERICAN RAILROAD PROBLEM

THOMAS W. LAMONT
Of J. P. Morgan & Co.

FOR many generations of Americans the covered wagon has been the symbol of pioneer transportation, of that hardihood and determination which set this nation of ours upon its way to conquer a continent. It was the covered wagon that bore hardy veterans of the American Revolution from the Atlantic seaboard west to the fertile fields of the Mississippi Valley, and in turn carried their intrepid sons and grandsons on to the sunny slopes of the Pacific.

The covered wagon of those early days has become the stream-lined mechanism of today — the Diesel-powered train that dashes from Chicago to Denver, well over a thousand miles, between dawn and dusk; that lands the traveler in Los Angeles less than forty hours from Chicago.

Ups and Downs of Past Years

It was just about a century ago that railway building started in the United States. Soon state legislatures were passing laws to attract investors who would build railroads and plot out town sites. Congress provided great subsidies to tempt groups of capital to speed up the establishment of a transportation system that would connect every village and hamlet with the outside world. As a consequence—for we Americans never do things by halves—capital plunged into an era of railroad building far beyond the existing demand. The ensuing collapse of values was a great factor in bringing on the serious business depression of 1857.

Twenty-five years later the country was emerging from the great and prolonged depression that had followed the Civil War by a few years. As in every great war, there had been vast inflation followed by a cruel deflation, a sequence as dark and as inevitable as the night that follows the day.

The ensuing recovery of the early '80s brought a new railway building boom. And again there came the aftermath when, in the depression which ran from 1893 to 1896, twenty-five per cent of the railway mileage of the country fell into receivers' hands. Those systems which were sturdy enough to weather that storm and the others which were drastically reorganized at that time are, speaking generally, the ones on whose strength we are able to rely today.

An Ailing Industry Today

Nevertheless, we have today the melancholy spectacle of about 28 per cent of the country's railway mileage in the bankruptcy courts, or going through forms of reorganization. How has such a serious state of affairs come about?

Let me mention some figures that give an idea of the gravity of the railroad problem. At the moment almost 70,000 miles of railroad, representing property investment of approximately five billion dollars, are in bankruptcy or in receivership. Their securities are almost all in default. While the recent improvement in traffic and earnings is encouraging, still less than one half of the Class I railroads (those representing over 95 per cent of the railroad business of the country) are even now able to earn their annual fixed charges.

Furthermore, the carriers owe the Reconstruction Finance Corporation, the Public Works Administration and also the Railroad Credit Corporation over half a billion dollars; and, except for a few railroad systems of unusual strength, the carriers are today unable to command new capital.

How the Public Interest Is Affected

Now, how seriously does this situation affect the public welfare? My answer is, first, that the soundness of railroad transportation affects directly or indirectly every individual in the country—the grower, the manufacturer, the consumer, the investor, and labor itself, because by its very character it is essential to the success of every other enterprise, including agriculture. Including the families of employees there is an army of three million citizens whose livelihood is directly dependent upon this industry.

Second, there are fully 30 million citizens with a financial interest in the railroad industry. Of the eleven billion dollars

of railroad bonds outstanding, almost one half are owned by savings banks and insurance companies. This means that millions of savings banks depositors and holders of insurance policies, whether they all know it or not, have a vital interest in the integrity of these securities. Almost two billion dollars additional of railroad bonds form part of the endowment of churches, hospitals and educational or charitable institutions.

Think, next, of the prodigious consuming power of the railroads when normally they purchase in each year over a billion dollars of goods. The Department of Commerce has stated that nearly a quarter of the country's annual output of bituminous coal, one fifth of all the fuel oil, and about 17 per cent of the country's iron and steel output are utilized by the railways. Thus the railroads are truly a bulwark of our national economy. To keep them sound is a matter of paramount concern to all of us.

Certain Points of Difficulty

What, then, is the chief difficulty? It does not lie solely in the reduced volume of goods transported. Even with returning prosperity, railroad revenues on the average are insufficient to render proper service, and to make decent return upon the actual value of the property as determined by the Interstate Commerce Commission. Take, for example, 1935, a year far better than the low period of the depression. How was each dollar of gross railroad earnings applied? Forty-five cents went directly to labor, twenty-five cents to fuel and supplies in which labor costs largely figured, seven cents to taxes, eight and one-half cents to rental of equipment and incidentals, and the remaining fourteen and one-half cents represented earnings of only 2 per cent upon the $25,000,000,000 investment.

The point is that as years have rolled by freight rates have been materially lowered, and certainly the tendency in the future should not be toward higher, but toward lower, rates. Lower rates have been brought about in part through competition among the railroad systems themselves, and very particularly through competition with new forms of transportation, such as motor trucks, busses, air lines, pipe lines and water carriers. But as rates have gone down many costs have been going up.

Staggering Burden of Taxation

Another trouble is taxation, heavier by far by our states and municipalities than by the federal government. The railroads are fairly staggering under the burden of taxation. Their taxes increased from $44,445,000 in 1900 to $402,698,000 in 1929, thus multiplying themselves nine times during a period when railroad property investment increased only two and one-half times.

Then there is the Railway Retirement Act, whose constitutionality is at present before the courts. The Bureau of Railway Economics estimates that on the basis of 1935 pay rolls there would be put on the railroads an additional annual burden of $57,000,000, which is equivalent to one fifth of the total earnings in 1935 that accrued to the owners of the railroads. Add to this the Social Security Act of 1935 which provides for unemployment insurance, calling for $16,000,000 taxes in 1936, $32,000,000 in 1937 and $48,000,000 in each year thereafter. There will also be additional taxes through the increase in the income tax rate as well as in the rate of tax on capital stock.

Other Cost Increases

All this is above and beyond the movement now on foot, as manifested by a bill introduced in the last Congress, for a six hour day with no reduction in total wages paid. Can such constant and heavy increases be borne by the present frail structure of earnings? To bankrupt railroad transportation through the operation of wages, hours and working conditions alone is not at all inconceivable.

Do not understand me as disparaging legislation looking toward the betterment of working conditions. But you cannot get blood out of a stone. Commendable as is the purpose animating these projects, we have to realize that the railroads themselves are among the nation's poor today.

Government Regulation over the Years

With national and state legislation adding such heavy burdens to the railroad carriers, we naturally approach the whole question of governmental regulation as it has worked hitherto. Congress passed the initial Act to Regulate Com-

merce in 1887. Under it the Interstate Commerce Commission was appointed. It was high time that adequate governmental regulation should be undertaken. Violent rate wars were being waged, unsettling to shippers, disastrous for carriers and investors. Special rebates to favored shippers had reached a point of scandal.

The original Act was designed not to encourage ruinous competition but to do away with it. And during the thirty years following the enactment of this law the public enjoyed good railroad service at reasonable and generally stable rates. The results in the main were beneficial to both the railroads and the public. Small and weak units were encouraged to ally themselves with larger ones. In this way strong systems, advantageous to the whole community, were built up—units like the New York Central, the Pennsylvania, the Southern Railway and the Atlantic Coast Line, as examples.

But the statute law and court decisions discouraged further railroad consolidations, and high pressure competition again became a mark of the industry. Such competition led to inevitable and excessive duplication of facilities and services.

A Restrictive Tendency

Gradually, moreover, as amendments (some of them well designed in themselves) were added to the original law, measures of regulation were carried so far that as Winthrop M. Daniels, for nine years prior to 1923 a member of the Interstate Commerce Commission and since then Professor of Transportation at Yale University, stated: The regulatory measures became "progressively hostile and restrictive."

With the return of the railroads to private management upon the close of the war, Congress attempted to meet the serious situation in terms of the Transportation Act of 1920. This Act imposed upon the Commission a duty which it was very likely impossible to carry out. It had to set up a standard of railway rates which would be just to the public, and which at the same time would enable the railroads under efficient management to furnish adequate service and to earn a fair return upon the value of the properties.

Consolidations the Aim

For the effective carrying out of this eminently sound principle the Commission was instructed by the Act to formulate a plan of consolidation of the railroads into a limited number of well-balanced, soundly financed, and competently run systems. However, the Commission's comprehensive plan involving national consolidations was not presented until over nine years later, in 1929, and since then hard times have made progress impossible on any such scale as the Commission outlined.

Many Groups in Opposition

Now I have no intention of attempting to appraise the blame for the manifest failure of the Act in its mandate for railway consolidations. The apparent impasse has been due to a variety of causes. Shippers and the public generally have set up frequent and strenuous opposition. Almost every big town or community in the land relishes the idea of enjoying duplicate or even triplicate facilities in railroad transportation at its doors, and such centers have displayed slight interest in the deficits of the railroads serving them.

The governments of states, through which parallel and competing lines have run, have opposed consolidations, partly because they have feared to lose duplication of taxes which they now enjoy from parallel and competing lines.

Labor has frequently been in opposition, fearful that many of its number would be thrown out of employment in a series of consolidations. A formula on this point has now been at least tentatively reached through the Washington conferences between the railway executives and labor representatives.

Also, many of the great railway systems have held back, feeling that the Commission's plan, which manifestly coupled many of the weaker roads on to the stronger, gave no assurance that traffic rates could be maintained on any such scale as would enable the strong roads to earn the " fair return " contemplated by the Transportation Act, and thus to carry the weak roads.

Motor Transport Ignored

One fundamental weakness of the Act, moreover, as the situation developed, was that it was based on the theory that the railroads enjoyed a monopoly of transport. The hearings prior

to the passage of the Act contained almost no allusion to motor transport, although even in 1920 there were 10,000,000 motor vehicles (mostly passenger, to be sure) on the American highways. And that number has now been increased to over 26,000,000. This includes, of course, trucks, busses and motor cars. Within ten years, too, the extent of surfaced highways was doubled, and today is equal to four times existing railroad mileage. We are all aware of the growth of air transport and pipe lines. Thus before the liberal Act of 1920 had begun to function, the theory that the railroads enjoyed a monopoly had flown out of the window. In fact, Mr. Eastman's report as Coördinator, dated January 21, 1935, says: " The rapid development of competition with the railroads from other forms of transportation has made the emphasis in the Act upon the preservation of railroad competition unnecessary in the public interest."

Subsidies for Water Carriers

Another formidable form of competition has arisen from the federal subsidies granted directly or indirectly to coastwise and to inland water carriers which have been able, through lower rates made possible by this federal assistance, to deprive railroad lines of much of their traffic.

Let me again emphasize that it is quite contrary to my purpose to give the impression that the great, strong systems of the American railroad world are in a bad way. I am pointing out that in the present situation the weaker roads seem to have an almost hopeless uphill task, and that the industry as a whole is in the slough. As to the future, at least one thing is plain: With the extraordinary development of the internal combustion engine (so advantageous to the public at large), and with the devastating inroads being made upon the traffic, both freight and passenger, of the railroads; with the difficulty of increasing railway traffic on any grand scale; the problem before the railroads is how to bring about great and sweeping economies in operation.

The Record of Fifty Years

How can this be done? It is true that the first federal act of fifty years ago was designed to do away with ruinous competition among the railways. But, as I have indicated, in the last twenty years they have suffered sorely on three accounts. First, our so-called anti-monopoly laws again forced competition upon them in the early years of the century, and railroad administrations themselves expanded their facilities and increased their fixed charges on a wholly unprecedented scale. Second, as Professor Daniels has pointed out, governmental regulation became increasingly restrictive and difficult for the roads to work under and still make any fair return to those who provided their capital. Third, the prodigious development of the motor for both freight and passengers, with its obvious desirability for certain forms of transportation, has furnished the form of competition perhaps most difficult to meet.

No Ready-made Formula Possible

In the existing situation, as I see it, there is no ready-made solution available. It is clear that what has blocked consolidations up to date has been the unreadiness of all sections of the American public to accept the compromises necessary to effect sweeping consolidations. Certainly such consolidations cannot be forced down the throats of all concerned unless the government steps in and does the forcing. That would probably mean "government ownership".

Now, that phrase can, so far as the railways are concerned, be discussed without heat or fury. Yet, of course, such a step would not be my solution. Government ownership might result logically in elimination of competition among the railways. But still, with competitive highways, waterways and air lines, with alarmingly increasing labor costs, where would the government come out? And if the government owns the railroads of the country, will it be able to avoid going a step further? Can it avoid taking over the whole transportation machinery, trucks, busses and water carriers; or will it, by subsidies to competitors, destroy its own investment in railroads? No, I believe that private management still has a far better chance of solving the problem, always provided it has the enlightened and liberal coöperation of government.

Difficulties of the Problem

I have no illusions as to the immense difficulties of arranging regional consolidations. To a layman like myself, never familiar with the technical aspects of railway operation, but for many years deeply interested in sponsoring the issuance of sound railway securities, it would seem that such consolidations on a large scale, or some pooling of operations, voluntarily initiated by the railways themselves, can provide the only ultimate solution of the American railway problem today.

It would be futile to discuss the railroad problem without a frank exposition of the difficulties it presents. Without a blunt and honest diagnosis there can be no adequate remedial treatment. Yet I do not wish to be understood as complaining of the things which I have sought to explain. The Interstate Commerce Commission is an honest, diligent and high-minded body which has dealt as best it could with a most difficult problem. Mr. Eastman here and his associate members of the Commission have the respect of the railroad world and of the world of finance. The Reconstruction Finance Corporation and other government bodies have been most helpful in tiding over the emergency. Successive administrations at Washington have shown every desire to see a constructive policy adopted. The appropriate committees of Congress have given much attention to the problem.

Prosperity for All or for None

As to labor: high wages and good working conditions are greatly to be desired. So is steady and plentiful employment. There can be no prosperity for the country or for the railroads that is not based upon the prosperity and welfare of labor. But —and note this well—there can be no prosperity for railroad labor that is not based upon the solvency and prosperity of the railroads.

It would be stupid as well as futile to complain of good roads and motors, of canals and rivers and pipe lines and airways, or to seek to throttle the growth of these magnificent means of transportation. These things we have and are grateful for and we want, and shall have, more and more of them.

All Around Coöperation Essential

Finally, the railroads and investors in such properties are, it seems to me, recognizing the developments and tendencies in the modern world of transportation. Our only hope—and it is a hope which I strongly cherish—is that on all sides there will be further quickening of understanding. That means among the railroads themselves, on the part of labor as well, and as already shown, on the part of government. Only through coöperation on a scale more sympathetic and active than ever before, shall we be able once more to have prosperous railroads that will efficiently and economically serve the great American public. That is the sole reason for their existence.

PROCEEDINGS

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PREFACE

WHAT should be the guiding principles of American foreign policy in these days of mounting appropriations for armaments and disturbing national rivalries? Is neutrality, as it has recently been defined by the Congress, sufficient to keep us out of war? Should our government attempt anew to coöperate with the governments of other nations in a general program of collective security? These are some of the challenging questions with which this issue of the PROCEEDINGS is concerned. Its pages, containing the variant but reasoned views of economists and financiers, of diplomats and legislators, of experts in history and political science and international law, may help to create that intelligent public opinion which is essential for the solution of the insistent problems arising from the realities of our foreign relations. Rarely have the formal papers and addresses elicited such spirited extemporaneous discussion as that which occurred at the Semi-Annual Meeting (Fifty-seventh Year) of the Academy of Political Science. This volume constitutes a record of that meeting, which was held on April 7, 1937, at the Hotel Astor in New York City.

The officers of the Academy take this occasion to express their gratitude to the speakers, to those who participated in the discussions and to the Committee on Program and Arrangements which planned three interesting sessions. The members of the committee were: Owen D. Young (Chairman), Ethel Warner (Director), Winthrop W. Aldrich, Merlin H. Aylesworth, W. Randolph Burgess, Frederic R. Coudert, Walter S. Gifford, Pierre Jay, Philip C. Jessup, Thomas W. Lamont, Sam A. Lewisohn, Roswell C. McCrea, Eugene Meyer, Ogden L. Mills, Wesley C. Mitchell, Shepard Morgan, William L. Ransom, George Roberts, David Sarnoff, Thomas J. Watson, Leo Wolman.

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THE UNITED STATES AND CONFLICTING WORLD FORCES

INTRODUCTION *

PHILIP C. JESSUP, *Presiding*
Professor of International Law, Columbia University

IN opening this first session of the Semi-Annual Meeting of the fifty-seventh year of the Academy of Political Science, I think it is appropriate to remind you that the Academy itself has no policy to advocate except the dissemination of information and the stimulation of intelligent interest in public affairs. Twice each year it brings together men who are expert in their respective fields, to analyze the topics of the day. These men are drawn from the ranks of government officials, from leaders in business, finance, and other activities, and from the academic world.

Such a group is assembled here this morning and will reassemble this afternoon and this evening to discuss "The Foreign Policy of the United States—Political and Economic". In this first session the particular part of the topic is "The United States and Conflicting World Forces".

We are all well aware that the United States exists and that conflicting world forces exist. As a result of the discussion here today, we should know much more clearly how much each affects or may affect the other.

Our speakers include a former Under Secretary of State, a present Assistant Secretary of State, the Chairman of the Committee on Foreign Relations of the United States Senate, and two eminent professors who have also played their parts in shaping the affairs of nations.

* Opening remarks at the First Session of the Semi-Annual Meeting.

Twenty years ago yesterday the United States entered the World War. Arguments still rage on the precise reasons for our taking that step. There is no disagreement on our national desire to avoid taking such a step again. Our question is: How can the necessity for going to war be avoided?

Two months ago today a great American statesman died on the threshold of his ninety-third year. Elihu Root had for fourteen years been an honorary member of this Academy. For this occasion it is appropriate to quote something of what he wrote in an article in *Foreign Affairs* for September 1922. The title of his article was, "A Requisite for the Success of Popular Democracy".

That requisite, he said, is

> that the democracy which is undertaking to direct the business of diplomacy shall learn the business. The controlling democracy must acquire a knowledge of the fundamental and essential facts and principles upon which the relations of nations depend. Without such a knowledge, there can be no intelligent discussion and consideration of foreign policy and diplomatic conduct. . . . When foreign affairs were ruled by autocracies or oligarchies, the danger of war was in a sinister purpose. When foreign affairs are ruled by democracies the danger of war will be in mistaken beliefs. The world will be the gainer by the change, for while there is no human way to prevent a king from having a bad heart, there is a human way to prevent a people from having an erroneous opinion.

That way, he said, is to make widely available the facts about international affairs "so that the people themselves will have the means to test misinformation and appeals to prejudice and passion, based upon error."

This meeting of the Academy of Political Science is designed to serve that purpose. In our accustomed freedom here to discuss publicly questions of foreign policy, it is easy to forget that such freedom is not universal. It is easy to attribute to the peoples of other countries, policies of which they may well be wholly ignorant or which they may completely misunderstand because they have no freedom of discussion in open forum, in the press, or over the radio. It is easy also to accept as facts statements which are based on guess or rumor. It is easy to allocate blame in advance of an event on the basis of a prejudicial feeling rather than on the basis of accurate in-

formation. Once the mind has come to embrace a fixed opinion it requires a conscious effort to give due weight to other opinions of a conflicting nature. Yet in international affairs particularly, unless we are willing to be fair and open-minded and to practice in word and thought a certain restraint, we cannot as a democracy shape foreign policy in the direction of its real objective—peace.

This morning the subject of our first address is "Democracy and Other World Forces". The speaker was for fourteen years an officer in the United States Department of State. For two years he was Under Secretary of State, and during the important period of the London Naval Arms Conference, of 1930, he served as Ambassador to Japan. Being myself in the academic field, I cannot pass over the fact that prior to this period of public service he was for seven years Assistant Dean of Harvard College.

I take great pleasure in introducing to you Mr. William R. Castle.

DEMOCRACY AND OTHER WORLD FORCES

WILLIAM R. CASTLE
Former Under Secretary of State

THERE is a widely accepted theory that since the War the world has drifted away from democracy. This loss of the democratic tradition is not wholly true, even though England and France are the only European nations which have maintained without material change their form of government. The sound character of the British people, their respect for valid tradition, makes them suspicious of change. The French, who have in the past been the leaders in revolutionary changes, have now settled on the form of government they want and are apparently satisfied with changes within the form. Germany is wholly undemocratic, but it has merely got rid of one master and taken on another. The interlude of the Social Democratic Republic just following the War was psychologically an error. The German has always acknowledged a master, whether he was lord of an independent duchy or, later, emperor or "Fuehrer" of the Reich. Russia, in spite of the camouflage of the new constitution, is an absolute autocracy—but this is what it has always been. The government is changed only in name. Stalin has taken over all the powers held by Nicholas and has added to them. A small minority still rules, although it happens to be a different minority. In Italy, to be sure, there is less democracy than there was before the War or immediately thereafter. A constitutional monarch has always delegated the powers of government to a group, whereas now they are held by one man. Even so, it is hard to consider the country less well off than when it was being ruined by corrupt politicians. There seem to be times when democracy has grown so rotten that purging is essential, even if it means the temporary disappearance of democracy itself. The world, apparently, has not yet learned how to apply this purge except through the power of an individual who, generally through his personal

popularity, becomes a dictator. Spain is in the bitter throes of revolution, the clash between two conflicting forms of government, neither of which, in this case, seems to have much relation to what the world knows as democracy. But it must be remembered that Spain, also, has never been a democratic country. With some exceptions Latin America is learning the lesson of democracy; there are fewer so-called presidents in Latin America who are actually dictators. In the Far East Japan remains, what Japan on the whole always has been, Asiatic, and therefore normally anti-democratic, although it wears the trappings of Western civilization. China, on the other hand, through the gradual emergence of individualism, as distinguished from family or class discipline, seems to be groping rather successfully toward democracy. The Siamese have demanded a liberal constitution and no longer have a king with autocratic powers. India is reaching out, not primarily through the hunger strikes of its Gandhis, but through its forward-looking young men who are thinking constructively. The Orient is developing along much the lines followed by Europe a century and a half ago. We can see there, in rapidly intensifying action, the same forces that we read about as revolutionizing the Western world at the beginning of the nineteenth century.

Mere recitation of these obvious facts shows that, by and large, the world has not greatly changed so far as the *extent* of democratic government is concerned. Whether democracy is, in general, as highly respected as it was a century ago is another question. The newer forms of anti-democratic government, because they are novel, are more striking than were the stodgy kingdoms and empires which used to represent autocracy. Therefore we think more about them. And, unfortunately, we are compelled to think about them not only because they are novel but because they depend in an unusual degree on physical force, both to hold the government in office and as a means of government. This is nothing new, but it looks new in the twentieth century because we have become accustomed to the idea that, in domestic matters at least, reason has replaced force. Fear has always stalked the lonely plains of Russia, but fear of the Cheka is more gripping than was fear of the secret service of the Tsars. In Germany fear of brutal reprisals on the part of the military caste has for many years lurked in the background of the German mind, but the starker fear of sudden and secret death has now taken its place. The Italians whisper in corners or talk not at all, whereas they used to chatter politics at every street crossing. Force is the fulcrum of these dictatorial governments, and thus the rulers rule eventually through the people's fear. Yet we cannot deny that among the masses of these same people there is also a certain elation that comes from identification of themselves with the nation; they glory in its boldness and in the fact that the whole world talks about it. In contrast, the sobriety of the citizens of democratic nations seems drab and lifeless. In the first years of dictatorship there is a glamor which stirs violently popular imagination; the light dies only when inevitable poverty and loss of liberty at home and the more and more freely expressed contempt of the outside world reveal the sham of the setting. It is this initial glamor which makes dictatorship contagious and, therefore, very dangerous.

There would not be many dictators in this world if men announced that they wanted to be dictators, or even if they called themselves dictators when once they had obtained control of the government. Men who become dictators care as a rule very little for titles or honors or wealth, but infinitely more for power. The true dictator would rather rule in personal obscurity than be hailed as king or emperor. Furthermore, there would be few dictators in the world if they had to seize power by force — this is true, at least, of the larger and more advanced nations. If the people could see the rape of their liberties, they would fight back, whenever possible. But there is seldom an open attack. Except in Russia, where there was revolution after the War, the governmental changes in Europe have been comparatively quiet, so legal in their outward forms that there has not been even the necessity of recognition. The populace has been fascinated by a great personality, enchanted by his words and by the sound of his voice so that they have hardly noticed his stealthy withdrawal of one after another of their rights. The would-be dictator pays little attention, at first, to the intellectuals or the thoughtful men of the nation. He finds it more effective to play on the emotions. When he has achieved power he may call in

the intellectuals to justify his acts. There were not many people in Germany who really *thought* as Hitler thought, but there were millions who felt as he felt, who took as a tribute to themselves his flattery of the nation—and loved it. There would have been a revolt long ago against the autocracy of Mussolini had it not been for the man's tremendous personality, for his cleverness in keeping the crowd occupied. This, perhaps, was more important than his control of the force necessary to prevent trouble. Stalin is more brutal in his methods, but his flattery of the crowd is even more subtle and effective. Under such leadership, and in such conditions, people simply do not look into the future. They refuse to see the mounting taxes behind the unbalanced budget that results from war or other extravagances. Children and grandchildren are forgotten in the personal enthusiasm of the moment.

Democracy, as it has developed during the last three centuries, was largely made possible through education. Individuals in larger and larger numbers learned to think for themselves. Democracy was thus the child of reason, and its development immediately fostered the growth of liberalism. True liberalism can exist — and also is sure to exist — only where there is freedom for all reasoning individuals to think and speak. Yet there is in this very freedom the seed of decay. We who believe in democracy would not willingly sacrifice any of the forward strides in liberalism that have occurred historically, especially since the revolution of 1688 in England, yet we must, if we are candid with ourselves, admit that liberalism has in this way facilitated the disintegration of democracy itself. Take, for example, the question of free speech. If everybody can say anything he wants at any time—and this is essential in a democracy—the result is all too often veritable rivers of words which do not represent real thought, which carry only chaff and other refuse in their current. Speech must be free, but to be good speech it must be well thought out, must be the truth as the intelligence of the individual grasps the truth; and further, if it is going to contribute toward the building of character, the speaker must know that his ideas will be hotly contested, that he must fight for them, often at serious personal sacrifice. Individualism, without which liberalism is impossible, has often become confused through sloppy thinking. In the growing realization of the rights of the individual man, furthermore, there has been failure to emphasize the duties of the individual man. Rights always entail duties. The only way to avoid duties is to renounce rights.

Liberalism has failed to knit firmly enough together the various elements in a democratic state. As hard thinking has seemed less necessary, individuals in the state have all too often allowed selfish interests to prevail, have recognized only emotionally the rights of others. This tendency toward a selfish consideration of personal rights, combined with an emotional outlook, has meant the growth of a race of men and women who are a little soft, who are inclined to substitute good words for good deeds, who do not think with clarity because they think in groups of words rather than in groups of facts. It is a lot easier to feel than to think. A few days ago, in discussing the neutrality bill which was before the House of Representatives, a Congressman was asked what one of his colleagues thought of the bill. "He never thinks", was the answer. "He has looked at the title of the bill and will vote for it, of course. It is a neutrality bill, isn't it? And he and his constituents are for neutrality."

All this is pertinent because it suggests some of the reasons why democracy is losing its grip in those countries which have long had representative government, in Europe and in America. It came to these countries through the spread of knowledge, in exactly the way it is now dawning in other parts of the world. The liberalism which became the handmaiden of democracy is one of the most precious of our intellectual possessions. Early liberalism reasoned out the rights of man through hard and consistent thinking; it had profound faith in men as human beings, with certain inalienable rights and equal opportunity to progress. It was always willing to fight for what it believed to be the right. And then it gradually began to get emotional rather than intellectual. It became sentimental. Its writers wrote books about the downtrodden but ceased to take much interest unless the books paid good royalties. Its orators drew tears and applause with their moving descriptions of wage slavery, but did nothing practical to put an end to it. Rich men who called themselves liberals

began to feel that very, very generous contributions to charity absolved them from any personal obligations toward those who worked for them. There are many people, who will give lavishly for the relief of famine in China, who refuse even to contemplate suffering in the slums of their own cities. That is a little bit the attitude of liberalism today — it believes in the relief of suffering, at a distance, and in the equality of men who are too far away to be offensive.

When this sort of thing happens, and it is already happening in the long-established liberal democracies, liberalism, emasculated, is unconsciously leaning toward dictatorship in one of its many forms. The believers in a totalitarian state and the believers in a liberal democracy find themselves in sudden accord—for different reasons, to be sure, but still in accord. That was rather amusingly illustrated in the foreign press reaction to the recent proposal of the President to add six justices to the Supreme Court. The liberal papers in England, led by the *Manchester Guardian*, acclaimed the proposal as making it possible for the President to carry out his profoundly liberal policies. But equally the press of Germany and of Italy welcomed the plan as proof that the President at last realized that he must get rid of the courts in order to seize all power. Both groups of papers may have been mistaken, but the alignment between two originally antagonistic philosophies was instructive.

In another way the liberal democrat, whose convictions have largely become emotions, who has found sympathy less tiring than hard work, is likely to be seduced by the would-be dictator. He wants to believe, and, if a man speaks the phrases to which he has become accustomed, he does believe. He sees things exactly as he wants them to look. He no longer sees any difference between promise and performance. But remember that he is still a liberal democrat, a reformer, a professed lover of mankind. The trouble is that during all the years of his life he has been living politically on words, on formulae—words and formulae that to his grandfather were vibrant and full of life, concepts worth fighting for, worth dying for, if necessary, but to him a little faded, stereotyped, so obviously true that they are banal. Any violent departure from these truisms would shock him, just as the thought of dictatorship shocks him. But the man who is going to be a dictator does not shock him because that man speaks in the same old language, merely suggesting little changes here and there, little additions necessary to improve the common lot, merely making gentle compliments that are never so gross as flattery. Mussolini, restoring Italy to itself, was merely wresting power from those who were about to destroy the glory of Rome. Of course people followed him. It would have been indecent to do anything else. Hitler played, as few men have ever played, on the sensibilities, the pride, the sentimentalities, also, of the German people. Everything was perfectly legal. Was Hitler not appointed chancellor by that wonderful old man Hindenburg? And was he not himself elected president through the suffrage of the people? The Weimar Constitution had not been long in existence, but already it had given people a sense of the dignity of individual liberty that must not be tampered with. The whole Bolshevist revolution was to make the people supreme, yet there was no touch of democracy in it. Democracy always wells up from below. The Soviet was imposed from above. In Russia, however, there was no democracy to crush, almost no individualism to crush, because there was no general education. So everywhere the liberal democrat trusts the man who speaks in his formulae, who outdoes him only in his desire to help the underdog. He trusts, and he votes as he is asked to vote. And when, after a few months or years, he finds himself the slave of a system, it is too late. Handcuffed, and in a strait-jacket, he still finds life easy — far easier than it would be if he chose to fight for his lost liberty. Modern reason has been ousted by magic. After centuries of slow progress toward the peace of reason man has found only the peace of force. He has ignored that question of Spinoza as to whether he preferred "freedom through knowledge and understanding or emotional bondage." The two looked alike.

Modern dictatorship rests ultimately on force, although its trappings may be the adulation of the people and the widely exploited humanitarian personality of the dictator. Where force is supreme, fear always motivates action and reason is in abeyance. Force makes the strong stronger and withdraws the protection of law from the weak. Where force is supreme,

nationalism is raised to the dignity of a cult, and just as soon as the nation becomes the source and the reason for all things, the old-fashioned virtues of truth and loyalty to ideals necessarily go by the board. Have we not recently seen in Europe and the Far East the most cynical disregard of formal international agreements? Everything must give way to the necessities of the state as they are envisaged by the dictator or by the military group which actually rules, whatever appearances may be. Nor does a dictatorship respect domestic laws when those laws are drawn, as they generally are, for the protection of the citizens. In Germany the treatment of the Jews would have been declared illegal if the German system had not been such that by gaining control of the Reichstag Hitler also controlled the courts. Emasculation of the courts first opens the minority to the complete dominance of the majority and finally destroys all freedom. As to relations with the rest of the world, a dictatorship living on force must extol war. The *Encyclopedia Italiana* says, in an article contributed by Mussolini himself, that fascism "believes neither in the possibility nor the utility of perpetual peace."

When we are discussing the theory of government from our point of view as members of a democracy, it makes little difference whether dictatorship labels itself fascism or communism. The two systems are equally destructive of individual freedom and, therefore, of any kind of liberal democracy. It is true that communism, when we get beyond the high-sounding patter of the adepts, speaks the word language of democracy better than does fascism. Germany and Italy, paying no tribute whatever to liberalism, call the whole democratic system outmoded. The Soviet, on the other hand, claims that the dictatorship—the added words "of the proletariat" are apparently intended to mislead—is only a temporary measure leading to the fullness of democracy. Communism is thus perhaps even more dangerous, in that it seems to look forward to freedom. In its present manifestation it is more brutal than is the dictatorship of the right. It is equally dependent on force for its existence, equally imperialistic, even if the aims of imperialism are differently defined by the two systems. It more completely submerges the individual than does dictatorship of the right, which is seen in its most extreme form in Germany. The individual seems to give up his own personality, to become the puppet of a ventriloquist. Some, at least, of the men who recently confessed in Moscow to atrocious crimes against the state were probably innocent of the crimes. Their confessions were the result of self-hypnosis like the confessions of the Salem witches. On the other hand, any successful dictatorship blinds its adherents largely through their emotions. Because Hitler hates Jews, the rank and file of the German nation, obedient to his will, forget that Jews fought valiantly in the War, that Jewish bankers saved Germany financially after the War was over, that the glory of Germany in music and literature is due as much to the Jews as to the Aryans. In any case, the denizens of a country under dictatorship — they can hardly be called citizens — are spiritually shackled.

In distinction to these dictatorships we have the democratic states which are founded on reason and on individualism—the only states where liberalism is possible. Reason binds individuals into a working unity that can withstand shocks. Emotion, which is the only binding force in a dictatorship, is volatile and evaporates under the pressure of reality. Democratic government is the result, through education and the growth of individualism, of the reform movement which flowered in the nineteenth century, a movement which was determined to give a fair chance to all men and to all classes, in this way to eliminate class warfare and to eradicate the inhumanity which for centuries had disgraced treatment of the masses.

Laws passed by a democracy are likely to be sounder and more responsive to the needs of all than are the laws issued by a dictator. A democracy is deliberative; it has not the speed of the dictatorial machine, but it has greater accuracy and is more responsive to popular desire. Here in America we took up in its purest form the inspiring task of democracy because we started fresh, with no traditions, except those brought from overseas, to hamper us, with a clear field in which theory might flower into reality. But here, just as in France and in England, democratic fervor has weakened because hard thinking has degenerated in too many instances into sentimentalism. Too many of us are willing to let the other fellow do it. Too many of us accept as progress and as

liberalism anything phrased in a new way. We fail to hear the clanking chains of slavery because siren voices are proclaiming a new and beautiful world. We do not think. We are reverting to a belief in magic.

We do not want dictatorship in America, but, the times being what they are and world trends being what they are, we can avoid it only at the price of eternal vigilance. We are not a democracy merely in the sense that the old Greek states, or the villages of New England run by town meetings in colonial days, were democracies. The United States is the greatest representative democracy in the world. It is based on an inspiring written Constitution, elastic enough to expand with new needs. We elect our representatives to Congress in the belief that they will think through the problems presented to them and that they will vote as their intelligence and their consciences direct. If we want to save democracy here, and even throughout the world — as failure here would have disastrous repercussions everywhere—we must elect the best we have, certain in the knowledge that only the best will defend our rights and privileges as free citizens, that only such men can pass honorably and intelligently on the great questions that arise from day to day, that only such men will vote in accord with their sense of right, rather than in accord with the patronage they hope to receive. We must never be fooled into accepting a government of emergency decrees. It is one of the first steps toward dictatorship to call all measures emergency measures. The Senators and Congressmen whom we elect must, therefore, be men of keen intelligence, able to evaluate; above all, they must be men of spotless integrity and high courage. Unless this is true, representative democracy must fail. If we can make it true, we shall avoid the dictatorships that in Europe are leading the world to war and misery. We shall be the outstanding liberal nation of the world.

REMARKS BY THE CHAIRMAN

CHAIRMAN JESSUP: The time schedule on which we operate this morning fortunately does not provide any interval during which the Chairman can comment upon speeches either past or future. I must proceed rapidly to introduce the next speaker. He must suffer in his introduction from me because I am a colleague of his and, if I should attempt to eulogize him, you would naturally suppose we had agreed beforehand on such procedure.

Fortunately, he does not require any such procedure. By spoken word, action and inspiration, he has become a familiar and very welcome speaker in gatherings not only in this city but throughout the United States and Europe. His subject this morning is "The Mechanism for Peace in Europe". I take very great pleasure in introducing Professor Shotwell.

MECHANISM FOR PEACE IN EUROPE

JAMES T. SHOTWELL
Professor of History, Columbia University
Director, Division of Economics and History, Carnegie Endowment for International Peace

I TAKE it from the title assigned me that we are to have a short interlude, that we transform the Academy into one of archeology, exploring the remains and ruins of past times and ideals exploded. We are to do this under the menacing front of an armed Europe, seizing an interval between the serious contemplation of the problems of democracy and its relation to the outside world. I have become rather used to being an archeologist these last years, since I am perhaps one of the specimens myself as a man who still stands for the League of Nations!

That does not disturb me in the slightest; in fact, I am rather enjoying my isolation. I had better perhaps begin by a little historical parallel to invite our contemplation of the processes of history. There are those who hold that we are now repeating the experience of the nineteenth century almost literally and that in this idea of repetition we have the clue to our time. Thus, it is claimed that we have had a Holy Alliance once more, under the benign inspiration of Wilson—instead of Alexander—and that then there came along the Castlereaghs and Cannings of realism in the modern world and brought us down to earth with a return of balance of power, and that now nothing is left of a great experiment.

It is perfectly true that nationalism today is a stronger force for separation than Metternich with his return to the old monarchies of the past, and that, therefore, the scene before us presents even a stronger contrast with the period of high ideals than the thirties of the last century; but I am inclined to think that history has become infinitely more complex and that the problems of today are not simply a repetition of events that took place with a different nexus, under a different series of causal circumstances. So I turn to these, with as much sense of reality as Providence has given me, and try to see where we are.

I begin with the mechanism for war, because that is what is in our minds. If this title had been given with a proper regard for the feelings of an American audience, it would be "Mechanism for War", so let us begin with that and see what there is that we can analyze.

First of all, let me say that this is a subject with which the Academy of Political Science too seldom deals; nor is it sufficiently discussed in our academic curriculum. War has played a dominant part in human history, and yet it has never had a prominent place in the study of politics. We have tried to get away from it. We have concentrated on constitutional developments and the process and evolution of public law, of politics within the state; but we have left out of our consideration a mature examination of what war has done in history, and why it is still with us as a menace or as a portent.

If you look back into the time after the Holy Alliance, which I referred to, you will find there the philosophy of war set forth for the first time in clear form by the German strategist, Clausewitz. From him it passed into German political science through a whole series of authorities. It was simply this: that war was an instrument of policy, or a continuation of policy, with a definite technique of its own.

War is properly an instrument of national policy. Any other kind of war, Clausewitz said, or implied, is crime; but war waged by nations for the fulfilment of their policies and the achievement of their ends—if those ends be legitimate at all, and that is for the nation to judge—is part and parcel of politics, and a normal function of states.

It happened that in the years after the War, I was given the task of analyzing, as well as one might, the nature of war in a modern society, with the great laboratory of the World War to work in. The one definite conclusion which came out of that analysis of war history—supervised in all of the countries of Europe by men most competent to judge — was that war in the modern world, carried on by chemistry and industry, is no longer a pertinent instrument for the attainment of political ends; that victory or defeat in the field is not the

index of the final defeat or victory for the nation that is engaged upon a war; that the instrument is different in character, as well as in extent, from the nature of the result.

Let me bring this down from generalities. I was talking in Germany with a high military officer, back in the days of Germany's irritancy over the Polish Corridor, in the early days after the War, and I asked him whether the German army, even in its weakened state, wouldn't be strong enough to re-occupy the Polish Corridor if Germany decided on the use of force. He laughed and said, "I think perhaps we could push the Poles out of the Corridor with the remnants of the German army [it might not have been very hard work at that time — it would be different now], but you know that isn't what would happen. Of course, France would be in it and we would have them on the west; and Great Britain thinks it wouldn't come in, but it would; and you think you wouldn't come in, but you would. So we would have Europe in flames [this was back in 1921], and all I can calculate is that all of Europe would be more in debt to America at the end."

Now, if that was the case, war has ceased to be the instrument of politics that it was in the days of Marlborough, that it was in Turenne's time, when the German frontier was pushed back. It is no longer simply military force against military force. It is the expenditure of national strength against national strength, directed not according to the plans of the general staff, but following the direction of the entire national economy of the belligerents and of neutrals as well.

In the World War the most distinctive development that took place was in the German formation of the Rohstoffsabteilung War Ministry in Berlin. It began with Dr. Walter Rathenau and two secretaries sitting in a back room, and ended with a larger staff than the rest of the ministry, organizing the resources of Germany under the blockade.

That glimpse of history is enough for me to build my first conclusion upon: that war has changed its nature since the introduction of chemical and industrial mobilizations; that it is no longer the pressure of human strength mobilized against human strength, but of resources drawn from all corners of the world, bought if you can buy, mobilized by industry if you can manufacture, in any case thrown into the crucible of the conflict and coming out of it vastly changed; for after the war is over, these instruments, the war factories, are no longer readily adaptable to conditions of peace.

Now, is there no comprehension of these facts in Europe today? Ladies and gentlemen, there is a strong and real apprehension of them. The one force for peace that is strongest in Germany today is the General Staff itself, for it realizes the nature of modern war.

Under those conditions, if war has ceased to be what it formerly was, a directible and definite instrument of policy, then the question is whether or not this growth of armaments which you see today is a direct denial of human reason. No, because you will find, if you look into it, that the growth of armaments is a test of the new kind of competition in industrial and chemical war industries, *Kriegswirtschaft*, as they call it in Germany—and they have a definite place for it in their curriculum. It is now becoming a weighted measure of pressure without use, calculations against calculations of war potentials without resort to war. The pressure of the sum total of these pressures is the one thing which is keeping Europe back from war at the present time.

There are all the irritants that bring war, all of them. There is every reason for nations to go to war according to the political thinking and planning of 1913; but we are not approaching war, I believe, because of the sanction in the danger of the use of a non-directible instrument that would in itself, if applied, destroy civilization at the present time.

Under these conditions we have very interesting parallels to work out in terms of peace. I think there is time. No one knows; and, of course, a historian never ought to be a prophet. The historical discipline stops with the past; and the minute before the last, of course, is still past. However, I do believe we have been witnessing in the last year a sanction for peace in the new knowledge of the new nature of war.

Now, that is a different thing from the emotion about war which Mr. Castle touched upon. It has a challenge to intelligence in it. If that is the case, how can we deal with it?

The first thing I want to say is that we cannot solve our problems by any magic formula of 5–5–3, or 10–10–7, or any

such thing. I am speaking with the utmost freedom of an academician in the presence of statesmen, so you will permit me to say whatever I think in connection with it. I say these are magic formulas which have fooled the American people.

We have to put something in the place of war, if we desire disarmament, because we cannot get disarmament in any other way than by resolving the antagonisms of nations.

We tried to put a League of Nations in the place of war. But you will say, "Now that is gone." Let us see! I turn to Mr. Castle's previous analysis and insist that it is very hasty thinking to say that the League of Nations is gone because it failed in some emergencies. When I was in Berlin last November, I remarked to one of the men there (I will be very, very vague—perhaps it was in Munich) that the League of Nations was regarded as dead, and I was put in my place at once. He said, "We have to have a League of Nations in Europe or we can't continue our modern civilization." So, perhaps it is worth while to look at the League after all.

The League of Nations was organized as a democratic instrument. That means the use of discussion, which takes time. Now the issues of war and peace are crisis issues, when there is no time. This brings up our first problem, that of dealing with the way in which the League met its difficulties in Manchuria, in the Chaco and in Ethiopia.

There was that incident in Mukden. The League had its instruments for pacific settlement in session, both Council and Assembly. They did then what they had done before to stop war. They called for a commission to go to the spot, but they made the great mistake of allowing the proposal to be made by one of the parties to the dispute. That was a diplomatic blunder of the first order, but a diplomatic blunder commonly made. That method had been used before. It had stopped war in the Balkans in 1925. I was there and saw it, when Greece marched over the mountain frontier to Bulgaria. The proposal to have a commission investigate what had happened in Mukden, therefore, was a natural and proper one. It was stopped and not taken up for a long time. Why? Because the United States came to the conclusion that that was not the right step to take. Its reasoning was that such a move would cause the liberal government of Japan to lose face and, therefore, would be playing into the militarists' hands. Mr. Stimson, acting on advice from Ambassador Debuchi—for both of whom I have the highest respect — opposed the League proposal. The mistake was in having two general staffs for peace, which said opposite things in the world crisis at that time. If you have two general staffs on any battle front playing opposite strategies, there is going to be defeat. Blame for defeat does not fall alone upon the League of Nations. The fault lies in the absence of a consolidated front dealing with an issue that had to be dealt with immediately.

That is the Manchuria episode. The same is true of the others. In all of them we meet the one issue upon which wars are fought, prestige. People do not go to war over oil in Tampico, but when the flag is fired on in Vera Cruz. That is the kind of thing that brings the war spirit. It is prestige rather than consciousness of national interests which, even in the industrial nations of today, brings the danger of war.

It was prestige that led Berchthold and the Austrian Cabinet to make the fatal decision. It was prestige which led Berlin to back it. That was the issue. A great deal of our neutrality legislation today, therefore, does not touch on the real issue of war and peace. How can we deal with it? The League Covenant, in my opinion, is drafted wrongly on that point. Article XIX brings prestige into the open. It says that, if there is a treaty to be revised or a condition that no longer exists, you must discuss the matter before the Assembly itself in the fullest light of day. Ladies and gentlemen, that is a place at which our attack upon the old diplomacy of the pre-war days led us to wrong conclusions. We were afraid of what we called the old diplomacy and its secrecy. But there is a time and place for secrecy, and if ever there is a place for it, it is where you are dealing with the sensitive springs of action in national consciousness which have to be kept down and given something else to think about. That is where the League of Nations failed in the structure of its constitution in dealing with political issues. There should be more place for old diplomacy — for secret dealings, if you will, held to responsibility before Congress or Parliament—along with the conference method, which is suitable only for a certain kind of question. The conference method is very limited in its

application; but where it should be tried, it should be tried in full.

I suggest that the economic functions of the League should be more definitely separated and made autonomous. They should be made real. When an economic conference meets, as it did in 1927, you should not have an irresponsible American delegation, irresponsible to the government at that time, making pleas for low tariffs in other countries while unable to carry out the same method and policy at home. But while responsible in its own field, it should be autonomous and not linked with the responsibility for political decisions that might involve the sanction of war.

France and the other countries of the Continent never send delegates to conferences of this kind without knowing that what they say will be checked up and carried out, if the need arises. There should be more responsibility and less amateurishness in dealing with these vast things, linking them with the possibility of fulfilment in their own sphere, without tying them in with the military sanction. Autonomy, independence and responsibility in dealing with the economic questions of the world are needed, not simply reciprocal negotiations. I am in favor of what Secretary Hull is doing, but it is not enough. We must face the fact that the interplay of economics in commerce and finance and security is one that does not lie solely between two nations at any one time. It is a broad and interlacing fabric and it must be viewed in that way.

In this economic structure we have one section already under way and succeeding, that is, the International Labor Organization whose conference on textiles is meeting now in Washington. I venture to think that fifty years from now, when the historians look into the newspapers of today, hunting for the most important thing now taking place, they will find it on page 23 of the morning papers, the meeting of especially qualified international delegates to take the poison of international hostilities out of one of the great industries of the world. The conference is composed of men representing labor and capital as well as the government, every man knowing what he is talking about (and that means a good deal in every conference), facing issues of rivalry in a world of capitalist industry. If they succeed now they may possibly save us from that greater international rivalry of socialized and communized states, which brings the full mobilization of politics along with economic forces, one against another.

Our antagonisms in a world of private capital are the antagonisms of technique against technique. It is a very different thing if you get nations wholly organized in communistic form. This I.L.O. is one of the latest efforts that a world of free industry has put forth to resolve the difficulties of international antagonisms by honest conference and exchange of views.

The I.L.O., the International Labor Organization, is on its way. It has already put through and had ratified over six hundred labor treaties, international labor treaties. It should not be called the "International Labor Conference"; it should be called "International Industrial Conference". Capital and labor have an equal part in it, though its program deals with social welfare.

There is no such parallel institution in the fields of commerce or of finance. The section of trade (of economics, as it is called) and of finance, of the League, is ridiculously inadequate. There should be world parliaments dealing with those fields as well as labor, and they will, I think, come to fruition before long. Of course, they would be equally autonomous.

There is, also, the question of social welfare which the League has undertaken to deal with. Everyone in the United States is in favor of that. We are all for helping humanitarian efforts and for advancing the social welfare. But there is one great field that still lies challenging before us, and that is what the Germans call *Kultur*, the full heritage of the nations' culture and thought. It includes the activities of bodies like this, which analyze the problems of the day, as you and I are trying to do. This is what the Committee on Intellectual Coöperation, with which I happen to be associated, is furthering. It is, for example, calling an important conference this summer for the study of the most difficult of all problems in international relations, that of peaceful change. It will take up, under the auspices of the League, not the problem of *status quo*, but the way in which we can, in a world that is dynamic, adjust the conditions of peaceful life to these changing situations.

How can it be done? No experiment was ever made in history, from the ice age down, that would adequately deal with it. But if we are to apply intelligence to save civilization, there is no other place to apply it so effectively as in this study of the ways and means by which change can be brought about peacefully.

In closing, let me say that the first result of that analysis would be the correction of certain grave errors in fact and conclusion, which some nations now share: namely, that colonies are to be thought of as profitable property, and that raw materials can best be secured for strong nations by giving them full opportunity to seize the raw materials for themselves.

There must be coöperative action, and there must be a League back of that coöperative action, to deal with those peoples whose lands are held in trust as well as with the raw materials of the world. There are two kinds of raw materials: there are the raw materials that the sun produces every day, embodied in power, sending the rivers to the sea, building its strength into the fibres of the vegetable world. There is no great danger of exhaustion in this field. The danger of exhaustion lies in those raw materials of which the earth possesses only a limited amount. They should be placed under some kind of general control, otherwise they will be used up forever by a civilization that is unaware of what it is doing.

For metals, the raw material of the earth, we need to make some provision under the community of nations. The anarchy of isolation will not suffice. We need to build into the consciousness of nations such as ours a sense of responsibility for mutual coöperative control of our heritage, so that we can ultimately save something for the future. Otherwise future generations will look back to this age as we look back to the Dark Ages after the Roman Empire.

Remarks by the Chairman

Chairman Jessup: Thank you, Professor Shotwell!

Our next speaker is Assistant Secretary of State of the United States. The last twenty years of his distinguished public service have been devoted to Latin American affairs—the relations of the United States with its sister republics to the South. He has dealt with those affairs in the field in various capacities, as Special Commissioner, as Ambassador to Cuba, and in the discharge of other functions; he has dealt with them as Chief of the Division of Latin American Affairs in the Department of State. He is dealing with them now as Assistant Secretary of State.

Only a few months ago he was one of the vital factors in the conduct of the Conference at Buenos Aires, the Conference which is referred to on the program as "the" Conference. I have great pleasure in introducing to you Mr. Sumner Welles, to speak on the work of that Conference.

RESULTS OF THE SOUTH AMERICAN CONFERENCE

SUMNER WELLES
Assistant Secretary of State

The Inter-American Conference for the Maintenance of Peace held at Buenos Aires in December 1936 marks the end of an old chapter in inter-American relations, and signalizes the beginning of a new epoch in this Western hemisphere.

In order to make clear to you my reasons for making this assertion, let me remind you of certain of the phases which our own relations with the other American republics have undergone during the past hundred years. I think it may be said in all fairness that, during the decades immediately following upon the declaration of their own independence by the majority of the American republics, their struggle to maintain that independence and their endeavor to construct a system of democratic and representative government, such as the people of the United States had themselves established, were viewed with a genuine and friendly sympathy by our government and people. It is true that the difference in racial origin, the physical distance between the Latin American world and ourselves, and the lack of communications impeded, on the part of our own people, any intimate concern in, or detailed knowledge of, the progress made by these young democracies of the Americas along the paths of self-government, but our sympathy was genuine, and was not infrequently voiced by outstanding American statesmen of that period. Thereafter, for many decades, the United States undertook a policy of aggressive territorial expansion which may, perhaps, be said to have reached its most extreme form in the war with Mexico and to have ended a few years subsequent to the war with Spain. It was during that period, of course, that there were sown the seeds of the abiding belief on the part of the peoples of Latin America that the United States was dominated by imperialistic ambitions, and it was that period during which confidence on the part of the rest of the continent in the good faith of the United States as a government was seriously impaired.

With the turn of the century, a new phase began. There began to be manifested what might be termed a missionary spirit on the part of our own people. The great republics of South America had already reached a stage of self-development which precluded any direct interference on the part of the government of the United States in their domestic affairs. Certain of the republics of the Caribbean and of Central America, which had perhaps not yet attained the same degree of stability in government, however, appeared to offer a fertile field for the manifestation of this evangelistic spirit. Public opinion here seemed to believe that because we ourselves had attained a notable degree of advancement in the art of government, our own standards should prove desirable if laid down for the peoples of those adjacent countries, notwithstanding the fact that those standards might be neither adapted to, nor desired by, the peoples of those independent nations. Treaty relationships into which we entered during those early years of the twentieth century with Cuba, Haiti and the Dominican Republic and the armed interventions undertaken by the United States in certain of the Caribbean and Central American republics during that same period have their origin, I am convinced, in this root cause. That pressure from commercial and financial interests within the United States played its part in the formulation of this policy of domination cannot be denied. The policy so undertaken was, of course, likewise predicated upon the belief that were the United States itself to refrain from undertaking this type of self-imposed assistance to these weaker nations, when domestic turmoil occurred, some non-American power would intervene in direct violation of the fundamental principles of the policy of self-preservation of the United States. And yet, as one looks back today, what have we as a people gained by that particular manifestation of policy? I know of no act of intervention undertaken by the United States which has accrued to the benefit of the American people. We reaped only hostility, suspicion and ill will, and, in similar degree, I am unable to find that the people of those countries where such intervention took place gained any benefit other than the temporary advantage which the road construction or the sanitation imposed upon them brought them. It has been demonstrated by this experience—if such experience were necessary—that domestic peace and the utilization of the orderly processes of democratic self-government cannot be imposed from without by an alien people; they can arise only from the individual genius, the needs and the will of peoples themselves.

Finally, it has been brought home to us during these same years of the twentieth century in unmistakable terms that, if the people of the United States desire to avail themselves of the continental market for the benefit of their own export trade, or if they desire to retain the good will of their southern neighbors, they will render these objectives impossible of attainment if they persist in their determination to build a tariff wall about the United States so high as to make it impossible for the other American republics to sell to the people of the United States.

This summary review of the relations between the United States and its sister republics of the Americas, involving as it does the changes in our own policy from the extremes of frank imperialism and "dollar diplomacy" to the "big brother" attitude, brings forcefully home to us with what reason our neighbors to the south have regarded us at times with fear, with deep suspicion, and with resentment. It became perfectly apparent to every thinking man or woman in the United States that until the grounds for antagonism, enmity and suspicion had been dispelled—and dispelled by deeds, not by words—any permanent improvement in relations between the United States and the other American republics was out of the question.

When I speak of the chapter now concluded, I desire by no means to exclude from that chapter the grave deficiencies in the relations between the other American republics. The pages of history included in that chapter have seen many jealousies and rivalries between the southern republics, many failures to adopt the procedure of reason and conciliation when controversies arose, many losses of opportunity to solve the dispute in its early stages rather than to permit it to grow until public opinion on both sides had become so inflamed that the resort to arms was inevitable. Only a few years ago, for example, an armed conflict of major proportions between the great republics of Colombia and Peru was averted at the last moment only because of the statesmanship and will for peace of President Benavides of Peru and of President Olaya Herrera of Colombia, whose recent death has been a loss which every citizen of the Americas must recognize; and even more recently, the war between Paraguay and Bolivia, which actually had broken out, was arrested only because of the willingness of the governments of those two republics to agree to the friendly mediation of a group of American states.

But it was more than clear in 1933 that if real progress was to be made in placing inter-American relationships upon that solid foundation of mutual trust, friendship and understanding which I think every American citizen today believes to be to his own advantage, the initiative must be undertaken by the United States. In the period which elapsed between March 1933 and December 1936, I think the American people justly feel that their government did its part in achieving those aims, not by words, but by deeds. I have, on other occasions, in some detail, related what these steps have been, and I feel that all of you whom I am addressing today are familiar with that page of our foreign policy. I may further add that if that page had not been written, the Buenos Aires Conference could never have been held. For many years past, in inter-American conferences, the United States delegation found itself suspected of ulterior motives and regarded with open hostility by its colleagues. At Buenos Aires, it found itself an equal among equals and a friend in a gathering of friends.

You are all of you familiar with the fact that the Inter-American Conference for the Maintenance of Peace assembled by invitation of the President of Argentina upon the initiative of the President of the United States. When the Chaco war was arrested and a state of peace prevailed throughout our continent, it seemed to the President the part of wisdom, as he said in the letter which he addressed to the other American presidents on January 30, 1936, that the American republics should consequently "seize this altogether favorable oppor-

tunity to consider their joint responsibility and their common need of rendering less likely in the future the outbreak or the continuation of hostilities between them and by so doing serve in an eminently practical manner the cause of permanent peace on this western continent". Furthermore, the President was not unmindful of the situation which prevailed in the world at large. Old antagonisms in other quarters of the globe were once more arising, rearmament policies were again being embarked upon, militaristic expansion was undermining world peace. The President therefore made clear in this letter his belief that the steps which he suggested "would advance the cause of world peace inasmuch as the agreements which might be reached would supplement and reinforce the efforts of the League of Nations and of all other existing or future peace agencies in seeking to prevent war".

What President Roosevelt made doubly clear by this personal letter, which he addressed to the other American chiefs of state, was that he had in mind no plan of narrow isolation, but that he did desire to further a method of friendly, and practical coöperation between the peoples of the Americas in order to assure the maintenance of peace in the Western world, and in that manner to advance the cause of peace everywhere.

The accomplishments of the Conference can be classified under two headings: accomplishments in the form of written instruments, and gains of a spiritual character. With the latter aspect of the Conference I need deal very briefly. I may merely state that throughout the sessions of the Conference there existed an entire lack of suspicion, of recrimination and of friction. As I have stated on other occasions, there was not only a complete unanimity as to the objectives to be sought, there was also for the first time in the history of inter-American conferences a complete unanimity of opinion as to the methods to be employed. The three major conventions adopted by the delegates were presented to the Conference jointly by the twenty-one delegations, and when the Conference adjourned there was a greater measure of real understanding and friendship between all of the delegations represented than there had been at the opening session.

During the course of its sessions the Conference adopted eleven treaties and conventions, and sixty-two resolutions and declarations. I will limit myself to listing very briefly what I conceive to be the outstanding instruments to which the nations represented at Buenos Aires subscribed. First of all, let me cite the "Convention for the Maintenance, Preservation, and Reestablishment of Peace". This convention establishes in contractual form the obligation on the part of the American republics to consult together for the purpose of finding and adopting methods of peaceful coöperation in certain contingencies. These contingencies are as follows:

1. Whenever the peace of the American republics is menaced, whether that menace arises through threat of war between American states or whether it be of any other nature whatsoever; and

2. "In the event of an international war outside America which might menace the peace of the American republics", in order to "determine the proper time and manner in which the signatory states if they so desire, may eventually coöperate in some pacific action tending to preserve the peace of the American Continent".

This convention provides the following new factors in inter-American relationships: first of all, the mechanism for consultation, namely, the respective foreign offices; second, the scope of the consultation provided for, namely, the finding and adopting of methods of peaceful coöperation; and third, the practical method for the mobilization of public opinion on the American continent in behalf of the maintenance of peace. In the event that the peace of the Americas is threatened in any of the ways above indicated, and the twenty-one governments, upon the demand of any one of them, consult together, I believe that public opinion in every one of the republics will insist that the governments consulting together find the peaceful solution. Furthermore, this convention makes it possible for the peaceful solution to be found at the outset of a controversy—at the moment that the threat to peace first appears upon the horizon. That in itself is a major safeguard.

As an additional protocol the Conference unanimously declared "inadmissible the intervention of any one of them, directly or indirectly, and for whatever reason, in the internal

or external affairs of any one of the other parties" and agreed likewise that "the violation of the provisions of this article shall give rise to mutual consultation, with the object of exchanging views and seeking methods of peaceful adjustment".

In close relation to the convention and protocol just referred to is the "Convention to Coordinate, Extend and Assure the Fulfillment of Existing Treaties between the American States". This convention refers specifically to the five peace instruments to which the American republics are already parties: the Gondra Treaty of 1923 to avoid and prevent conflicts; the Kellogg-Briand Pact of 1928; the General Convention of Inter-American Conciliation, 1929; the General Treaty of American Arbitration, 1929; and the Treaty of Non-Aggression and Conciliation, known as the Anti-War Pact, of 1933. It recognizes the obligations of the American nations undertaken in those earlier treaties to settle by pacific means all disputes which may arise between them. Through this convention the American republics likewise agree that, when an emergency arises affecting their common interest in the maintenance of peace, they will, through consultation and coöperation, assist the other American republics in fulfilling existing obligations for pacific settlement, while at the same time recognizing the general right of each American state to individual liberty of action. Should any dispute arise between two or more of the parties, and should consultation on the part of the American republics take place, the parties in dispute agree that they will have no recourse to hostilities nor take any military action whatever during a period of six months. Moreover, those states which may be involved in some controversy, and which have been unable to solve the controversy by diplomatic negotiations, agree not only to have recourse to one or more of the peace instruments above cited, but also to report the method for pacific settlement which they adopt, and the progress made thereunder in the adjustment of their dispute, to all of the other signatory states. Finally, in the event that any American republics should fail to carry out their obligation to settle solely by pacific means the controversies which may arise between them, the signatories agree to "adopt in their character as neutrals a common and solidary attitude", to consult immediately with one another, and to "consider the imposition of prohibitions or restrictions on the sale or shipment of arms, munitions and implements of war, loans or other financial help, to the states in conflict, in accordance with their municipal legislation and without detriment to their obligations derived from other treaties", in order to discourage or prevent the spread or elongation of hostilities.

Another signal contribution to closer relationships between the American republics, and to the creation of that unprejudiced and friendly understanding which is one of the surest foundations for the maintenance of peace, was the "Convention for the Promotion of Inter-American Cultural Relations", by which the American governments each agree to award fellowships in some one of their universities or colleges to two graduate students or teachers from each other American country, and to receive an exchange professor from each of the other American republics to lecture and to teach in appropriate institutions of learning.

Furthermore, the American governments unanimously joined in demanding the abolition of economic barriers to peace. They recommended the reduction of excessive or unreasonable prohibitions and restrictions upon international commerce, and that this policy be carried forward through the conclusion or revision of bilateral commercial agreements and treaties. They likewise recommended the suppression of all discriminatory practices in their commercial policy, including those arising in connection with import license systems, exchange control, and bilateral clearing and compensation agreements, and called upon the other nations of the world to join with them in the removal of those economic barriers which so gravely menace today the maintenance of world peace.

Finally, I will list among the outstanding achievements of the Conference the "Declaration of Principles of Inter-American Solidarity and Cooperation" adopted by the Conference upon the initiative of the five republics of Central America. The text of this declaration is as follows:

> The Governments of the American Republics, having considered:
>
> That they have a common likeness in their democratic form of government, and their common ideals of peace and justice, manifested in the several Treaties and Conventions which they have signed for the purpose of constituting a purely American system tending towards the preservation of peace, the proscription of war, the harmonious development of their commerce and of their cultural aspirations demonstrated in all of their political, economic, social, scientific and artistic activities;
>
> That the existence of continental interests obliges them to maintain solidarity of principles as the basis of the life of the relations of each to every other American nation;
>
> That Pan Americanism, as a principle of American International Law, by which is understood a moral union of all of the American Republics in defense of their common interests based upon the most perfect equality and reciprocal respect for their rights of autonomy, independence and free development, requires the proclamation of principles of American International Law; and
>
> That it is necessary to consecrate the principle of American solidarity in all non-continental conflicts, especially since those limited to the American Continent should find a peaceful solution by the means established by the Treaties and Conventions now in force or in the instruments hereafter to be executed,
>
> The Inter-American Conference for the Maintenance of Peace declares:
>
> 1. That the American Nations, true to their republican institutions, proclaim their absolute juridical liberty, their unrestricted respect for their several sovereignties and the existence of a common democracy throughout America;
>
> 2. That every act susceptible of disturbing the peace of America affects each and every one of them, and justifies the initiation of the procedure of consultation provided for in the Convention for the Maintenance, Preservation and Reestablishment of Peace, executed at this Conference; and
>
> 3. That the following principles are accepted by the international American community:
>
> (a) Proscription of territorial conquest and that, in consequence, no acquisition made through violence shall be recognized;
>
> (b) Intervention by one State in the internal or external affairs of another State is condemned;
>
> (c) Forcible collection of pecuniary debts is illegal; and
>
> (d) Any difference or dispute between the American nations, whatever its nature or origin, shall be settled by the methods of conciliation, or full arbitration, or through operation of international justice.

I know of no relationship existing between nations of the world today which is on a higher plane than that proclaimed by the American republics by means of this declaration. If the twenty-one republics carry out the terms of this declaration in spirit as well as in letter, they will indeed be able to mark the new era in inter-American relationships which I believe to be before us as arising from the date of the signing of this declaration.

If I were to be asked what I believe to be the one most essential feature in this new inter-American relationship, the reply would have to be, "the sanctity of the pledged word". The plight which our modern world finds itself in today is due obviously to a variety of causes—many of them material and many of them undoubtedly moral—but it seems to me that if there were any one outstanding factor responsible for the growth of fear, and for the loss of confidence between nations, it would be the flagrant disregard by nations of their treaty obligations. No one would presume to say that treaties entered into under duress or which contained injustices or inequities are not breeders of international antagonisms, and should not consequently be revised through negotiation, but if international law still exists, if our modern civilization, so painfully built up during these past centuries, rests on any foundation, it must necessarily be founded upon the sanctity of treaties. There can be no healthy international relationship, if nations violate by unilateral action the obligations into which they have solemnly entered. There can be no hope for the peaceful adjudication of international disputes until, and unless, the nations of the world are again enabled to have faith in the sanctity of the pledged word.

That is why I stress this factor as an indispensable requisite in the ideal inter-American relationship. There are pending controversies between the American republics which must be solved if the peace of the Americas is to be maintained. Many of these disputes, I am glad to say, are already in process of adjudication by the peaceful processes of conciliation or arbitration. They are relatively few in number, and that they can be solved in this manner to the advantage of us all cannot be doubted, always provided the will to peace and the maintenance of the pledged word of the participants in the negotiations prevail.

Many of the American republics today are in the same situation in which the United States was placed during the nineteenth century. To develop the natural resources of our country, the investment of foreign capital was required—and that is the situation in many of the republics to the south of us. To develop their own vast natural resources, as yet hardly touched, the investment of foreign capital and the opening

of trade channels abroad are essential. Except on the basis of confidence, which must rest primarily on faith in the pledged word of the governments of those countries, and on the conviction that it will receive fair and equitable treatment, investment of new capital on reasonable and mutually profitable terms cannot be anticipated. The promotion of the economic development of the entire continent, which should bring with it increased employment and improved standards of living to all of our peoples, is chiefly dependent upon this one essential.

In this new epoch, there is also a need for an ever increasing stimulation of communications between our peoples. Some advances in material communication of recent years have been of the utmost benefit. The development of aviation has brought us all closer to one another. The development of highroads and the improvement of steamship communications are equally essential.

In the field of intellectual communication a great step ahead was taken at Buenos Aires. The governments of all of the republics have now pointed the way by assuming themselves the responsibility for providing for a limited interchange of students and teachers between all of the American countries. It is to be hoped that the start so made will bring in its wake an initiative on the part of universities everywhere, and on the part of those foundations and other organizations in the United States and in many of the other American republics, which can so greatly assist in bringing about that closer and better understanding of each other by the young men and women of the continent, which would tend to prevent that type of misunderstanding and prejudice so often conducive to national antagonisms.

Finally, the new period before us offers the American democracies, if they stand together, an opportunity unrivaled in its potentialities. I am well aware that certain sensational writers in our own country have claimed, since the Buenos Aires Conference, that democracy as we understand it is held in poor esteem in some of the other American republics. Not infrequently, I have also noted an apparent insistence on the part of such writers that the United States ought to do something about it. It is a strange thing that a certain type of professional liberal is always very liberal except in so far as his own point of view is concerned. If there is one thing above all others that the government of the United States today stands for in its relationship with the other republics of this hemisphere, it is its utter unwillingness to interfere, directly or indirectly, in the domestic concerns of those nations. Of one other thing I am equally convinced, and that is the fact that, no matter what certain passing manifestations may indicate, the life of every one of the republics of the Americas is instinct with the spirit of democracy.

There is no greater safeguard for democracy as we live it here in the United States, and as we understand it today, than international security. The example which the American governments gave the world at Buenos Aires, that a quarter of a billion of human beings, the citizens of twenty-one independent republics, can agree together to maintain peace between themselves, in order to advance their common good as well as their individual interests, is one from which the peoples of the rest of the world have already taken renewed hope and courage. To quote a phrase used not long ago by the distinguished President of Columbia University, the American democracies can be and have shown themselves to be a "stabilizing factor" in the universe of today. That, I believe, is the destiny of this New World.

REMARKS BY THE CHAIRMAN

CHAIRMAN JESSUP: Thank you, Mr. Secretary.

The next speaker is just completing a quarter-century of service as United States Senator from Nevada. For the last four years he has been Chairman of the Committee on Foreign Relations of the Senate, and in that position has played a leading part in the formulation of the legislation on neutrality in 1935-36, and during the current session. It is on "The Policy of Neutrality" that he will speak to us now.

I have great pleasure in introducing Senator Pittman.

THE POLICY OF NEUTRALITY

HON. KEY PITTMAN
United States Senator from Nevada
Chairman, Committee on Foreign Relations

I DEEPLY appreciate this honor of being invited to address you on the subject "The Policy of Neutrality". It is always a pleasure to discuss with scholars and distinguished students vital problems that require immediate action by Congress. I gain inspiration from such a discussion, though I approach this subject with some humility in the presence of the distinguished members of this nationally known and recognized Academy of Political Science.

I am restricted under the program to the topic, "Our Policy of Neutrality". I prefer under this title to discuss proposed Congressional legislation intended to aid us in keeping out of foreign wars.

The President and the Congress of the United States at the present time are naturally most interested in those phases of neutrality which will tend to keep our country out of the threatened, if not impending, world war.

While the general definition of neutrality is well understood, it is well known to you also that international writers, international lawyers, courts and arbitration bodies have given peculiar definitions to the expression, deemed necessary in defining the rights of belligerents as well as neutrals during war. For instance, is is held by high authority that it is unneutral for a neutral, after war has commenced, so to change its financial and commercial relations with the belligerent as to take such belligerent by surprise and suddenly deprive it of sources of supply upon which it had depended, and the deprivation of which will seriously injure it in the conduct of its defense. I call attention to this view solely as an illustration of an extreme case which, while apparently just to the belligerent, may work great harm to the neutral, in arousing the animosity of the enemies of such belligerent and possibly in-voluntarily involving the neutral in a foreign war not of its own making.

For instance, during the Italo-Ethiopian war, Mussolini declared that the placing of an embargo by the League of Nations upon the export of oil to Italy would be deemed not only an unneutral but an unfriendly act, attended with grave consequences. In fact, he clearly indicated that he would consider such an embargo a *casus belli.* At the time this matter was under consideration by the League of Nations, when the President indicated that he was considering bringing about an embargo upon the export of oil to both of the belligerents, Mussolini communicated to our government that he would consider such an act both unneutral and unfriendly. This whole incident was packed with the most sensitive explosives of imminent war!

Our government, in my opinion, undoubtedly has the legal right to place an embargo upon the export of any commodity. The Supreme Court of the United States in a recent decision entitled *United States v. Curtiss-Wright Export Corporation et al.* seems to hold that the President possesses such power without expressed authority of Congressional enactment. Certainly such an act is not prohibited by any so-called international law recognized by, or binding upon, the United States. There is no existing treaty, of which I have knowledge, that would prohibit such an act. Two treaties, which might have been so construed, have been vitiated through the acts of the parties to such treaties. Whether the exertion of such right is moral, just and wise during war is a grave question. It is for this reason that Congress has determined that any such restrictive legislation must be enacted during times of peace, so that all future belligerents may have notice.

Wars between powers separated by the seas have most often arisen over controversies with regard to the "freedom of the seas". In the very nature of things, as no government beyond the limits of its territorial waters has any sovereignty over the seas, all governments possess absolute and complete freedom upon the seas, except in so far as they may have voluntarily restrained or surrendered a part of such rights through national legislation, treaties, or through the recognition and conformity with certain general customs universally recognized and accepted by governments. These universally accepted customs are included in what is designated as "international law".

Philosophers from the earliest times have written upon the law of the seas. These rules of conduct, universally designated as international law, have relation generally to the rights of neutrals and the rights of belligerents upon the high seas during war. Grotius, one of the earliest writers upon the subject, as far back as 1625, in dealing with the question of contraband, divided contraband into three classes, namely: "(1) those that were of use only in war, (2) those that were of no use in war, but served only for pleasure, and (3) those that were useful both in war and in peace." He held that the first was contraband of war subject to seizure and confiscation; that the second was free; and that the third became contraband of war if the "belligerent could not protect himself without seizing it".

This rule has been substantially approved in principle by all of the great governments of the world, and has been restated in treaties at various times with various modifications. The difficulty arises in the application of the rule. What are the articles and materials that constitute contraband, non-contraband and conditional contraband? Some governments by their proclamations and their treaties have abandoned the classification of non-contraband, dividing contraband into the two classes, that is, contraband and conditional contraband. The question, then, arises during naval warfare as to the circumstances that change conditional contraband into absolute contraband. Who is to determine whether the "belligerent could not protect himself without seizing it", that is, seizing conditional contraband of war? Undoubtedly Grotius meant that the belligerent should primarily determine such a question. This has been and ever will be a source of violent controversy between belligerents and neutrals. Primarily, the belligerents determine and proclaim what constitutes absolute contraband and conditional contraband, and the circumstances in which conditional contraband will be treated as absolute contraband.

The neutrals, on the other hand, desiring that their commerce and trade shall be interfered with as little as possible, make and assert their own definitions of contraband, non-contraband and conditional contraband. They also for themselves declare the rule as to what state of facts and what acts result in the conversion of conditional contraband to absolute contraband.

Such was the practice of the belligerents and the neutrals during the World War. Our government, before it entered the War, asserted the broad rights of neutrals with the restricted list of contraband and yet, when it entered the War, it repudiated its former contentions as a neutral and as a belligerent adopted most of the rules, policies and practices of the belligerents against whom it had so strongly complained. It depends upon whose ox is gored. Neutral nations always anticipate the time when they may be called upon to defend the lives of their nationals, their property and their government. It is a fear of becoming a belligerent that prevents governments in times of peace from agreeing upon rules that would protect the rights of neutrals. It is this fear of becoming a belligerent that has made impossible the serious attempts through the years to codify the so-called rules of international law.

I again repeat that what our government is most vitally interested in at the present time is the enactment of laws prescribing rules of conduct for our own citizens, during a foreign war, which will eliminate some of the chief causes that have heretofore dragged us into such wars.

Whether these rules be necessary or not under the implied powers of the President, nevertheless they constitute the pronouncement of a policy which undoubtedly will be respected by the President in the conduct of foreign affairs.

At a time when another world war of even greater magnitude and destructiveness is threatened, if not impending, we have little time to discuss the academic questions involved in the rules of contraband, blockade, mining the open seas, and other questions generally included in the hazy doctrine of the "freedom of the seas". We must first prepare to meet an emergency. When peaceful conditions throughout the world arrive, it will be the duty of governments to renew the attempt to have all governments, through a convention or conventions, adopt certain fundamental and humane rules of warfare. These conventions will be morally, if not legally, binding upon the governments that adhere to such conventions. The

convention will in itself be a codification of international law. There is no other way, in my opinion, to accomplish the establishment and codification of international law. We should then bend every energy also, through universally accepted and ratified conventions, or at least through the adoption and ratification of such conventions by all of the powerful nations of the world, to secure the adjustment of international controversies by peaceful means.

In preparing for the next world war, and in determining what action we shall take on our own behalf in such event, it would seem wise and profitable that we should consider our relations to the last World War, and the causes that involved us in that great catastrophe.

When the War broke out in Europe in 1914, our government contended that under international law the citizens of the United States had a right to export anything to belligerents, and that only arms, ammunition and implements of war were absolute contraband subject to seizure and confiscation on the high seas, unless such other articles and materials were being shipped to, or for the direct use of, the military forces of a belligerent, or to a port occupied or blockaded by a belligerent.

Instantly the recurrent controversy between belligerents and neutrals arose. All of the belligerent powers, as is customary, arbitrarily made and defined their own lists of contraband and conditional contraband. These lists of contraband contained numerous articles other than arms, ammunition and implements of war, such as fuels, foodstuffs and clothing. The rules governing the conversion of conditional contraband to absolute contraband were so broad that substantially all items listed as conditional contraband were treated by the belligerent powers as contraband, subject to seizure and confiscation.

In fact, early in the War, Great Britain, by reason of the alleged action of the German government in covering into her military forces all of her subjects and in taking over control of all property, abolished the distinction between contraband and unconditional contraband, and proclaimed everything going to her enemies to be absolute contraband of war. Germany and her allies, of course, instantly followed the same course. The result was that there was nothing that we could ship to any belligerent without having it subject to seizure and confiscation.

Our government protested violently against this usurpation of the alleged rights of neutrals. These protests accomplished nothing. There was no treaty to which we could appeal, and there was no rule of international law that the belligerents recognized as binding upon them in the circumstances. There was no way to protect and enforce our alleged rights save by war or acts of war. We had the alternative of surrendering our alleged rights or fighting for them. The uncertainty and impotency of so-called international law, at least during war, was conclusively demonstrated.

Professor John Bassett Moore, distinguished authority on international law, correctly stated the condition of international law during war when he said: "The ancient maxim *inter arma leges silent* merely states a fundamental legal principle, which was happily expressed by Shakespeare in the line, 'The law hath not been dead, though it hath slept.'" As we must have some law, even for the governing of our own citizens during war, and as international law sleeps during war, we will have to make our own laws.

Great Britain then violated the accepted rules of blockade and the humane understanding that destructive mines should not be placed in the high seas. On November 3, 1914, she announced: "They therefore give notice that the whole of the North Sea must be considered a military area. Within this area merchant ships of all kinds, traders of all countries, fishing craft, and other vessels will be exposed to the gravest dangers from mines which it has been necessary to lay and from warships searching vigilantly by night and day for suspicious craft."

The Declaration of Paris, in defining blockades, declared: "Blockades, in order to be binding, must be effective; that is to say, maintained by a force sufficient really to prevent access to the coast of the enemy." Similar definitions have been given at various times by courts, boards of arbitration, and writers upon international law. Under none of these definitions, nor under the accepted customs of international law, was it legal for Great Britain to take the action provided for in her declaration. She strewed mines on the high seas, in the

course of travel between neutrals, which demonstrated her contempt for all so-called rules of international law.

The United States, of course, made every protest and demand that such violent action warranted. Nothing was accomplished by these protests and demands. Great Britain justified such acts on the grounds that it was legitimate retaliation against Germany for her illegal use of the submarine in sinking merchantmen without notice and without making provision for the safety of the lives of those on board.

There is always, it appears, some exception or excuse that belligerent governments can find and use to justify the violation of their treaties and of the so-called rules of international law.

And then Germany, on January 31, 1917, in retaliation against Great Britain, as she alleged, established a war zone upon the high seas around Great Britain, France, Italy, and the eastern Mediterranean. This zone not only surrounded these countries but covered trade routes on the high seas between neutrals. In giving public notice of the establishment of such zone, she declared: "Under these circumstances Germany will meet the illegal measures of her enemies by forcefully preventing, after February 1, 1917, in a zone around Great Britain, France, Italy, and the eastern Mediterranean, all navigation, that of neutrals included, from and to England, from and to France, etc. All ships met within that zone will be sunk."

There was no question of contraband involved here. Any neutral vessel, including our own, entering the zone with or without its knowledge, accidentally or deliberately, carrying neutral cargo to a neutral country, would be sunk without notice. Our government gravely protested against such an inhuman proposal, which violated every accepted custom of naval warfare. Germany stood on the supreme law of self-defense and the alleged right of retaliation, and so our government, having no remedy save war, sought to bring about an adjustment between Germany and her enemies so that the destruction of the lives as well as property of neutrals might cease.

On January 18, 1916, Mr. Robert Lansing, Secretary of State, with the approval of the President, had addressed identical letters to the British Ambassador and the French, Russian and Italian Ambassadors, and the Belgian Minister, in which he said:

> While I am fully alive to the appalling loss of life among non-combatants, regardless of age or sex, which has resulted from the present method of destroying merchant vessels without removing the persons on board to places of safety, and while I view that practice as contrary to those humane principles which should control belligerents in the conduct of their naval operations, I do not feel that a belligerent should be deprived of the proper use of submarines in the interruption of enemy commerce, since those instruments of war have proved their effectiveness in this particular branch of warfare on the high seas.

In this letter Mr. Lansing laid down five rules governing the conduct of submarines and merchantmen. I will not set out these rules. I will quote only one of the paragraphs from this letter, which I think discloses the gist of the proposition. Mr. Lansing wrote:

> It would therefore appear to be a reasonable and reciprocally just arrangement if it could be agreed by the opposing belligerents that submarines should be caused to adhere strictly to the rules of international law in the matter of stopping and searching merchant vessels, determining their belligerent nationality, and removing the crews and passengers to places of safety before sinking the vessels as prizes of war, and that merchant vessels of belligerent nationality should be prohibited and prevented from carrying any armament whatsoever.
>
> In presenting this formula as a basis for conditional declarations by the belligerent governments, I do so in the full conviction that your government will consider primarily the humane purpose of saving the lives of innocent people rather than the insistence upon a doubtful legal right which may be denied on account of new conditions.

All of the governments so addressed declined to accept or consider such proposals. The President then announced to the world that he intended to stand on our rights under international law. We had stood upon our alleged rights under international law from the very beginning of the World War. It had led us to the position that the President found our country in when he made that celebrated declaration. This announcement had no effect upon the situation. The sinking by submarines continued and the violation of all our rights under the accepted customs of nations with regard to naval warfare proceeded with renewed vigor.

On the 13th day of March, 1917, the President proclaimed armed neutrality and ordered the arming of our merchant vessels. This was the gravest mistake that our government made. Between that date and our entry into the War on April 6, 1917, less than a month, we lost the lives of a greater number of our citizens in the sinking of our merchantmen by submarines than we did from the beginning of the War until March 13, 1917. President Wilson, in his war message, recognized the failure of armed neutrality. In that address he said:

> When I addressed the Congress on the 26th of February last I thought that it would suffice to assert our neutral rights with arms, our right to use the seas against unlawful interference, our right to keep our people safe against unlawful violence. But armed neutrality, it now appears, is impracticable. Because submarines are in effect outlaws when used as the German submarines have been used against merchant shipping, it is impossible to defend ships against their attacks, as the law of nations has assumed that merchantmen would defend themselves against privateers or cruisers, visible craft giving chase upon the open sea.

And such was the history of the relations of our government to the War before our entry.

We relied upon international law as a justification for our citizens in traveling upon belligerent vessels. We relied upon international law as a justification for supplying the Entente powers with arms, ammunition, implements of war, and all materials and supplies essential to the successful conduct of the War by the Entente powers. We relied upon international law as a justification for the approval by our government of the sale of the bonds of the Entente powers in our country to enable them successfully to conduct the War. We relied upon international law in opposing the sinking of merchantmen by submerged submarines without notice. We relied upon international law for our declaration of armed neutrality. We relied upon international law for every assertion of our alleged neutral rights. This reliance brought us no benefits or protection and was our undoing. By our unrestrained supply of credit, by our unlimited and unrestrained supply of arms, ammunition and other contraband of war to the Entente powers, by our failure to force Great Britain to respect our undeniable neutral rights, we excited the German people and aroused their hatred until they had conclusively determined before we entered the War to engage in war with us, either during the pending contest or after that war was over. They undoubtedly had in mind that they would win the World War and that we would be made to pay the entire cost of it through a subsequent war with us in which they hoped and expected to have powerful allies.

This was clearly evidenced by the conspiracy that the German government attempted to consummate with our neighbor Mexico, and the powerful government of Japan. A hatred that inspired such an act and the intent for war could alone explain why an enlightened power, through its diplomatic officers in our country, at a time when we were at peace with it, and its diplomats were enjoying diplomatic privileges and immunity, would violate our hospitality and confidence and seek to destroy us. This act alone, without regard to other causes, justified our government in declaring a state of war to exist and was the chief reason why I voted for such declaration.

And yet we must not be too intolerant. We must place ourselves in the position of the German people at that time. We must realize that they were fighting for their lives and their liberty. The law of self-defense excuses many violent and inhuman acts.

The excuse for Germany's illegal acts, and I may say also those of Great Britain, is best expressed in a memorandum written in 1915 by Secretary Lansing, in which he said:

> What does a government whose people are dying by thousands for the sake of their country care about a legal right of property? What is the observance of law compared to a nation's life? How much do commercial interests weigh against the sacrifice of human life? That is the attitude of the governments of warring Europe. Can we blame them for their indifference to our legal rights? Can we blame them for their bitter complaints that we are mercenary, selfish, and unsympathetic when we insist that our own rights shall be respected, if to do so seems to conflict with their efforts against their enemies?

In this same memorandum he laid down the alternative for our government, in frank language. He said:

> Unless this Government is prepared to back up its threats with force it is useless to make them. No one believes that we should go as far as that, if it can be honorably avoided. There is only one way to avoid the issue, and that is to adopt a conciliatory and amicable tone. Even that may fail to give partial relief, but it is the only way to obtain any relief under present conditions.

His declaration was sound and true. His prophecy was sustained by history. Our insistence upon what we termed our legal rights could but lead to war, and I firmly believe that in the event of a similar war—and such a war is threatened—if we follow the same course of action we will again be involved in a foreign war.

And so Congress seeks to profit by our experience in the last war, that we may be able to keep out of the next war. The Senate and the House of Representatives have enacted legislation of a similar character, now pending in conference between the two Houses. This legislation prohibits our citizens from traveling on belligerent vessels except under such rules and regulations as the President may make to meet emergencies. It prohibits the arming of our merchant vessels engaged in commerce with belligerents. It prohibits loans to belligerent governments, or the sale in the United States of bonds, securities or other evidences of indebtedness of such governments. It provides that armed merchantmen of belligerents may enter our territorial waters only under such rules and regulations as the President may prescribe. It permits our citizens to sell to belligerents as well as to neutrals any and all products save arms, ammunition and implements of war. It defines and places an embargo upon the exportation of arms, ammunition and implements of war to belligerents. This is the only embargo imposed. It cannot be enlarged by any agency of our government. The only restriction upon the sale or export of other goods is that the title of such goods when intended for export to a belligerent shall be transferred from the citizen of the United States before being placed upon a vessel for shipment to a belligerent. There is another provision which authorizes the President of the United States to prohibit vessels of the United States from transporting such articles and materials in addition to arms, ammunition and implements of war, when he determines that such transportation of such articles or materials to belligerents will endanger the lives of our citizens and threaten the peace of our country. Most of the lives of our citizens were lost while traveling upon the vessels of belligerents. There is no good reason why our citizens should travel on vessels of belligerents. It is not only unnecessary but it is a useless danger for them to take and, upon their destruction, causes greater excitement among our people than anything else that leads to war. No one, I believe, can successfully oppose this provision. No one has seriously opposed the placing of an embargo upon the export of arms, ammunition and implements of war to belligerents. There is no reason to oppose the prohibition against the arming of our merchant vessels. Such arming is no defense against a submerged submarine and invites and even justifies attack.

There is considerable complaint against the provision requiring a transfer of title of our goods before they are exported to belligerents. Some contend that it is an unjustifiable burden upon our producers. Nearly all manufacturers ship their goods in the United States f.o.b. Why should our citizens be required by belligerent countries to take the risk of the loss of their goods in crossing a sea infested with submarines and war vessels of all of the belligerents intent on destroying commerce intended for their enemies? It is a well-known fact that those who lose their goods always contend that the destruction was illegal. They immediately start violent protests and seek to force our government to demand redress even to the point of war. These things have often involved neutral countries in foreign wars.

It is again contended that the transfer of title to belligerents will bring the war to our doors. What reasonable grounds do they find for such an assertion? The place of attack is determined solely by naval strategy and naval necessities, and not by the ownership of the product being transported. It is well known that naval vessels cannot successfully operate three thousand miles away from their base of supplies. Where would submarines and naval vessels obtain their fuel, their ammunition and their supplies? A submarine might have a cruising radius that would carry it to the shores of the United States and back again to its base in Europe; but it could not

carry supplies sufficient for it to remain long upon our coast. At the most, a submarine cannot carry over ten or twelve torpedoes. When they are shot away, the submarine must return to its base for additional supplies of torpedoes. Imagine a German submarine traveling three thousand miles to shoot ten or twelve torpedoes and then returning three thousand miles through a sea covered with cruisers, destroyers and airplanes seeking its destruction!

The same impracticable condition exists, but to a lesser degree, with regard to surface war vessels. None of these belligerent vessels could remain in our ports over twenty-four hours, and none of them could return to our ports within a period of three months thereafter. None of such war vessels could take on arms, ammunition, or any other supplies for the purpose of the conduct of war off our coast. It is far easier to blockade a narrow area near the enemy than it is to cover thousands of miles of the coastline of the United States. This contention is absurd.

Strong opposition in some quarters is manifested against the provision permitting the President to prevent our merchantmen from transporting certain articles to belligerents. These opponents of the measure contend that it will injure our merchant marine. I do not believe that that would be true. Our vessels now engaged in trade with countries that became belligerent might be compelled to transfer their trade to neutrals. The history of the last War was that ships of all nations left the Pacific and the south Atlantic, abandoned their existing trade, and flocked to the Atlantic ports of the United States to carry the more profitable freight to the belligerent countries. This abandoned trade would be open to the vessels of the United States. It might and probably would result in the opening up of commerce over trade routes from which our American vessels had been largely excluded. But it would be far more economical for our government if it paid to our merchant marine a bonus to cover the loss that it might sustain by reason of such restrictions than that our American seamen should lose their lives and that our people should be incited to war, as happened in the last War.

This provision is intended solely for the purpose of preserving the lives of our seamen. It is intended to meet such a condition of unrestrained submarine warfare as existed in 1917. I do not believe that such warfare will ever again be carried on against our neutral vessels. If we mark our vessels each time that they leave our ports, so that they may be readily identified by belligerents, and not be compelled to rely upon a misused flag for such identification, and if we notify all belligerents that our vessels are unarmed, that they will stop when commanded, and that they will submit to peaceful visit and search, I am sure that such vessels will not be sunk as they were during the last war. If this eventuates, then there will be no danger of the loss of the lives of our seamen and there will be no necessity, therefore, to put in force and effect this provision of the Act.

There are a great many wild expressions uttered, even by learned men, in opposition to any and all restraint upon our citizens and upon our commerce, even though Congress may deem such restraint necessary to keep us out of a foreign war. They say that we are surrendering the freedom of the seas. Well, what freedom of the seas? Do they mean the same freedom of the seas that we claimed prior to the last War? Do they mean the same freedom of the seas that was constantly and continually challenged by all of the belligerents for a period of nearly three years, while the lives of our citizens were being taken and our property destroyed? If they do mean that freedom of the seas, do they intend to fight for it, or will they allow the destruction and loss to continue, and after the war is over seek damages for such destruction, under some theory of international law? This may seem to international lawyers, who profit through damage suits, to be adequate protection, even though such damage suits are rarely won. The American people do not recognize that there is any adequate compensation for the loss of the lives of our citizens.

It is asserted that the reasonable restraint that we place upon our own citizens and upon our commerce will be more likely to drag us into the war than to keep us out of the war. What arguments have they in support of such a silly assertion? The people of this country fully realize the futility and tragedy of our entrance into the World War. They lost the lives of many of their sons. Others came back to them broken in body and mind, maimed, blinded, deranged, too

frequently to spend the rest of their hopeless lives in hospitals and insane asylums. And where was the financial profit? The money that we spent will never be recovered. The money that our government lent to the Entente powers with which to purchase our products will never be returned, and all of the false profits that our people thought they were making will be taxed out of them, and more for years will be taxed out of them, for the little comfort and protection that we can give to our heroic disabled soldiers.

War was not so near to our people in 1917 and 1918. It may be much nearer to all of them in the event of another great war. All of us may be soldiers then; in fact, wars in these days are wars, participated in not alone by armies but by all the people and all the resources of their government. In the next war it is probable that there will be no war profits, and every man and woman will be required to serve first his government.

I have mentioned these things only that the seriousness of war may be brought home to all of us, and that our people may be thinking more of keeping out of war than of the controversial questions of the "freedom of the seas", the rights of neutrals, and the rights of belligerents, and the possible injury to our merchant marine!

Serious controversies constantly arose between the United States and Great Britain prior to our entry into the War, in regard to the seizure of our products in transit to neutral countries, which threatened the involvement of our country in the War. These controversies included questions of contraband, which was involved in a more hazy question of continuous voyage. They involved the question as to whether Great Britain could take our vessels off the high seas into her ports for the purpose of search. They involved the question of military areas on the high seas and what constituted a blockade. These questions were so grave that had we asserted what we then believed to be our rights under international law, we would have been justified in pronouncing the acts of Great Britain as acts of war. Germany, however, precipitated our entrance into the War by her unrestrained submarine destructions beginning in 1917, and by her conspiracy against our peace. The President in his Declaration of War stated:

I am not now thinking of the loss of property involved, immense and serious as that is, but only of the wanton and wholesale destruction of the lives of noncombatants, men, women, and children, engaged in pursuits which have always, even in the darkest periods of modern history, been deemed innocent and legitimate. Property can be paid for; the lives of peaceful and innocent people cannot be.

And so we were dragged into a futile and devastating war not of our own making and against our will. We might have avoided the horrors of such a war had we been less contentious with regard to what constitutes international law and our rights thereunder, and had we been willing to make some temporary sacrifices.

It is not necessary to surrender our just rights, but it is better that we suspend them than that we lose the lives of our citizens without settling the questions and without any beneficial results.

If we intend to assert what we claim to be our rights, let us not place the burden of protecting them upon helpless merchantmen, but let us place the responsibility upon our naval forces. Our government can not determine the rules of neutrality; they may be determined only by a convention of nations. We can determine the acts of our own citizens in relation to a foreign war. This I conceive to be our duty. No mere handful of citizens seeking the excitement of travel, nor exporters seeking extraordinary profits, should be allowed to disturb the peace of our country and drive all of our people into a useless and devastating war.

DISCUSSION: THE UNITED STATES AND CONFLICTING WORLD FORCES

CHAIRMAN JESSUP: The discussion of these four extremely interesting papers which we have listened to will be opened by Professor Fenwick, of Bryn Mawr College, in charge of the international law work there for nineteen years. In addition to his many other activities he has recently served as international law expert to the American delegation, and was one of that delegation, at the recent Pan-American Conference at Buenos Aires. It is a great pleasure for me to introduce to you Professor Fenwick.

PROFESSOR CHARLES G. FENWICK: It would be futile to deny that those of us who have crusaded over a period of seventeen years for a better-ordered world are sadly discouraged at the present day. We had high hopes in 1920 that new principles of law were going to be adopted by nations. Today, after seventeen years, we find those principles largely rejected by our fellow countrymen or, if not rejected, set aside as no longer practicable. Because the ideal of a world of law and order could not be put into effective operation, we find our fellow citizens abandoning the ideal; because the conditions under which we sought to establish principles of law in the world proved to be conditions too hard to meet under the circumstances, the principles are being set aside as no longer the proper guides of our foreign policy.

If I may paraphrase the great English journalist, Chesterton, we have not only lost our way, we seem also to have lost our address. We are wandering blindly in a fog. We cannot be directed because we do not know where we want to go.

I turn now to the problem of neutrality, and I speak with great respect of the Senator who has just concluded his address, but I am thinking of the Senator who in 1918 told us of the new theories that were to prevail among the nations. "The old law of force is past", he said. "There is a new law, a new theory of peace and justice", and with great determination he argued in the Senate that the United States should take its part in the development of that new theory, that new law of nations.

Alas, we now have before us only a policy of neutrality. What is neutrality? In fundamentals it is a policy of washing your hands of any responsibility for law and order in the world. I say it with all due respect, with no criticism at all of those who hope to attain peace by neutrality. I am not unaware of the difficulties of the alternative policy.

Professor Jessup has sometimes accused me of crusading for a mirage and running the danger of being lost in the desert. That may be, but I say to you that we could have no law in the state of New York if the principle of neutrality prevailed in our midst. There is no neutrality in the state of New York, when crime is before us. No citizen may be indifferent to the commission of crime. You may not be able personally to meet the situation. You can only give the hue and cry; but you are personally responsible for the maintenance of law. You have your share in the integrity of justice and you cannot wash your hands of it. As citizens, we are collectively responsible for the maintenance of peace.

So it is within the Constitution of the United States. I have no time here (and I have done it on many other occasions) to show you that our Constitution fundamentally involves a system of collective security. It is written into Article IV, section 4, of our Constitution that the United States (plural) guarantee to each state a republican form of government and will protect each of them against invasion. That is the principle of collective responsibility written into our Constitution. There is no neutrality in the Constitution of the United States in the relations of our member states.

In international relations, however, the policy of neutrality now seems to be our only refuge. It is not a genuine policy of neutrality. Our new law ought to be called a policy for keeping the United States out of war. I doubt much whether it will do it, but that ought to be its name. It is not a neutrality policy. Neutrality means treating both alike, and that can only mean complete withdrawal from all intercourse of any kind with belligerents.

Are we willing to do that? We will not pay that price. We are willing to punish the wicked munitions makers and the wicked bankers whose center is here in New York, but we will not stop the trade in oil, nor will we stop the trade in cotton. If today an act of aggression were committed in Europe, if one powerful state were to attempt to absorb its neighbor—and you know what state that might be and what neighbor that might be—if little Denmark were the victim of an aggression, is there anything in our policy of neutrality that would treat them both alike? There is not. The aggressor would come and buy in our ports the goods that we have to sell, and little Denmark (or it might be Belgium or Holland) would have no chance of purchasing them—and yet we call it a policy of neutrality.

It is a policy which attempts to keep the United States out of war. If it can do so, well and good, but I question the very fundamentals of the policy. The policy of neutrality looks upon war as a cyclone, something beyond man's control; therefore, build a cyclone cellar and, when you see that little black cloud on the horizon, take to the storm cellar—but don't stay down too long. Rise up from the cellar from time to time to sell your goods, if customers can come and get them, but do not assume any share in the moral issue of responsibility for the community around you!

My friends, war is not a cyclone. War is of man's making, and man can stop it. The policy of neutrality is at best an attempt to protect oneself by having no concern, no responsibility for it. If war were a cyclone—hide! But I repudiate the suggestion that war is a cyclone. War is a conflagration, they say; build yourself an asbestos house and, if the town burns down, at least you will have a roof over your head. It is not a policy worthy of a great country.

I do not propose to go crusading to war. I do not propose, the moment a war breaks out anywhere, that the United States shall put on its armor and dash in and quickly choose one or the other as an aggressor and take sides and make war. That is fantastic! All this talk of commitments and entanglements, of making another war to end another war, is only drawing a red herring across the path, the path towards a system of collective responsibility on the part of all nations for the maintenance of peace.

What does that mean? That means that the United States has a concern in law and order in the world, that we are not merely a nation of economic interests, a conglomerate of material possessions which it is our sole interest to protect. We have a concern in the maintenance of law and order everywhere and, if, without commitments and entanglements, and without involving ourselves in any new war, the United States could contribute to the maintenance of law and justice in the world, then we should be but living up to the ideals of our own Constitution.

I insist that in our Constitution lie the principles of a better-ordered world. We have said to the individual states of the United States: You shall not be the judges in your own case. We have said to them: You must take your disputes to the Supreme Court of the United States. We have given compulsory jurisdiction to our Supreme Court. We have said to the individual states of the United States: You shall not take the law into your own hands, but you must all get your protection from the combined force of the whole United States.

We have introduced the principle of collective security and I beg to say once more—as I have said many times in these past seventeen years, and, again, I am only echoing words of the Senator—that you *cannot* get disarmament except as a result of the establishment of collective security. As has been well pointed out this morning, it is folly to try to get peace by matching six-inch guns against eight-inch guns, or by ratios of 5-5-3—1.75-1.75. Nothing is more futile. If we get disarmament, we shall get disarmament as a result of collective security, not before.

The United States is gravely interested in this great problem of law and order in the world. The only question is, what leadership can we assume? In this disordered time, with anarchy prevailing in the world, with one nation arming against another with a feverness which did not exist in 1914, is it possible to do anything?

We have the same grave concern in the avoidance of war anywhere in the world that we would have in the avoidance of war just across our boundaries. You may remember the story of the colored chauffeur who was driving his captain along a dusty road in France, when the captain said to him, "Sam, how long do you think this war is going to last?" Sam replied, "Boss, I think the war is going to last one hundred years. It will take one year to lick the Germans and ninety-nine years to wind up all that barbed wire."

Interpret barbed wire in terms of human passion and human hate, in terms of resentment and suspicion and distrust. The world is still winding up the barbed wire of the World War, and it will be a good many more years before it is entirely wound up.

What can the United States do? Shall we call a conference? A few days ago, to my regret, the President and the Secretary of State announced that no conference was possible. It may be asked, how can a conference be called when all the nations are arming? Would it not be a joke for the press, a conference now, with everybody arming to the teeth? The time to stop the race in armaments is the moment when the hope of doing so seems almost lost.

Are you going to wait until things cure themselves by another war? The time to call a conference is when you have just one chance in a hundred, and you take that chance because it may succeed.

I think myself that it is not just "one chance in a hundred"; there are many more chances in a hundred, and we should assume the leadership in trying to find those principles of law that will save the nations from this "next war".

The principles are clear; they are in our Constitution. There is no novelty or mystery about what could be done. It is only a question of who will be bold enough to take the lead.

Do not set up another league, and do not encourage the present League in the idea, which Professor Shotwell has shown is erroneous, that it can keep peace by merely maintaining the *status quo.* Strengthen the League; remake the League; insist that it must not only keep the peace but must go on to remedy the injustices of international relations, must go on to meet the causes of war, must go on to cure those economic conditions, so well described by Secretary Welles, which are the things that bring on wars.

It is not too late. Why is it not too late? It is not too late because the urgency is so great. We can not wait till next year. We must destroy war today, or war will destroy us tomorrow. The time to act is now, and I say, with all the conviction I can put into my words, that the United States has a responsibility based upon its power. We alone today, in this disordered world, have the power to act. We alone are sufficiently aloof from the whole problem to be able to approach it impartially, fairly and constructively.

If the United States, as Secretary Welles has said, gave leadership to America at Buenos Aires last winter, if we held up new principles of law, if we turned, in his words, "a new page", if we opened a new chapter in history, we can do for the rest of the world, for Europe, what we did there.

CHAIRMAN JESSUP: The meeting is now open for discussion from the floor.

MR. PRAGER: May I ask Senator Pittman to reply to Professor Fenwick?

SENATOR PITTMAN: Yes, I wish to say that Professor Fenwick has correctly quoted me in 1918. I was very strongly for the League of Nations at that time. I did not believe that force was necessary in the Covenant. I had argued a number of times that if the members of the League had a large table to sit around, like a directors' table, and if they would all discuss what they considered their wrongs, most of their problems would be settled. However, as I look back on it, I think that I can see some mistakes which were made by the organizers of what we call the League of Nations.

I realize now that we could not have a successful League of Nations unless the conquered, as well as the conquerors, sat around that table. I think that so long as Germany and Austria and some of the smaller countries, Turkey, for instance, were kept out of the League, and Russia was not invited into it, a real League of Nations did not exist. There was no place where the conquered could go for the purpose of discussing what they considered to be the injustices in the Versailles Treaty; they could not find a forum before which they could present their contentions concerning their wrongs. That very fact has rankled in the breasts of the German people, until a spirit of hatred again has arisen with varying manifestations.

At the present time I believe that we have very little influence in world affairs. We refused to go into the League of Nations. The League of Nations became a failure for the reason that I have stated. The old hatreds were aroused again, and alliances were made in violation of the Covenant itself. When the time came to enforce the provisions of the Covenant, there was no unity, for governments manifested greater attachment to these alliances than they did to the League of Nations.

We are not in a position to go to any great country in Europe today, in my opinion, and say to it, "Reduce your armaments", unless we are prepared to say at the same time, "and we will aid you to the limit of our power in protecting you against aggression." Our people are not now ready to make any such guarantee and, until they are ready to do so, we accomplish nothing in times of great excitement such as this, when fear is everywhere, by suggesting reduction of armaments.

MR. ZINSARI: May I ask Professor Shotwell to comment on Senator Pittman's remarks about a reorganization of the League of Nations to meet present problems?

PROFESSOR SHOTWELL: It is perfectly clear that the problem of the sanction had not been thought through, when we were considering the League of Nations in the first form. The situation becomes apparent, if you follow the trend of Senator Lodge's mind in his debates with the President. He was one of the founders, or one of the chief members, of the League to Enforce Peace, which went much further than President Wilson had ever intended to go, or ever willingly went. Then, when Senator Lodge began to meditate upon the consequences of his philosophy, led thereunto by the fact that the President of the United States had got on the same side, he turned to the other side and pointed out the danger of enforcing peace.

That should have been realized from the first. There is a danger. There is danger for the policeman whenever he has to go into action. The question is, as Mr. Fenwick put it: Can you have a community of nations and have no provision for police?

I am on Mr. Fenwick's side one hundred per cent. That is part of my answer. The conception and the method of law enforcement

in the world have not been thought through, either in the United States Senate or outside of it. It is a vast new problem. During the period when we are thinking of it, we must, of course, avoid the dangers of precipitate action, but the experience of the League of Nations is not without some lessons for us. That experience showed that when a crime—and I believe it to have been a crime—was committed in Ethiopia, the states in Europe, which felt the danger of becoming involved themselves, stayed out of coöperation in police measures. Furthermore, take a simpler case; the French were never more willing to send their *poilus* into Manchuria than we were to send our boys to the Balkans. I suppose, therefore, that the problem of world police is a problem that must be graded according to the interests and responsibilities of the component parts. I have failed to find any debate in the Senate, or anywhere else, that has penetrated to that fact.

We have considerable interest in the maintenance of peace in the world at large. It is the only way that we can be secure in our own peace. To accept a doctrine of nonresistance may satisfy, for a time, a certain section of our country, but it is not wholly in keeping with the tradition of our Puritan past. Should an issue arise, and should we find ourselves really accomplices with criminal nations, forcing further and further elements of anarchy upon the world, I am certain that no Senator of the United States could stand against the aroused anger, resentment and sense of justice of this country.

It is all very well in times of peace to say that we shall not discriminate between an aggressor and a victim, but that is not in the tradition of America, and I ask Senator Pittman whether our history runs along those lines, whether our institutions could ever have been founded if we had stood for that kind of compliance with crime. Is there no way for us to distinguish aggressor from victim? Certainly we will never find the way if we do not try. Certainly we will never find the way if we refuse to experiment in the principles of jurisprudence.

Does anyone in Washington seriously come to grips with the proposal laid down in the League, that the aggressor is not just that nation which has an irritant or a cause, but is that nation which refuses to go to court? In a world that is playing with anarchy, have we done anything to support the principle of going to court? No, we have not. On the contrary, we have applied every patent medicine for peace that the American people could think of.

MR. CASTLE: I agree very strongly with what Senator Pittman said, and with what Mr. Welles said, about the spiritual value of these conferences, including the League of Nations. It seems to me that we do not realize how much the League of Nations has so far done for the world. We see all the failures. We see the failure in Manchuria; we see the failure in Ethiopia, if it was a failure; we do not realize how often the statesmen of the world, getting together and talking things over quietly, have avoided trouble.

If the conference at Buenos Aires had done nothing in the way of written treaties, I believe it would have been of immense value to this hemisphere, because it drew the people together in a spirit of friendship and good will, and it ended with those people appreciating each other more than they did when they came together. That is of enormous importance.

So far as neutrality is concerned, I am a rebel, for I distrust local neutrality legislation. Of course, this legislation in Congress, as Senator Pittman himself has said, is not neutrality legislation; it is legislation to keep us out of war. I am not at all sure that it is going to keep us out of war. I should be the first to advocate another conference of the nations on that very subject, however, because it seems to me that the United States can go a long way in agreeing with the other nations of the world as to what the neutrals can do in war with safety to themselves, and with a great deal better chance of helping the world, than we can do by any local legislation—and we must remember that the only possible way we can surely keep out of war is not to have any wars.

MR. PHILIP SPORN: I wish to ask Senator Pittman two questions. The first one: Admitting that we are going to be a sufferer from a war, whether we enter it or not, and admitting that war seems imminent unless something is done, what possible excuse can there be for the failure of the United States to take active steps, whether such steps mean alliances or entanglements, to avoid this war? Now, if I am answered by the statement that the people of this country are not ready to take such steps, then I desire to ask another question. Is it not the duty of persons such as yourself, and other Senators, to prepare the people of this country for whatever steps may be necessary to avoid a war?

SENATOR PITTMAN: May I, Mr. Chairman, first respond to the challenge by Professor Shotwell? He asks whether the Senate has given any serious consideration to the questions which he was discussing. I wish to say that it has. In the Foreign Relations Committee of the Senate ever since the War there have been resolutions pending, off and on, which called for expert advice and we have had it. It is conclusively evident that the assurance of the United States that it will render protection to countries, who are willing to

risk their own peace in determining the aggressor, carries with it the ultimate assurance that, if necessary, all of the armed forces of the United States will be used. As Secretary Lansing said in that celebrated note, all of which I did not read but which I place in the record, we can not afford to bluff. When we bluff, we must be prepared to fight, and that means war.

I am asked whether the Senate should not advise the people of the country concerning the best means of avoiding war. The people of this country have an extraordinary knowledge of the history of the World War. They are a very intelligent people. The literacy is higher here than anywhere in the world. Our people have had an opportunity in several political campaigns to hear the ablest speakers of the United States on both sides of that question, and I remember that in 1920, when the Democratic candidate for the presidency, Governor Cox, of Ohio, really made the League of Nations the issue, the vote in this country was overwhelmingly against him in that campaign. I realize that there were other issues. There were local issues, but the League issue so far overshadowed all others that I am convinced that the people of the country knew what it was all about.

Our people love peace as no other people in the world. Our people would make almost any sacrifice for peace, but they do not intend to constitute themselves policemen to protect a foreign country. They lost too much during the last war. You cannot tell the mothers and the sisters and the brothers of the boys who did go over there that anything will compensate for the loss of those boys, for the maimed and blind and deranged and consumptives, who must suffer all of their lives. Yet we thought that we were fighting an aggressor. We thought that we were fighting a brutal power in the world, a power that was determined to conquer the world.

I say to you that if the statesmanship of distinguished scholars like Dr. Shotwell and Dr. Fenwick, after twenty years of the existence of the League of Nations, has not formulated some sound policy of enforcing the orders of that League, why should we criticize the United States Senate?

MR. CRAMER: It has been suggested by some of the speakers that the United States take a greater interest in the League of Nations' discussions concerning world peace and disarmament. It so happens that at the moment more and more of the European countries, including one of the Asiatic countries, have drifted into so-called economies where individuals—entrepreneur, laborer, peasant—speak and act in terms of one unit, one Italy, one Germany, one Japan, and so forth. Isn't there, therefore, a psychological and philosophical approach, when their representatives do attend a conference at Geneva, different from that of the representatives of true democracies, where the constituents still have full representation, or have a great deal to say in the running of their respective economies or governments? In other words, wouldn't it be futile for the representatives of one type of economy, in the countries of North and South America, for example, to try to convince the representatives of a different type of economy, such as we find to an increasing extent in Europe? I wonder whether Professor Fenwick and Professor Shotwell have considered this economic approach to the various factors involved.

Professor Fenwick: I do not consider the difficulty a fundamental one. It is very serious, but certainly not insuperable. We are not dealing here with a situation where, if you do not take action, nothing much happens. The situation in the world today is so terrifying that we must make a desperate effort to try to find a remedy. Is there an obstacle in dictatorships? Certainly there is an obstacle in dictatorships, but the dictatorships are partly an effect of a wrong international system. I suggest to you that the true Germany is the Germany of 1926, when Briand and Stresemann took hands across the table at Geneva and pledged the peace of Europe. If, at that time, the great powers, including the United States, had faced collectively the problem of removing the economic causes of war, and of protecting Germany, and Italy, and every other country, from a condition of industrial starvation, we might have prevented the very conditions that have arisen and that now make the approach so much more difficult. We ourselves are partly responsible for the conditions of economic strangulation which drove a fine people, as I believe the Germans to be, to take almost desperate measures to force the world to give them what might have been given them by international consultation.

Professor Shotwell: May I ask Senator Pittman a question? I wonder whether he would agree to give us neutrality legislation on a temporary basis for a couple of years instead of making it permanent, in view of the facts which have been brought out this morning and which, of course, have long been familiar to the Foreign Relations Committee of the Senate. The particular exigency in the world today is somewhat unique. We might be able within two years to work out legislation that would not run counter to the conscience of a great many people in the United States who may spend the next few years undoing that legislation.

Senator Pittman: Professor Shotwell, you know that the Foreign Relations Committee of the United States Senate thought that that peace measure was such a perfect one that they wanted the people of the United States to have it forever. The House has not taken the same view of it, and they may insist that it last for only two years. However, if Senator Hiram Johnson had any idea that at the end of two years we were going into some kind of agreement to join others in naming the aggressor and punishing the aggressor, I think he would filibuster so there wouldn't be any bill passed for two years.

PART II

ECONOMIC AND FINANCIAL POLICIES ABROAD

INTRODUCTION *

WESLEY C. MITCHELL, *Presiding*
Professor of Economics, Columbia University
Director, National Bureau of Economic Research
President of The Academy of Political Science

THE Academy of Political Science is a non-partisan, non-propagandist organization of men and women interested in problems that are important to the radio audience as well as to those present in the Hotel Astor this afternoon.

The Academy welcomes to its membership all persons who believe that the manifold difficulties in the art of living together are best treated by the dispassionate consideration of conflicting viewpoints and conflicting interests. All who share this faith are cordially invited to become members of the Academy, participators in and supporters of its work.

The subject of this afternoon's session is "Economic and Financial Policies of the United States Abroad". The first paper is to be presented by Robert Warren, of Case, Pomeroy & Company. Mr. Warren speaks upon "The International Flow of Capital in World Economy", a subject about which public officials, businessmen and economists have recently become deeply concerned. As a member of one of the country's leading financial houses, Mr. Warren has had excellent facilities for observing the huge international shifts of capital that have been occurring in recent months. As an economist of insight, he has thought about the causes of these dramatic movements, the effects they have produced, and their potential significance in the uncertain times to come.

I have the pleasure of introducing to the Academy of Political Science, Mr. Robert Warren.

* Opening remarks at the Second Session of the Semi-Annual Meeting.

THE INTERNATIONAL MOVEMENT OF CAPITAL

ROBERT B. WARREN
Of Case, Pomeroy & Company

IT is fortunate if now and then we can turn our attention from daily concerns and survey the more general scene—if we can lift our eyes from the immediate pathway and look back over the road that we have hopefully and fearfully traveled. As we look back over this road, one fact strikes us forcibly as economists—its remarkable unlikeness to the descriptions in the standard guide books of thirty years ago. It is true that most of the topographical features and many of the works of man were noted in the economic Baedekers. Currency and credit, trade, labor relations, the function of speculation, the international movement of capital were discussed at length, but as we have encountered them along the road of recent years, we have found them quite different from the formal diagrams.

This is particularly true of the international flow of funds. In the textbooks, this chapter is conveniently set forth under two headings—the flow of short-term funds, described as responsive to minute differences of discount rates, and the flow of long-term funds from economically developed areas, with a surplus of capital and a high standard of living, to economically undeveloped areas requiring capital to increase the production of the materials needed by the creditor economy.

Now, however accurately this describes the international flow of funds in the past, it is unlike the reality with which we are familiar. In the post-war period, the United States has figured actively in three separate and distinct capital movements, each characteristic of a particular economic phase. In two of them, prior to the depression, the United States figured as an exporter of capital; in the third and current movement, we are the importer.

The first was distinctly political rather than economic in character, and properly belongs in the appendix of the history of war finance. I refer to our share in that complex of capital movements which derived from efforts at the payment and transfer of the reparations and inter-allied debts. Our rôle was to lend Germany the money which Germany paid to the Allies as reparations, and part of which they, in turn, paid to us.

The second movement was economic in character. This included certain of our reconstruction loans to Europe; but more typical was our financing of South America. It took two forms—equity financing and loan financing. We usually remember the loans, and forget that direct equity investment in enterprise—mining, public utilities, etc.—was of comparable importance. Both types have their place in a world which combines a yearning for stability with a persistence in moving. In a moving world, the flexibility of equity financing adjusts itself to the inevitable fluctuations more readily than the rigidity of loan financing. I would suggest for your consideration the personal conclusion that in international investment, equity financing is the preferable form. In the abstract, it would probably have worked out better if in the twenties the ratio of loans to equity investments had been lower; and, if in opposition to this argument it is stated that in that event the total magnitude would have been smaller, I can only add that such an argument would confirm my conclusion.

The third type of international capital flow has been neither political nor economic in character. It is peculiar to the period, and in aggregate magnitude, economic repercussions and social significance it is the most important of the three. I refer to that fitful sequence of movements which we designate as flights of capital. There was the flight from the mark in the early twenties, the flight from the franc in the middle twenties, the flight from the pound in the early thirties, and now the general movement of capital from Europe to the United States, which we picturesquely nickname "hot-money", and on which we have unusually complete data. In discussing this, I would offer two comments: (1) this type of movement is anti-economic, for it does not represent the export of a true capital surplus of a developed economy with a high standard of living to an undeveloped economy with a lower standard of living; and (2) it is anti-economic because it actually im-

poverishes the capital exporting countries and does not enrich the capital importing countries — in this instance the United States. I do not mean to imply that all of the capital that has flowed here in the last three years has been "flight money". It is, however, my contention that by character this great and continuous flow of money into New York in the past three years belongs in the general category of flight or refugee money, and that the movement, as an economic phenomenon, should be studied in that light. So regarded it takes on a far more serious significance and implication than if it is considered as a mere speculative movement, or than if it is viewed from a purely local standpoint as a question of "hot money".

For months "hot money" has been a topic of intermittent interest. The Treasury has issued a detailed report on the subject, which shows that in the past two years something like $100,000,000 a month has been flowing into New York. Only half of this money has been invested in American securities. The remainder has sought neither capital appreciation nor income; all it wanted was the security of the American dollar. It is not merely the magnitude, but the persistence and continuity of this movement of capital that make it one of the outstanding economic phenomena of our lifetime. Yet so persistent and so continuous has this movement been that we have come to take it for granted, or, at most, to consider it only from our own standpoint.

Now to me, the significance of this so-called "hot money" is not the statistical fact that capital to the value of x million dollars comes to New York from Europe every month. It is the question of why it comes. It is, as was stated above, obviously a non-economic movement. In no country of Europe is the standard of living as high as it is here; in no country of Europe is the standard of industrial equipment so high; the absence of the usual profit motive is evidenced by the fact that a great proportion of funds sent here remains uninvested. What then is the force which persistently impels these great sums hither, and what, to us, is the significance of an economic force of such vigor and such magnitude?

As we look back over the international movements of capital enumerated under the heading of flights, it appears that their common cause has been a distrust of currency. To meet the economic description of money, a medium of exchange must possess the quality of a store of value. This quality may be sought in a variety of ways; and in its perfection it remains but an ideal. Nevertheless, unless the nationals of a country have confidence that their currency possesses this quality to a practicable degree, they will endeavor to place their capital in some area with a currency in which they have greater confidence, not so much in the hope of making a profit as in the hope of preserving a given sum against loss. Since January 1934, the United States has been the sole country which combined a legal definition of its currency in terms of gold with an indubitable ability to maintain that legal definition. In other words, by this standard the American dollar has possessed the quality of a store of value above other units. The result has been and is a demand for dollars that has become a flight to the dollar.

This creates a serious problem for us, but it has created far more serious problems for the nations from which the flight of capital is coming. I will give but one illustration: The French government has just been able to sell a large amount of long-term 4½ per cent bonds at 98, payable at the bearer's option in dollars, pounds or francs; at the same time bonds of the same coupon denominated only in francs sell under 75. That is, the French capitalist is willing to pay a premium of almost 30 per cent for the sake of this currency option.

We must push this inquiry a little deeper. Supposing that these currencies are distrusted, why does this distrust exist? No doubt a variety of answers may be offered. In my opinion these currencies are distrusted by reason of governmental deficits, either financed by present inflation or threatened with the imminence of inflation. "Deficit" is an ominous word at best, but there are degrees of ominousness even among deficits. European nations, still staggering under the debts of the World War, are incurring these deficits in preparation for the next war. In my opinion, the flight of European money to the United States has a graver impulse than the fear of currency depreciation.

No doubt individual European capitalists made money out of the last war, but the consequence of that war was the extinction of capitalism over much of Europe. No doubt there

are European capitalists who are making money out of the present armament boom. Yet there is no European capitalist but realizes that nations arm because they anticipate a use for arms, and that another general war would end capitalism on the Continent. It is not conventional to identify capitalism with pacifism; but the most cursory glance at Europe will show that the sabre-rattling comes from those countries where capitalism has been subordinated to a non-capitalistic collectivism, under whatever alias that particular brand of collectivism may be known at the moment. The steady flow of capital out of Europe, continuing month after month, as the data show, is dominated by the desire of European capitalists to put three thousand miles of green water between their fortunes and the next war.

But note how in this phenomenon, as in so many economic phenomena, cause and effect mingle in a vicious circle. Capital flies from the distrusted currency, and the flight itself weakens the currency and justifies the distrust. Capital flies from the country threatened with war; the uneconomic flight creates unemployment, which the politician "relieves" by armament programs, lowering the standard of living of masses whose minds must be distracted from their distress by international adventures. The spokesman of a great nation recently acquired an invidious notoriety by declaring publicly that his people would rather have guns than butter. At least this had the merit of frankness, for I would assert with all gravity that there is scarcely a government in Europe today that has not made the same choice. Capitalists are not notorious for humanitarian sentimentality, and it is not soft-heartedness but hard-heartedness that makes the European capitalist send his money to a country that still prefers butter to guns.

At this point, I wish to present my first conclusions. The most conspicuous international movement of capital at the present time—and indeed the only one of note—is the flight of European capital to the United States. This movement is significant, not only for those reasons commonly given in discussions of "hot money", but also *for the consequences* to the European economy of such a continuing drain and *for its causes* — the fear of currency depreciation and of imminent war, fears to whose realization the movement of capital itself contributes.

We may deplore this movement from all of its varied aspects, but if this analysis is correct—or perhaps better, to the extent that it is correct — it appears so fundamental as to be quite beyond the superficial remedies. If there is a remedy, it must eradicate the cause. That underlying cause is the fear of war.

We must carry our inquiry one question further. What is the cause of this anticipated war which Europe both fears and accepts as inevitable—a war so imminent that every economic consideration must be subordinated to its preparation? Many answers to this question may reasonably be advanced, but to me the greatest single force moving Europe toward war has been the widespread acceptance of the doctrine of economic nationalism or national self-sufficiency. Basically, of course, this is a concept of war-economics; the nation that envisages itself as a beleaguered city shut off from the world must prepare itself for a state of siege. Since several great states which have adopted the doctrine of national self-sufficiency are well aware that economic self-sufficiency is impossible within their present frontiers, the nation that begins by envisaging itself as a beleaguered city presently finds itself under the necessity of contemplating conquests. But do not for one moment suppose that one particular group of nations can be singled out; the doctrine of national (or imperial) self-sufficiency has swept the entire Eastern hemisphere and its consequences have recoiled upon all its devotees alike; all have bowed the knee to Baal and all are offering their children to Molech.

The international movement of capital on a large scale, under the influence of the fear motive rather than of the profit motive, has been an outstanding phenomenon of post-war economics. The present movement of foreign capital into the United States seems to fall predominantly, although not exclusively, into that category. In meeting movements of this character, the remedies proposed are usually piecemeal and superficial. For example, in the present instance the measures proposed in the capital exporting countries are usually some form of exchange control, capital embargo, or the imposition or threat of punitive taxation. For the United States, as a

receiving country, the remedies commonly proposed are punitive taxation or an alteration of the exchange value of the dollar. None of these devices affects the cause or causes of the malady.

It is the contention of this paper that the current movement of capital to the United States does not reflect simply capitalistic speculation, but rather a flight. The argument has traced the cause of this flight back through the distrust of currency to the war fear; and it attributed this war fear to the consequences of the acceptance of the doctrine of economic nationalism—a doctrine which induces nations to reject the concept of the world as an economic unit, and to seek for national or imperial self-sufficiency, with the inescapable implication of war rather than economic coöperation.

It is quite possible that this phase of history must go through its logical sequences, and justify the gravest apprehensions. But, in conclusion, we should enumerate certain of those developments which seem to be working in the opposite direction. First, the tripartite monetary agreement of last September was a challenge to the application of economic nationalism in monetary affairs. Second, our bilateral trade agreements are a challenge to economic nationalism in trade affairs. In passing we may note that what was originally a tripartite agreement has since become multipartite, and that there have recently been concluded between several groups of European countries bilateral trade agreements analogous to ours. Third, some progress is being made in the direction of the re-creation of a normal international capital market in the Western hemisphere by the recent and current negotiations with South America. It is conceded that these are but tentative and provisional acts. In ascribing to them some significance as evidence of an incipient trend away from economic nationalism, I plead guilty to the charge of wishful thinking. It may be too much to expect that the nations of this world will suddenly decide to become good neighbors; the devastating alternative is only too clear. It is the part of economic realism to recognize the strength of those forces which have converted so much of the world to the doctrine of economic nationalism, and to point out that the wealth of nations is not increased by following this doctrine. It is the part of economic realism to recognize the strength of those forces that drive capital into international movement in an effort to escape the complex consequences of economic nationalism. It is also the part of economic realism to point out that frightened capital is unproductive capital, and to give due weight to those policies which are calculated to restore to the international movement of capital its economic function of raising the standard of living in both the capital exporting and the capital importing nations.

Remarks by the Chairman

President Mitchell: The second paper on this program, which is entitled "Foreign Lending by the United States—The Record and the Prospects", will be presented by Francis White, Executive Vice-President and Secretary of the Foreign Bondholders Protective Council. As many members of the Academy of Political Science know, Mr. White is one of the most widely experienced of American diplomats. Even during his student days he was an internationalist. After completing his college work in this country, he carried on post-graduate studies in France and in Spain. Entering the diplomatic service at an early age, he has worked in China, in Persia, in Cuba, in Argentina, in Spain, and in Czechoslovakia. For four years he was in charge of the Division of Latin American Affairs in the State Department, and for six years Assistant Secretary of State. Out of this abundant experience comes his equipment for serving as Executive Vice-President of the Foreign Bondholders Protective Council and for speaking upon the subject which he will now discuss. Mr. White!

FOREIGN LENDING BY THE UNITED STATES—THE RECORD AND THE PROSPECTS

FRANCIS WHITE
Executive Vice-President and Secretary, Foreign Bondholders Protective Council

APART from the $10,350,000,000 loaned since 1917 by the United States government to foreign governments, private investors in the United States have loaned abroad since the close of the World War about $9,830,000,000, of which amount some $6,832,000,000 comprises loans to 40 foreign governments and 119 governmental subdivisions and to corporations whose bonds are guaranteed by such governments or governmental subdivisions. Of this latter amount $5,290,000,000 was outstanding at December 31, 1936, and of this amount approximately $1,900,000,000 was in default. That is, of the direct and guaranteed governmental bonded indebtedness about 36 per cent is in default. Divided geographically, this represents 38 per cent of the loans issued for European governments and governmental subdivisions, 1 per cent of those in the Far East and 81 per cent of those in Latin America.

The recovery of these huge sums is of vital interest to everyone in the United States whether he be the holder of any of these defaulted bonds or not. The $1,900,000,000, which constitutes the foreign default on American loans, represents that portion of the national wealth of the United States which has gone abroad, and the whole economy of the United States must be adversely affected unless that national wealth be restored.

The real significance of this problem can perhaps be more vividly realized if it be considered in connection with international trade. There cannot be commerce without credit, and there cannot be credit with a record of unsatisfactory debts. Let us examine the situation in Latin America in this connection.

On the basis of trade for 1936 the foreign investments of American citizens in the dollar securities of Latin American governments are more than four times the value of our annual exports to Latin America. As of December 31, 1936 approximately $300,000,000 in interest was due and unpaid from Latin American governments, or approximately 90 per cent of the total value of one year's exports from the United States to Latin America. The mere statement of this record suggests the importance of doing something to clear up this situation. The question at once arises, who is to undertake the task?

Many look to their government in such a situation, but there are very definite limitations imposed by the practice of nations in such matters. A distinction is made in international law between contract claims, in which category bonds fall, and tort claims. There is a distinct sensitiveness on the part of foreign governments to diplomatic or other governmental action touching their public bonded indebtedness, and they have, therefore, always been most careful of the steps which they might take in such matters. Negotiations concerning defaulted bonds have generally been left to the bondholders themselves, the government giving such assistance to the representatives of the bondholders as it felt to be appropriate and proper.

As the cost of such negotiations would be prohibitive to individuals, bondholders' associations have been formed in most creditor countries to deal with the matter. The British Council of Foreign Bondholders has been in existence for sixty-nine years now, and there are similar associations on the Continent.

In this country the Secretary of State, the Secretary of the Treasury and the Chairman of the Federal Trade Commission invited some twenty gentlemen from various parts of the United States to meet in the office of the Secretary of the Treasury on October 20, 1933 to discuss with them the creation of an adequate and disinterested organization for the protection of American holders of foreign securities. The latter stated that this is a problem of very great and urgent importance to American investors and of such public significance as to make its proper handling a public service. Thus was the Foreign Bondholders Protective Council, Inc., formed.

In considering what may be done in this matter, it is essential to keep in mind the difference between a domestic and a

[illegible]

foreign bond. In the case of foreign governmental bonds there is no court, no sheriff, no sheriff's sale, and no police or armed force to make the sale or the judgment operative. Sovereigns may not be sued in their own courts unless, and as, they consent and provide. As the sovereign may wish and determine, and at his discretion, such consent may be given and enlarged, or may be curtailed or withdrawn. Therefore, resort to the courts of a foreign government to enforce bonds against it as an unwilling defaulting debtor, or as one unable to pay, is hardly likely to be effective. Furthermore, even if judgments were obtained in its courts against a foreign defaulting government, the creditor must look for satisfaction of his judgment either to the property of the state — and such property is rarely or never subject to execution, otherwise the government could not carry on—or to an appropriation by the national legislature. But a legislature that would not, or could not, appropriate funds to meet interest and amortization on its solemn bond contract obligations would hardly feel more bound, or be more able, to appropriate funds to satisfy a judgment of its own courts.

So attempted enforcement in foreign local courts holds practically no promise of success. The alternative to enforcement by the bondholders themselves against the foreign government, whether in the courts of that government or in the courts of other sovereigns, is the enforcement of the bonds through action against the defaulting government by the government of which the bondholders are the nationals. But the usual form which such international action might take could be interpreted by the defaulting government as acts of war. Because of this situation, governments, despite popular misconceptions to the contrary, never undertake such action.

In the absence of any measure of coercion the bondholders and their representatives are thrown back on persuasion through negotiations, and it is this method which the Council uses. We are somewhat prone in this country to consider action the test of effectiveness. Of course, results are what we are really after, and there are times when seeming inaction in the end produces really more effective results. This is what Mr. J. Reuben Clark, Jr., President of Foreign Bondholders Protective Council, Inc., calls "alert patience". Patience is the prime requisite, and this element the Council strives earnestly to possess and exercise.

In considering the prospects of having these defaulted issues repaid one must constantly bear in mind that the determining element is the will of the debtor to pay. This, obviously, varies with each debtor. There are governments which have made almost heroic efforts to maintain their payments in full and, when that did not seem possible, have made great sacrifices to pay the maximum amount of which they were capable. There have been other cases where the debtors have shown a complete disregard for the rights of their creditors and of their own credit and reputation. Generally those countries that affect not to be concerned about their credit, alleging that they realize that they cannot borrow again and do not want to, are the very ones most in need of future foreign credit for the development of their resources.

All undeveloped countries need capital for their development, and capital will go where there is opportunity and security. The opportunity exists in practically every one of the countries now having bonds in default. Whether capital will flow there again, and how soon and on what terms, depends upon the security which capital finds in the justice of those countries, exemplified by the way they deal with their creditors when in financial and economic difficulties.

It may not be amiss to set forth here some of the arguments advanced by debtors as reasons why they should not serve their loans. Back of it all, I repeat, is the lack of the will to pay and to undertake the burdens necessary to that end. The creditor is far away and has neither vote nor voice in local political problems. It is, therefore, easier, when the pinch comes, to put the burden on the foreign bondholder rather than to ask the people who contracted the loans and benefited from the expenditure thereof to make the sacrifice necessary to service the bonds. This is what is at the bottom of many of the defaults, but this unwillingness is dressed up in various ways.

Lest you may gain the impression, from what I am about to say, that the outlook is most unpromising, let me state here that most of the arguments given to cloak a lack of will to pay are made by a small group of countries and that in gen-

eral the debtors have shown a meritorious concern for their credit and a desire to make an adequate service on their bonds.

Some have alleged that the loans were forced upon them and that the proceeds were improvidently spent. The borrowing government wanted the money and asked for it; it was a sovereign state and did not have to make the loan unless it so desired. The purposes for which the proceeds of the loan were to be used were determined, not by the bondholders, but by the borrowing government and approved by the legislative and executive branches thereof; the proceeds were spent by the government without the control or voice of the bondholders and, if they were improvidently spent, that is the fault solely of the debtor government. To say that the bonds should not be repaid in full, because the loan was forced on the government or because the proceeds had been improvidently spent, would be to argue that the government was not fully sovereign and to serve notice that for any future financing some foreign control should be exercised by the lenders over the expenditure of the proceeds of the loans. No sovereign government would wish to be put in that position.

Another reason advanced by certain governments to absolve themselves from repaying their debts is that the loan was contracted in an unconstitutional manner. This argument is based purely on political expediency and does not seem convincing when viewed in the light of international law. There is quite a difference between a new state arising from the partition of an already existing state and a new régime coming into office in the same political jurisdiction. It is a well-recognized principle of international law that such a régime is responsible for the acts of the preceding governments. Any other basis would be destructive of international relations, trade and commerce. Agreements could then be made only for the period the régime making the agreement is likely to remain in power, and all relations would have to be conducted on a cash-and-carry, hand-to-mouth basis.

Another well-worn phrase is "capacity to pay". The theory of sovereignty is that the sovereign shall have the right to levy on all the property within its jurisdiction and on all the property of the individuals owing allegiance to it, wherever such property may be found. That, in the last analysis, is the capacity of a government to pay. Of course, I am not here suggesting that these extreme measures should be taken to pay the service on the bonds now in default. There is no necessity therefor. The governments can pay their debts in whole or in substantial part without resorting thereto. Most of the countries in default have not taxed many sources of wealth; many have no taxes on landed property, for instance, or on income, to mention but two. While their bonds are in default, many of these governments have embarked upon large and unusual expenditures for public works—works which may well be desirable, but for which they heretofore generally have shown little, if any, concern. No one denies that governments should provide for the development of their countries and for the welfare of their inhabitants, but to do this, not at the cost of the people of the country who benefit thereby, but by forced loans on foreign creditors — and the diversion of the funds rightfully belonging to the bondholders to these public works is nothing else than forced loans — is unjustifiable in law, morals or equity. To do so when many reservoirs of taxation have not only not been exhausted, but have not even been tapped, does not support a contention of inability to pay.

Another gauge of the willingness of a government to service its debts is very readily afforded by the percentage of its budget receipts which it devotes to its debt service. When many governments are applying over a third of their revenues to debt service, a government, for instance, which will appropriate little more than one per cent of its budget receipts for the interest on its foreign loans—such sum being adequate to pay but a small fraction of the interest due — and which will do this in the face of budget receipts at times considerably greater than when the bonds were served in full, and with no serious exchange problem, cannot overcome the feeling of its creditors that it would be able to meet a great part of its debt service, if it so desired.

Another argument, used to cover up the lack of will to pay, is that the defaulted bonds are selling at a fraction only of their face value, that the bonds have been bought up at those low prices by speculators and that it would be unjustifiable to pay the full interest on the bonds because it would give an

exorbitant rate of interest to those who bought at default prices. The untenableness of that suggestion is at once patent. A government cannot be defended in its allegation that these bonds should be served only on the basis of the prices at which they are selling, when the low market prices are due to the fault of that government itself. Furthermore, the information in the hands of the Council indicates that relatively few bonds are in the hands of speculators and that a very large majority of the unfortunate investors, who, in many cases, put their life savings into these bonds and bought them at or near the issue price, are still holding the bonds. The government got the money, spent it and benefited from it, and cannot now justly refuse to repay the sums which it borrowed and enjoyed.

Linked up with this question is the consideration of the national wealth of the United States. When a domestic bond goes into default, whatever individuals may gain or lose, the national wealth is not affected because the whole transaction lies within the country. In the case of a foreign loan, however, so much of the national wealth as is represented by the issue price of the bonds to the foreign government has left the country, and unless that money be returned the national wealth of the United States suffers. What individuals may suffer or gain is purely incidental.

Of course, when the defaulting government buys up its bonds at depreciated prices, the bonds being kept at such low prices through the continued failure of the government to serve them, then that government has dropped the mask. No justification can possibly be given for using funds which belong to the bondholders for buying up bonds at defaulted prices. The action of buying up the bonds shows that funds exist for some service at least and that the sole reason the bonds are not served is purely the lack of will to pay on the part of the government.

Another allegation put forward by defaulting debtors is that interest rates have declined and that, therefore, the debtor government should not be obliged to pay the higher rate stipulated in the contract. Of course, in any long-term operation a risk is taken by both the borrower and the lender. If interest rates increased very greatly, the debtor government would not listen to its creditors should they ask that they be paid a higher interest rate than that called for in the bond. Similarly, the fact that interest rates have gone down does not absolve, legally or morally, the borrower from paying the rates agreed to. The borrower, however, does have the possibility of benefiting by lower interest rates, if he has scrupulously maintained his credit, because then he can borrow new money at the lower rate of interest and retire his higher interest bearing obligations. Argentina, Canada, Finland and Norway have all recently done this in the American market. While four per cent may be the interest rate on the New York market at present for Norway, who has maintained her credit, it does not follow that that is the interest rate for a defaulted debtor. In fact, the price of the defaulted issue will give the defaulting government some idea of what rate the New York market puts on its credit. A seven per cent defaulted bond selling at twenty-five would seem to indicate that the credit of that government in this market is on the basis of twenty-eight per cent and not the four per cent it may seek to have its creditors grant it.

I do not wish to be understood to say that concessions should not sometimes be made, especially where transfer difficulties require temporary accommodations, but the need for the readjustment must be real and not merely because the government in question would rather spend the money in some way other than by serving its bonds.

In dealing with these problems the Council has felt that in general it should favor temporary and not permanent arrangements. Otherwise, a permanent settlement made now on the basis of economic conditions in the country as it was just emerging from a world crisis would not give the bondholders the benefit of the prosperity, which we all hope will eventually return. Examples of such temporary adjustments are the Brazilian offer made in 1934, and the offer made by Poland about a month ago. There have been exceptions, however, where special considerations were involved. The Dominican Republic agreed to continue to pay full interest service on its bonds. The amortization provisions in the contracts were unduly onerous, however, and the Council recommended a permanent plan extending the maturity of the loans and providing a fairer basis of amortization.

The Province of Buenos Aires offered a permanent settlement at a reduced interest rate, but offered, as security, revenues in large part collected by the federal government and paid through the Bank of the Nation directly to the paying agents in New York without the money going through the treasury of the Province. This arrangement was felt to offer more assurance to the bondholder that the plan would be lived up to and the pledged revenues not be devoted to other purposes as had been the case before the settlement was made.

In order to protect fully the interests of the bondholders it would seem to be essential for all creditor groups to work together in harmony and not to prey on one another. Foreign Bondholders Protective Council, Inc., has recently had the benefit of a month's visit by Sir Otto Niemeyer, of the Bank of England and of the British Council of Foreign Bondholders, which we expect to be of value to the two Councils in pursuing their parallel aims. The Council is also in touch with bondholders' associations on the continent of Europe and has coöperated with them in the past, notably in recommending to bondholders not to accept the very unsatisfactory Chilean offer.

The outlook would seem to be far from hopeless. Governments, whether they realize it now or not, are eventually going to need new credit, and as they do they must begin to consider what they must do for their bonds already in default. Bond default adjustments are not going to be made overnight. As no force is available to oblige defaulted sovereigns to pay, the endeavor must be by persuasion to induce them to pay. Continuing negotiations are often required before a default situation is finally cleared up, and the groundwork of confidence and mutual respect, necessary for a final settlement, cannot be laid by intemperate and abusive language, bringing asperity into a situation which requires calm, serene tempers if success is to be achieved. Firmness and tenacity of purpose do not require bluster and abuse. In closing, therefore, I emphasize again that patience is essential in working out these situations.

REMARKS BY THE CHAIRMAN

PRESIDENT MITCHELL: Our next topic, "Foreign Trade and Peace", is one that few men could venture to discuss in the brief time allotted in this afternoon's program. The Honorable William S. Culbertson, however, has had opportunities in his past experience to consider this question over a long period of time with a thoroughness which enables him to reach conclusions that can be stated concisely. Mr. Culbertson was connected for many years with the United States Tariff Commission. He served as its vice-president at the time when the Tariff Commission was doing a great deal of its most important investigatory work. Later, he was Minister to Rumania, later still Ambassador to Chile, so that he has had the opportunity to look at this question not only from the point of view of an American citizen and an American official, but also from the point of view of a man who has become intimately and sympathetically conscious of the problems of other nations. I have the pleasure in introducing the Honorable William S. Culbertson.

FOREIGN TRADE AND PEACE

WILLIAM S. CULBERTSON
Of Culbertson and LeRoy, Washington, D. C.
Former United States Ambassador to Chile

WHILE Mr. White was making that very calm and effective analysis of the foreign debt situation, I had a feeling of regret that the broadcasting had been stopped just before he began to speak; in fact, I had the feeling that the broadcast should have been left on and extended to some of our good neighbors across the seas!

This subject of "Foreign Trade and Peace" is a very large one. The reciprocal trade program of the Secretary of State, Mr. Hull, falls within it. I assume that Mr. Sayre, who will speak later this afternoon, will discuss that program. I cannot refrain, however, from saying just a word of the place which that program holds in the problem of peace. It is a very substantial contribution to the field of economic peace. Any systematic, continuous negotiation on the basis of the principle of equality of treatment inevitably contributes to good will and understanding among the nations.

Its antithesis is the program of "America Self-Contained", and other isolationist policies, which, in my opinion, have in them, although their advocates do not always realize it, the seeds of war. The very nature of a policy of self-containment is that once it grows up, it will insist on fighting; such is the tendency of programs of that kind.

On the domestic side, the reciprocal trade program of Mr. Hull seems to me to offer no opportunity for differences of opinion. I am a Republican, but I believe that the fundamentals of that program, representing a non-partisan approach to the negotiation with other nations on commercial matters, is a program which should have the united support of the American people regardless of political party.

However, the Trade Agreements Act brings us only to the threshold of the problem of foreign trade and peace. There are more things in that problem than are comprehended by the philosophy of, shall I say, the Chemical Foundation and of other "hundred per cent" Americans whose patriotism stops at the international boundary. I have a hope that this program of reciprocal trade negotiations is a prelude to a wider and more effective leadership in other economic problems which arise between nations.

I shall speak of one or two of these problems, not with any idea of covering the entire subject, but with the idea of illustrating the nature of the problems which may arise.

Nations and empires have a habit of excluding certain practices and certain policies from the field of accepted commercial policy and commercial negotiations. They take commercial policies and convert them into political policies. They establish exceptions to the principle of equality of commercial treatment, or exceptions to other fundamental principles, which should govern the economic relationship of states. As an illustration of this, I shall speak of the preferential tariffs of the British Empire.

As you know, there have grown up during the last few decades, within the British Empire, exclusive tariff arrangements, exclusive concessions voluntarily granted by the dominions to Great Britain and to other dominions; certain exclusive arrangements between the dominions themselves, and finally in the Ottawa agreements, an extension of the principle of reciprocal preferences to Great Britain itself.

When these preferences came into existence in the nineties, Germany was the only country which took exception to them under the established principles which govern the economic relationship of states, and, in doing so, Germany found herself with a trade war on her hands. At that time our interests in the preferences were relatively small. Our trade had not extended to a point where our industries were very greatly concerned and the government in Washington was not inclined to take the matter up on principle, although, as a matter of fact, the problem was brought to its attention through such publications as those of the Tariff Commission, when it was established, and in other ways.

I believe, as a matter of fact, these preferences are not defended by anyone on the basis of principle. We might analyze

them in this way: if the parts of the British Empire are considered as colonies, then these preferential arrangements are in violation of the open door principle which has been advocated and maintained by the American government and by the British government for many, many years; if the dominions are regarded as nations, independent and sovereign, then these preferential arrangements are in violation of the unconditional most-favored-nation principle. Consequently, it seems to me that, whichever way you view the problem from the standpoint of principle, it is in violation either of the open door principle or of the unconditional most-favored-nation principle — both principles being in essence the maintenance of commercial equality in the world.

We have become concerned recently, in this country, with the practical phase of these British preferences. Certain of our industries have begun to lose markets, and they have begun to realize that these things which we have been calling preferences in a polite way are now really discriminations against American trade.

No one more than I realizes the importance of a good understanding between the American people and the British people in the development of sound principles and in the solution of world economic problems, but it behooves those who are interested in the maintenance and in the development of these good relations to face this problem of preferences squarely.

Our British friends should realize that there is a growing sentiment in this country against these preferential arrangements within the British Empire. There is not at the same time a unanimous sentiment within the Empire itself in favor of them. There are in the Empire those who advocate them on the basis of a strong empire, a sort of customs union excluding other nations from the economic benefits of the Empire, but there are others who view them more broadly and believe that the Empire cannot continue effective in world affairs if it does not adjust its affairs harmoniously to those of other nations.

I shall not myself undertake to characterize the British point of view, but I shall leave that to the London *Economist*. In its issue of March 6, 1937, *The Economist* has an article entitled "Canadian Tariff Concessions". I will ask you to bear with me as I read from some of these paragraphs the criticisms by the British of their own policy. The article begins:

> The trade agreement signed last week between the Government of Canada and of the United Kingdom has a much wider significance than derives from its character as a pact between two countries whose mutual trade totaled ninety-eight million pounds in 1936. It has an intimate and direct bearing on the problem of improving the economic (and therewith the political) relations between Great Britain and the United States. And as far as British policy is concerned it must be taken as a foretaste of the general revision of the Ottawa agreements that is due this year.

Then, referring to the United Kingdom side of that agreement, it says,

> Even where there remains a possibility of lowering both the preferential and the general rates of duty, the promise to retain at least a certain margin of preference is bound to be a handicap to the conclusion of pacts with foreign countries for the mutual freeing of trade. The new pact, and presumably the other revisions of Ottawa agreements that are to follow it, will not merely solidify imperial preferences; over an important area of trade they will solidify the British protective tariff at its present level.
>
> Another feature of the Anglo-Canadian agreement is even more to be deplored. It renews the exchange of a Dominion undertaking to extend the preferential tariff to exports from the British dependent empire for a United Kingdom undertaking to "invite" the Governments of the colonies (except such as are pledged to the Open Door by international agreement) to grant to the Dominion general preferential benefits and some specific preferences. These preferences include, among others, a high rate of duty on foreign rubber-soled canvas shoes, an imposition which notoriously strikes a blow at the standard of living and health of the poorest and most defenseless of His Majesty's subjects. The former Open Door in the colonial empire was shut before Ottawa; the Ottawa agreements double-locked it by making any reopening dependent on an all-Commonwealth amendment, instead of a decision of the United Kingdom Parliament. The new pact renews this double-locking at a time when the British Government is ostentatiously sponsoring an international inquiry into access to colonial raw materials, which must depend to a large extent on access to colonial markets. The question involved is not merely one of the volume of trade between Canada and the British dependencies, but one of trusteeship for native interests and of vital issues of international policy.

In conclusion, the article states:

> The principle of quantitative restriction remains; so does the ring-fence of preferential tariffs round the colonial empire; so does the guarantee of minimum margins of preference, which prevents a reciprocal lowering of tariff barriers with foreign countries. These are grave and—in our judgment—exceedingly unfortunate decisions, in view of the hopes raised that a valuable Anglo-American economic agreement might be reached now, though possibly not later, and in view of the efforts being made by the Oslo Convention countries towards general freer trade. But the battle is not yet lost. There is no reason to believe that the Canadian Government, which has shown its own desire for more liberal trade all around, sets store by the illiberal sections of the terms it has secured from Great Britain. There is time yet for a review of British policy that will look beyond the narrow bilateralism now in evidence.

On our own part, we should realize that the system of preferences cannot be disposed of in a cavalier fashion. It cannot be fought by penalty duties. It has to be dealt with by delicate negotiations.

These preferences are grounded in sentiment. I can recall that, when Canada extended her preferential tariffs to Great Britain in 1897, Kipling wrote that poem, "Our Lady of the Snows", in which he said,

> A Nation spoke to a Nation,
> A Throne sent word to a Throne:
> "Daughter am I in my mother's house,
> But mistress in my own.
> The gates are mine to open,
> As the gates are mine to close,
> And I abide by my Mother's House",
> Said our Lady of the Snows.

They are also grounded in vested interests that have now grown up and have certain claims to consideration. It is not easy to break them down. These preferences are also approved or accepted by treaties not only between different parts of the Empire itself, but between parts of the Empire and foreign nations.

I believe that these preferential tariffs should be a subject of careful discussion. Our own government has recently enunciated an important principle in this field of policy. I mean the joint statement issued by President Quezon of the

Philippine Islands and Mr. Sayre of the Department of State. In that statement it is indicated that we are in the process of removing from our commercial policy the one precedent which might cause us some difficulty in the discussion of the preferential arrangements with the British Empire. In this joint statement the following is found:

> It was further agreed [between President Quezon and Mr. Sayre] that preferential trade relations between the United States and the Philippine Islands are to be terminated at the earliest practical date consistent with affording the Philippines a reasonable opportunity to adjust their national economy. Thereafter, it is contemplated that trade relations between the two countries will be regulated in accordance with a reciprocal trade agreement on a non-preferential basis.

I feel, therefore, that it is an obligation of our government, an opportunity for our government to take up with the British Empire the discussion of these British preferences and, on the basis of reciprocal concessions, to work out a solution of a problem which tends to disturb the economic peace between the American people and the British people. Our preferential position in the Philippines could be used in bargaining but the whole discussion should be considered on a higher plane than a trade.

In the second place, I want to say just a word about raw materials. The distribution of raw materials is another of those problems which nations do not discuss with entire frankness. It is true that the speech of Sir Samuel Hoare set in motion a very important exchange of views, and the League Committee for the Study of the Problem of Raw Materials has recently been meeting in Geneva, and will meet again on the 21st of June. That Committee is divided into two subcommittees. The first subcommittee deals with such problems as these: export prohibitions and restrictions; export duties, including the question of discriminatory duties; régime of concessions; monopolies and agreements and cartels for the regulation of production and sale of raw materials.

The second subcommittee is considering the difficulties encountered by importing countries, particularly in the matter of payments on account of the lack of foreign exchange. It is also taking up customs tariffs: high and prohibitive duties, preferential tariffs, customs unions, and the question of the

open door. It is considering the control of imports—quotas, foreign exchange controls and clearings; and also the control of bounties and subsidies — production and export bounties, subsidized production of substitutes, *et cetera*.

You will notice that this field covers primarily, almost exclusively, the economic phase of the question. I hardly think that a report is any longer necessary from any committee to determine that there *is* a raw material problem in the world today. It is not a problem of production. Production is coming along in sufficient quantities in practically every raw material; it is the question of distribution which is causing trouble, and it is sometimes also the question of the ability to pay for raw materials once they are made accessible in international markets.

I might here refer to cartels controlling these raw materials. During recent years there has been a large number of these raw materials over which a control has been established by cartels. A most interesting discussion of this subject is found in the recent volume by A. J. Toynbee, *Survey of International Affairs for 1935*.

But to limit the discussion of raw materials to the economic aspects of the question is to fail to reach the real problem, for the problem is fundamentally, with most countries, a problem of strategy, or of political control. As we listen to the discussions of raw materials, we hear such contrasts as these: the suppliers of raw materials, on the one side, the receivers of raw materials, on the other; satisfied nations, on the one side, unsatisfied nations, on the other; nations with colonies, on one side, nations without colonies, on the other; thickly populated areas, on one side, sparsely populated areas, on the other; industrialized countries, on the one side, non-industrialized countries, on the other; even, complaining countries, on the one side, and non-complaining countries, on the other. If we are to face the problem of raw materials as it bears upon the question of peace, we must go beyond the mere economic discussion of the question and face the problem of political control and the problem of strategy.

Much of the confusion over raw materials is due to the practice of laying down, in the matter of the distribution of raw materials, rules which are useful in a world organized for peace, but inadequate in a world organized for war. I am not sure that this and similar fundamental problems in commercial policy are at all solvable, apart from the solution of the ultimate question of war and peace, but a great deal can be done to lessen friction among nations by the removal of discriminations and by the solution of this particular problem and that particular problem which perplexes certain nations today.

However, we must face this fact, that as long as one nation, or any group of nations, has the power to starve the industries of another country, the problem of industrial raw materials will not be solved. That is one of the reasons why Germany is developing substitutes today. It is true that she has financial difficulties in buying raw materials, but she is looking at the matter not merely as an economic problem, but as a problem of political control and of strategy.

The United States, both as a great supplier of raw materials and as a great receiver of raw materials, has a very real opportunity to contribute to the solution of the problems within this field; it is not possible within the scope of this speech to suggest what these solutions should be, but, in facing these problems, we must try to answer certain questions. Are we making policy for a world organized for peace or for a world organized for war? Can we separate commercial policy from political policy? Can nations or empires, with power to do so, continue in a coöperating world to exclude from commercial negotiations large fields of policy which are the very essence of the problem?

We are having today in this country much discussion of peace. As I view it, however, we do not always reveal a constructive approach to the problem. So much of the peace psychology that we hear today is a negative sentiment, the keep-us-out-of-war sentiment, the belief that we can live at peace in a world at war, the conceit that we are a more peaceful people than other peoples who lack our geographical advantage. Unfortunately, therefore, much of our pacifism is selfish, unwilling to do anything for anybody's peace except our own, an attitude which in the long run does not yield peace to us. I suppose that there is a partial excuse for this in the fact that collective security in Europe is not at the present time very strong.

In a world of wars and rumors of wars, it is stimulating to me to hear what the New York *Times* this morning called "rumors of peace". I am very hopeful that the leadership in world economic affairs of the Secretary of State, Mr. Hull, will soon have a great opportunity to contribute to real world peace, and I am sure that when that opportunity comes, he will meet it with a constructive program.

Remarks by the Chairman

President Mitchell: The fourth and final paper on the program this afternoon concerns the Hull agreements relating to international trade, to which Mr. Culbertson has given so generous an endorsement. It will be read by a Professor of Law, whose remarkable personal and intellectual talents have led to his being called to a wider field of service.

As Assistant Secretary of State, the Honorable Francis B. Sayre has been serving the country for several years in close collaboration with Secretary Hull. During that period he has been Chairman of the Executive Committee on Commercial Policy, so that his knowledge of this topic is singularly intimate.

I have the pleasure of introducing the Honorable Francis B. Sayre.

THE HULL AGREEMENTS AND INTERNATIONAL TRADE

FRANCIS B. SAYRE
Assistant Secretary of State

PRESIDENT Wilson used to delight in telling a quaint story of a Scottish Highlander who went into the market of Edinburgh followed by his dog. He went into a fishmonger's stall, and the dog incautiously dropped his tail into a basket of lobsters, and one of the lobsters nipped his tail. Whereupon the dog went yelping down the street, with the lobster bouncing after. "Hoot, mon", cried the fishmonger, "whussle to your dog!" "Hoot!", replied the Highlander, "whussle to your lobster!"

We must whistle off the economic policies which pinch before we can control the dogs of war. No peace machinery, however perfectly devised, can operate with success among nations which are economically at war. Hostile commercial policies make retaliation inevitable and thus sow the seed of resentment and ill will. The economic isolation which they engender inevitably creates unemployment, falling living standards and widespread economic unrest. Economic poverty and distress are fertile breeding grounds for national policies of aggression. If we would have peace, we must cultivate the soil for it through the pursuit of economic policies which make for friendliness and higher standards of living.

It is from this aspect that I wish to discuss America's commercial policy. No problem confronts us today more vital than this. We have taken steps in recent years to safeguard our neutrality, so far as possible, if the holocaust of another world war should come. But no legislation can save us from the effects of war abroad; no possible legislation can guarantee that we will not be involved as participants if another great war should sweep across the world. The only sure way to safeguard ourselves against another war is to prevent its outbreak. We must adopt policies which make for economic

peace. We must help to shape the economic forces of the world in the only mold which can produce peace — genuine liberalism in the regulation of trade movements and equal and non-discriminatory commercial treatment.

I

Under modern conditions trade constitutes the very life-blood of nations. The English people need food; unless they can import it in substantial quantities they will starve. The Italians need coal and oil and iron; without these they cannot carry on a modern economic existence. The Germans need raw materials, such as cotton; cut off from these they cannot be kept at work. The people of the United States, probably the most nearly self-sufficient of the great industrial nations, need rubber for their automobile tires, tin for their containers, antimony for their telephone equipment, jute for their burlap bags, hemp for their rope. Not one of these can be produced in the United States. Neither will the American people be content to go without coffee or tea or chocolate or bananas or silk. To cut ourselves off from all foreign importations would play havoc with our economic processes and our accustomed ways of living.

But the biting necessities of foreign trade rest today not merely upon the need of specific imports. The dire need is for foreign markets in which to sell exports. Since the industrial revolution the economic life of all great nations has come to be geared upon the production of surplus goods which must be sold abroad, if the national economic machine is to continue to run at its present speed and efficiency. Each country, because of advantageous natural resources, geographical conditions, peculiar labor aptitudes, mass production possibilities or otherwise, can produce certain goods more cheaply or better than other countries; these are the industries and occupations in which capital and labor find their most rewarding return and which have therefore grown far beyond the proportions necessary to produce for merely domestic consumption. Strip a country of its foreign markets and you cripple substantially those great domestic industries and throw millions of laborers out of work. Every time the United States loses a foreign market for its cotton, for its hog products, for its automobiles or for its machinery, men are thrown out of work and economic dislocation follows in our cotton fields of the South, on our farms of the Middle West, in our automobile plants of the North, or in our machine factories throughout the country.

Value attaches to goods because they can be exchanged for other goods. If foreign markets for national surpluses are lost, the surpluses become valueless. Not only are the values of surpluses lost; unhappily the injury strikes far deeper. Surpluses unsalable abroad are dumped onto home markets; and the consequent smashing of home prices works incalculable injury to the producers not only of the surplus portion but of the entire crop or industry. The resulting dislocations are nation-wide and bring disaster to producers who themselves do not sell abroad. Extended unemployment, depressed wages, defaulted loans, bankruptcies, sharply reduced purchasing power, widespread suffering ensue.

In a word, national wealth under modern conditions depends upon foreign trade. Existing national standards of living cannot be maintained without international trade; and international trade cannot be maintained if existing trade barriers are to be continually heightened and present discriminatory practices are to continue to spread their poison throughout the economic system of the world.

II

The American program of trade agreements is an effort to combat and defeat these destructive tendencies. The world today is caught in a vicious circle. To protect themselves against the economic shocks and disturbances of a disordered world, nations have built higher and higher economic barriers. Yet it is these very barriers and resulting artificial trade diversions which are the prime cause of increasing shocks and disturbances. The remedy which individual nations have frequently applied is economic nationalism, but economic nationalism is a virulent poison which undermines the health of the whole economic system. Economic nationalism at first intoxicates; if administered in increasing doses, it kills. The highly complex economic organisms of nations are today too completely dependent upon international trade and exchange to be cut off from such intercourse and survive.

If economic health and sanity are to be restored to the world, there is but a single cure. Economic nationalism must

be resisted. Trade barriers must be reduced. Discriminatory practices must cease.

III

The trading nations of the world are today faced with the choice between two opposing commercial policies—equal treatment of all nations alike or giving and receiving exclusive trade preferences.

The former is the policy which the United States has consistently practiced from the earliest days of our nation. We have maintained a single column tariff with rates applicable to all nations alike; we have bound ourselves under a network of treaties to extend to others the same treatment as that accorded to the "most-favored-nation". Equality of treatment to all alike was a policy enjoined upon us by George Washington and has been adhered to with a fair degree of consistency by statesmen of both political parties ever since. Until quite recent times it has been the normal rule of commercial intercourse among other nations throughout the world. It is a policy which makes for protection, security and stability. It spells economic peace.

But of late years, especially under the impact of the depression, a new policy has become increasingly evident. Certain nations, in dire economic or financial straits, sought to adjust their difficulties by securing exclusive preferences for their exports in foreign markets in exchange for preferential treatment accorded to foreign goods in their own markets. Thus grew up the system of bargaining in special preferences, as opposed to the equality of treatment policy. The new regulatory devices, such as quota restrictions, exchange controls, and various types of clearing and compensation arrangements, provided the principal instruments for putting into effect the system of preference and discrimination. These new devices, strangling international trade, intensified world-wide economic dislocations; and the resulting dislocations in turn became the cause of a more intense bargaining for special preferences.

It must be very evident, however, that every preference granted exclusively to one nation constitutes a discrimination against every other nation. And discrimination invites retaliation. Consequently, the policy of trading in special preferences has led inescapably, and always will lead, to heightened trade barriers, discriminations and counter-discriminations, unceasing efforts to undersell the goods of trade competitors through special privileges, monopolization and trade regimentation. It leads to insecurity, uneconomic and sudden shiftings of trade channels, disorganized trade, demoralization of price structures and increasing conflict. It is the pathway to economic warfare.

But the matter of real concern is not merely the economic dislocations directly consequent upon such a policy. The crucial point is that those nations drawn or forced into the orbit of Great Powers trading in exclusive preferences find it difficult, if not impossible, to grant equality of treatment to other nations. Clearing and compensation agreements make impossible the allotment of foreign exchange to third countries on a basis of entire equality or non-preference. Countries which grant discriminatory quotas in favor of other nations seeking such arrangements have no longer the power to give to third nations full equality of treatment. In other words, there is not room enough in the world for the continued existence of both of these conflicting policies of equality of treatment and trading in preferences. Ultimately one or the other must triumph and become the dominant policy of the world.

IV

Fortunately, there is persuasive evidence of a widespread realization that the policy of equal treatment is alone consistent with the true national interests of all nations in the interdependent world of today. Again and again in the recent past, authoritative spokesmen of those very countries which have gone farthest along the path of regimentation of trade and of its operation in terms of widespread discrimination have made it clear that there is no longer division of opinion as to the wisest course. They have not hesitated to say that only sheer necessity keeps them from following that course. The crucial problem confronting the world today is to find ways and means of translating these vital realizations into actual practice.

The trade agreements program, which our country has pursued with vigor and determination for nearly three years, is an important factor in the situation. It involves the negotiation of trade agreements based upon the reciprocal and mutu-

ally advantageous reduction of trade barriers and upon the firm principle that neither party shall henceforth discriminate against the other's trade.

Sixteen such agreements have already been concluded with countries whose trade with us covers more than one third of our total foreign commerce. Our effort to extend the list of these trade-reviving and trade-normalizing agreements continues unabated. The recent renewal of the President's authority to negotiate trade agreements, approved by overwhelming majorities in both houses of the Congress, furnishes ample proof that the work which is being done in this direction has widespread support in our nation.

The recent conference of the twenty-one American republics, held last December at Buenos Aires, unanimously and emphatically recommended to the governments represented the need for a relaxation of trade barriers and the abandonment of unfair and discriminatory practices in international commerce. A movement to put these wise recommendations into application through appropriate negotiations is already gathering momentum.

The representatives of the countries of northern Europe met last month to examine the means of improving conditions of international trade. They are to meet again shortly.

There are many other significant indications in the field of international commercial relations of a growing trend toward activities which are liberalizing and constructive, rather than restrictive and destructive.

The problem is one of great difficulty and vast complexity. In every country it requires broad vision and constant vigilance—lest measures be adopted, or maintained, which may seem to offer an easy way of solving immediate problems but which inevitably impair the attainment of the vital objective of restoring the world to economic health and thereby building a strong foundation for enduring peace.

Those of us who are intimately and directly concerned with the problem of international commercial relations are actuated not by loyalty to a forlorn hope, but rather by a reasoned and profound conviction that the difficulties with which the trade problem bristles today can and will be overcome. We are proud of the contribution which our nation is making through its determined policy toward this overwhelmingly important end.

DISCUSSION: ECONOMIC AND FINANCIAL POLICIES ABROAD

CHAIRMAN MITCHELL: The discussion of these four significant papers will be opened by Marcus Nadler, Professor of Finance, New York University. Professor Nadler!

PROFESSOR NADLER: In listening to the scholarly and interesting addresses, I was impressed by the underlying thought that the economic and financial problems of the world could be solved easily, if they were approached in a rational manner and by nations imbued with the spirit of good will. However, sound reasoning and good will are not the dominant forces in the world today.

Mr. Warren spoke about a continuous influx of gold into the United States. After May 1 of this year, the United States will have sterilized five billion dollars of gold. If ten per cent of that, or only five hundred million dollars, were used to develop the natural resources of South America, it would provide homesteads for about a million Europeans, and would raise the standard of living of a good many people. Instead, the gold comes to the United States in order to fulfill that passage from the Bible, "from dust to dust". The gold comes out of the ground of South Africa and Russia and goes into the ground at Fort Knox.

Mr. White has indicated clearly the reasons for this maldistribution of gold and has explained why the surplus capital does not go to undeveloped areas and to countries which need it. He pointed out that a great many nations, through default and through a negligent attitude towards their credit standing abroad, have forfeited the right to obtain new capital. Yet many of the countries which are in default on their foreign debts and which, as Mr. White stated, have indicated an unwillingness to pay are most in need of new capital. This applies to Europe as well as to South America. However, in this respect, there is some reason for hope.

A revival of the international movement of capital is beginning to take place in an entirely different form than was the case during the twenties. It takes the form, primarily, of direct investments, and today we find a slow but gradually increasing trickle of American and European capital going to South America, and even to some of the Balkan countries.

I do not entirely agree with Mr. Warren that the influx of gold to the United States impoverishes those countries losing the gold. I doubt whether Holland, Switzerland and Great Britain need any of the gold which they have shipped to the United States. Is it not a fact that most of the gold is newly mined gold and comes to the United States because the highest price is offered for it and because in no other country can it be sold at a fixed price to the government?

Mr. Culbertson and Mr. Sayre spoke about the importance of international trade in the preservation of peace. Obviously, if the trade barriers were to be removed, if we were to return to an economy similar to that which existed after the first Locarno Pact, all this talk about territorial expansion would come to naught, because nations, being able to export, would be in a position to import. They would be in a position to obtain their raw materials, probably at lower prices than they could produce them in territories which they would develop. Unfortunately, however, we are living in an age of economic nationalism. This doctrine has been accepted and practiced not merely by countries which have no colonies but also by great empires. Under this doctrine each nation would like to become independent of foreign products. Hence the desire to strengthen the economic ties with the colonies. Those countries which have no colonies endeavor to obtain them by force of arms, using the excuse that they need an outlet for their population or that they need raw materials. How easily they could obtain the raw materials if they approached the problem from a rational point of view and followed the policies advocated by Mr. Sayre and Mr. Culbertson!

I was somewhat disappointed that the previous speakers did not mention the effects which the economic and financial policies abroad have already produced in the United States. In this country, as far as I am aware, the Congress is primarily concerned with the problem of keeping us at peace in case a European war should break out. However, economic and financial conditions in Europe are exercising a very strong influence on our economic life.

The tremendous race for rearmament that is going on throughout the world has contributed to the increase in prices of commodities which the United States imports, such as manganese, tin and others.

The continuous inflow of gold at the rate of a hundred million dollars a month and more is creating a very serious problem for the government. A sterilization process has been instituted, but this compels the Treasury, with its already large deficit, to borrow in the open market in order to buy gold for which it has no use, and the purchase of this useless gold creates deposits, the volume of which is already much too large.

The spirit of economic nationalism results in an increased production of agricultural products and in the establishment of new factories to create substitutes. The farmers who receive a bounty on the commodities which they produce will not permit tariffs to be reduced. The establishment of new plants for the creation of substitutes has also created new vested interests which will oppose a reduction of the tariff for commodities produced by them. However, all of the former speakers ended on a hopeful note and I agree with them fully.

Mr. Culbertson has spoken about rumors of peace. The other day, according to newspaper reports, the British and French authorities asked Mr. Paul van Zeeland of Belgium to prepare some information for a future economic conference. Sooner or later the nations of the world must realize that a policy of international coöperation and of international trade is the only road that will lead to the economic well-being of the entire world; that a continuation of the present policies must inevitably lead to disaster.

CHAIRMAN MITCHELL: We have now a short period left for discussion from the floor under the five-minute rule.

DR. TARAKNATH DAS (The College of the City of New York): Professor Sayre and Professor Culbertson have probably raised the most important question of this afternoon; that is, the open door policy for the world versus the preferential trade agreements. Now, the people of Asia have had a taste of open door policy; that is, an open door for those who can enforce certain policies which will be beneficial to them and not to the people of Asia. That has been the history of open door policy.

Fortunately, the awakening of Asia has brought about a new trend in world politics as well as in the world economic situation. Professor Culbertson has pointed out the probable result of the British imperial preferential policy, which makes more than one fourth of the population of the world a special market for the British Empire. Is the British Empire going to be a field for British capital, or is it going to be a field for world capital? In this connection India may play the most important part in world economics in the future. Its industrialization, its development and its markets will be the deciding factors, even, as Professor Culbertson pointed out, in the strategy of raw materials and the strategy of war or peace.

I understand that the United States government is now negotiating for reciprocal trade treaties with the British Empire. India should not be treated as a colony of Great Britain, but should be treated as

a nation of 350,000,000 people, one of the greatest industrial powers in the world. The United States has a special interest in Indian trade. If I am not mistaken, the trade balance of the United States in relation to India is in favor of India; that is, the United States buys more from India than India buys from the United States, and this has increased since the establishment of imperial preference.

If you will study the American exports to India, such as automobiles, machines and other materials, you will find that imperial preference has cut the American export market decidedly, so far as India is concerned. We have often heard that the imperialistic policies of certain Asiatic nations constitute a menace to world peace, but I believe that the discriminatory policy of some of the European powers against the growing industrial nations of Asia is becoming a decided factor for war. By that I mean the special discriminatory tariff against Japanese goods within the British Empire.

CAPTAIN ELIOT WARBURTON (London, England): As the last speaker has pointed out, Mr. Culbertson took as his case history the British Empire. No doubt it was an entirely dispassionate choice, and, as long as it is so regarded, it is a legitimate subject for discussion and consideration, but it seemed to me that some of you might leave here this afternoon with the idea that there was one more black mark against poor old "Perfidious Albion".

Next to the Netherlands, Great Britain has fought a harder fight in the cause of free trade than any other nation in the world. For nearly eighty years, to the beginning of the War, Great Britain and the greater part of the British Empire did endeavor to maintain the policy of the open door. After the War, until 1931, we did attempt to continue that policy. Why were we not able to continue it? Our abandonment of free trade was not, I think, the result of subtle and careful thought. It was, rather, the economic nationalism (so heartily and excellently damned here this afternoon) of most of the other countries of the world, which drove us to go over to tariffs and, consequently, to preferential treatments in certain parts of the British Empire.

We live, as Napoleon said, as "a nation of shopkeepers." We live as a nation of manufacturers, too. We must sell our goods somewhere, and we found, after the War, that one market after another had been cut off from us. We need not go into the reasons for that. You all know them, because you all study the subject. We had to keep some sort of market to keep alive, and trade something for the food which, as I think Professor Sayre said, we need. Thus came this regrettable policy of preferential tariffs. I do not think that anybody would want to support it in general terms. It is simply an emergency measure, and I certainly hope that preferential tariffs and economic nationalism will be eliminated before they produce the terrible consequences that we have heard described this afternoon.

MR. WILLARD F. BARBER (The College of the City of New York): May I ask Mr. Sayre a question? Why have no trade agreements been made with Italy, with Japan, with Germany, or with Great Britain? If the answer is that the Department of State is now in the process of making such agreements, why is the American public left in the dark as to those negotiations?

MR. SAYRE: I am very glad to do my best to answer that. I wonder whether people realize how much work there is in carrying on these negotiations.

We must first reach a general basis upon which negotiations can be carried out. I think I need hardly say that the whole kernel, the basis of the American trade agreements program is unconditional most-favored-nation treatment. That means equality of treatment to all concerned.

You ask the question: "Why is not the United States making trade agreements with Italy, with Germany, and with other nations?". One reason is the difficulty of finding a basis for carrying on negotiations. Take Germany or Italy as an example. Neither is pursuing a policy of equality of treatment; neither is building its trade on a most-favored-nation basis of commercial dealings.

I think that it is no breach of confidence to say that I have talked many times with representatives of the German government, both of us eager to increase trade between Germany and the United States, both of us eager to find some solution of these conflicting policies, equality of treatment, on the one hand, for the United States, preferential treatment, on the other hand, for Germany. We are still working on it. I hope a formula eventually can be found. Neither of us has despaired, but it is exceedingly difficult.

Concerning Italy, a similar answer might be given. We did begin negotiations. Then followed various consequences of the Ethiopian war, which made it seem impossible to carry on further conversations. You ask also about Great Britain. We are now carrying on very general conversations with the British government to determine whether it is possible to find the basis for negotiations. I hope it will be; I do not know.

You ask why the American people have not been taken into the confidence of the State Department. Under the law, public announcement must be made before any negotiations can be carried on. You must distinguish between negotiations, which are one thing, and general, exploratory conversations to see whether there is a basis for negotiations, which are another matter. We always do make announcements before any negotiations are undertaken or any commitments of any kind are made, but, before that, we must carry on exploratory conversations, and those conversations may be of a most general character or they may get down to some pretty specific problems.

You ask about Japan. Again, my hope is that the day will come when we will be able to make a trade agreement with Japan, with all the other countries of the world with which the United States can find a means of profitably increasing trade.

MR. HEUSINGTON: I should like to ask Captain Warburton whether he thinks that it will be possible, in view of the vested interests which the protective tariff has fostered, for the British Empire to resume free trade at any time in the near future.

CAPTAIN WARBURTON: I am afraid I am ill-qualified to answer that question. I do not want to abuse the laws of hospitality by pointing a finger at my hosts, but the United States is one of the countries which have led the field in tariff legislation, for very good and sufficient reasons, of course. You were developing your own industries, and you needed a wall, or thought that you needed a wall, behind which to develop them. Since then you have kept the wall up in order to maintain the American standard of living. That is perfectly understandable. Yet that same tariff, tending to one-way trade, is one of the great causes of the difficulty the world finds itself in today.

If you will look at the map, you will see the unfortunate situation of the British Empire, broken up by water into little units. You wisely have assembled your forty-eight states in one country, and there is no preference between Massachusetts and New York, between, shall we say, Mississippi and Texas. We have had to meet the situation by preferential tariffs.

There have been exceptions, however, to the American tariff. I believe that the Philippines have made one. I think that I have heard of one in Cuba, and I am not quite sure that other countries send their exports into Porto Rico and Hawaii on the same footing as the American exporter. I am only pointing this finger very gently and hesitatingly, as you notice, but all those exceptions do become vested interests, and it is perfectly true, sir, that it is difficult to go backwards. But that does not diminish my hope that it will be possible for Great Britain and the British Empire, as for the rest of the world, to return to free, unrestricted trade wherein lies our best hope for world peace.

CHAIRMAN MITCHELL: Mr. White has been asked whether exchange difficulties have played a large part in the default situation.

MR. WHITE: Yes, exchange has played a very large part in many cases. In Germany, for instance, many of the debtors are able to pay the full service of their debts in marks, but they cannot get the exchange to transfer the marks abroad. You have the same situation in Brazil, where many of the state governments and municipalities are able to service their debts in full in milreis, but they are unable to get exchange to transfer that money abroad. Chile also has exchange difficulties. The problem plays a very large part in many of the southern European countries — Hungary, Yugoslavia and others. It is sometimes the most important reason why the bonds are not serviced.

CHAIRMAN MITCHELL: If there are no other questions, I shall take this last moment to express officially the warm thanks of the Academy of Political Science to Messrs. Warren, White, Culbertson and Sayre for their most interesting discussion.

PART III

FOREIGN POLICY OF THE UNITED STATES—POLITICAL AND ECONOMIC

INTRODUCTION *

HON. WILLIAM L. RANSOM, *Presiding*
Trustee of the Academy of Political Science

IT is a pleasure and an honor, in behalf of the Officers and the Board of Trustees of the Academy, as well as its members, to welcome you to this dinner which brings a notable meeting to a close. I greet and welcome, in behalf of the Academy, the distinguished speakers of this Semi-Annual Meeting and all of you who have come together tonight to hear the discussion of a most timely subject.

At the morning and afternoon sessions, the notable addresses and papers were concerned with the foreign policy of the United States in its political and economic aspects. Tonight we shall try, in a way, to head up the results of the day's deliberations and to indicate some conclusions for your consideration.

To you who are not altogether familiar with the purposes and the procedure of the Academy, during its many years of public usefulness, I take the opportunity to say that the Academy is outstanding as an independent public platform, at a time when agencies of this character are essential to the functioning of democracy. The Academy selects subjects which are of first importance, presents speakers who have reasoned and informed views concerning them, and offers the opportunity for open discussion. The Academy does not advocate or sponsor the views of any speakers, on the subjects selected or on any other subject. Academy meetings adopt no resolutions, reach no decisions, urge no program of action. The whole purpose is open and enlightened discussion, in the effort

* Opening remarks at the Third Session of the Semi-Annual Meeting.

to make, if possible, some contribution to the great body of informed public opinion of our time, and to that end to present, for the purposes of that discussion, men whose views should be heard and considered on their merits, alike by persons who agree with them and by persons who do not agree with them.

My attention was caught, a few evenings ago, by a sentence in the writings of Woodrow Wilson, which seemed to me to sum up the useful function of a great independent public forum such as the Academy of Political Science. He said: "The whole purpose of democracy is that we may hold counsel with one another, so as not to depend upon the understanding of any one man, but to depend upon the common counsel of all."

I profoundly believe that America owes a continuing debt to such untrammelled forums as the Academy. If you agree that there is need and place in America for such an independent and impartial institution, which has no axes to grind and no purposes to serve other than a better and wider public understanding of public questions in its field, the Academy deserves your membership and support.

As usual, the speakers who are to address us tonight represent diverse schools of thought, political affiliation and experience. Perhaps significantly, each of the speakers upon this metropolitan platform of the Academy comes from the great West, and knows at first hand the ideas and ideals which are uppermost in the minds of people remote from this city. Whether our speakers will bring to you sharp divergences of views tonight, I do not know. You probably have realized instinctively that I have no background of experience or knowledge entitling me to speak on tonight's subject, as distinguished chairmen of these dinner meetings in other years have so agreeably done. But I shall endeavor, if controversy develops here, to be an impartial umpire! You may agree that in these times the position of impartiality has become somewhat precarious. I assure you that if, in my judicial capacity, I offend either side of this great debate, the side offended may resort freely to the most modern expedient, by itself selecting a second toastmaster, to serve concurrently until I quit! And it may be that when our guest speakers have been fully heard, I shall venture to sum up some of the day's

observations and to pitch one or two inquiries for your further consideration.

As our first speaker this evening, we shall listen to an American lawyer who has had a most admirable and useful career in many capacities. As head of the Association of American Law Schools some years ago, as Chairman of the American Bar Association's Committee on International Law, as present Chairman of that Association's Section on Legal Education, as Dean of the Law School of the University of Colorado at Boulder, as Assistant Secretary of State under a recent administration and a first-hand observer of international affairs, and now as Master of Timothy Dwight College and Professor of Law in the Yale Law School, Mr. James Grafton Rogers has been and is, to my mind, one of the most worthy and forward-looking citizens of his years in this country. It gives me a great deal of personal pleasure to present to you a scholar and a leader of much experience, who will speak upon the subject "Some Difficulties before American Foreign Policy Today and Tomorrow". Professor James Grafton Rogers, of Colorado and Connecticut!

SOME DIFFICULTIES BEFORE AMERICAN FOREIGN POLICY TODAY AND TOMORROW

JAMES GRAFTON ROGERS

Master of Timothy Dwight College and Professor of Law, Yale University

MR. TOASTMASTER, LADIES AND GENTLEMEN: The field of foreign policy is equipped with so high a ceiling, so vague in its outlines, so undefined in its proportions, that men are easily tempted to talk about it. The familiar and friendly voice of your toastmaster has still further released my tongue, because he has said that you are not to believe anything that is expressed here tonight. He has repudiated responsibility, and Senator Thomas and I are free for a flight into the blue.

In spite of these general warnings, there are in my mind tonight two or three thoughts which are, perhaps, worth expressing. Loose, intangible and vague they are, but I suspect that their roots are somewhere near the realities. They occur constantly as I watch the drama of the world going on. They recur often as I see our own anxiety to remain out of the tornados and turmoils, which we are beginning to appreciate are the usual weather of international life.

A day like today, spent by the Academy in the discussion of concrete problems of debts, of neutrality, of tariffs, of economic policies, is, after all, only laboring detail. It concerns sectors of foreign policy. In the wider circle of the foreign policy of the United States, our welfare—our part or lack of part in war or in peace—depends much more upon our own character, outlook, ambitions and ideals, indeed upon the intangibles of life, than upon a scheme of topics. The critical questions of war and peace rest on the interplay of national attitudes and ideals, errors and understandings with those of other nations, rather than on the determination of explicit policies. In the end, the American people behave like the

American people, and the people of Czechoslovakia, Jugoslavia, Norway, Brazil and Argentina behave also in their own modes. These are the more important, if more difficult, elements in the topic of today. The final result is controlled not by tariff policies or debts but by the interplay of national personalities.

With that thought in mind, I have some suggestions to make about the difficulties that today face American foreign policy in giving effect to the determination of our people, if possible, to keep out of war and entanglement. In the first place, it seems to me that the American people's chief trouble today is that they are in possession of a mistaken school of thought. The premises of this school seem to me false in all major outlines. I can explain, but I cannot justify, its views. Its tenets seem to me one of the most likely grounds of entrapping us in misunderstanding of what other people are doing and, therefore, in failure to guage what Americans should do as we proceed in the next decade or two.

The school of thought to which I refer is called, in its broader phases, the economic interpretation of history. It assumes that everybody acts from the profit motive; it proclaims that the world is run by a vague kind of Frankenstein called an economic man. In its particular application to our question tonight, it assumes that every war is carried on for gain, that war is a profit-making enterprise. Let me illustrate this view for a moment, if you will, in another phase.

Many magazines and books have been issued recently with interpretations of the history of the American Constitution. Most of these preach the doctrine that the American Constitution was the product of a group of property holders in the years immediately following 1780, who wanted to protect their possessions. They joined a grand conspiracy. The upshot was a constitution expressly devised to protect their property and to enable the conspirators to make as much money as possible.

There is just enough truth in this view to be interesting, and just enough truth to be misleading. The real motivation of the Convention which led to the Constitution of 1789 was the desire to invent some scheme to unite in peace a lot of colonial foxes whose tails were tied together and who were all running in the various directions of the compass. It was a federal problem. If, as undoubtedly was the case, an economic theory or motive was in the minds of the men concerned, it was minor. We only deceive ourselves if we let the economic man seem to preside over all of human affairs. The school of the economic interpretation of history has contributed something to our understanding, because in the long run the economic motive is persistent and it counts, but in the detail, the school misleads us persistently.

When we turn to war and to motives for war, we discover that international conflict is attributable to the economic motive only in very narrow limits. Nobody who knows the history of Europe imagines that its wars have been fought for gain, or for any motives reducible to those of capturing bread or food or shoes or garments. Wars have been fought most often for dreams, for religions, for political motives, for idealization, or because of hatreds and fears.

The American people watch day by day, with their hearts in their mouths, the slaughter going on in Spain. They see a Spain torn by paroxysms of hatred and of anxiety, emotions so old in the centuries that the artists of Spain have painted them and the authors of Spain have described them through indefinite years. Two thirds of Spain's history has seen bloodshed. Groups of men, classes of men, provinces of Spaniards, suspecting and hating each other, have repeatedly resorted to slaughter. Anybody who looks at that picture and assumes that he sees an economic man parading around looking for food, clothing and shoes in a cold-blooded, balance-sheet sort of attitude is only permitting a current doctrine to fool his own mind.

It is true, perhaps, that the histories of the United States and of Great Britain have illustrated more concretely than those of any other modern nations the importance of economic motives. It is not true that even our own wars can be disposed of in those terms. It is not true that when war was made in 1914 it was made on that basis; nor is it true that today the nations which threaten the skies with their thunder are thinking in those terms. We deceive ourselves if we so construe the situation.

Three nations today, for the first time in the history of the generation here represented, are threatening aggression in the world. How many of those three can find their motives reduced to simple questions of material gain? Pride and ambition and self-realization are what dominate the ideas of Germany and Italy. Glory more than gain colors their motives. Turn then to Japan. Men say to me, "Why have we any concern in the Far East? We have no trade." I find myself saying to them, "Is it trade that makes war or peace? Is it trade that dominates the policy of Japan today?" It is the military motive which is usually urged by the people of Japan as the foundation of their aggression. An economic motive appears only in a collateral sense. Yet here is the clearest instance of the economic motive for warfare and for aggression commonly paraded in the headlines.

More men have died for dreams, for ambitions, for emotions of fear and of hatred than have ever died for food or for clothing. Look back over the centuries and then measure what you read against this simple nursery-rhyme theory that the essence of history is that men go seeking clothes and shoes and bread, and make war and die for them.

The economic man is everywhere seen out of proportion. Turn for a moment to Russia, where the economic motive seems to have dominated development. Can anybody look on the history of Russia today and not see that what originally was an economic philosophy soon became almost a religious crusade and has today degenerated to a large degree into a struggle for political power and prestige between groups of men in control? The ideal has so changed its form that it scarcely resembles its own youth. Can we conceive of an economic motive in its true sense when men die that their descendants may have more? Those who slaughtered and those who died in Russia, the men who sacrificed ease and life that some future generation might profit from the fruit of their dream organization, were not in any sense impelled by the kind of thing we talk about when we speak of material gains energizing mankind. My thought is that, if the American people treat the storms that break over this world as being simply explainable on some basis of excess populations, or of a desire for colonies and for raw materials, they are deceiving themselves. If they so deceive themselves, they run risks. The disease of war, like other ailments, is most destructive where ignorance prevails.

I turn to another thought. There is deeply imbedded in the American mind today the feeling that a policy of temporizing, of withdrawing, of retreating, of turning the other cheek, can somehow preserve us in the confusion and the turmoil to come. This feeling is partly a product of propaganda during the last ten years. It is partly a resort of desperation, as I see it, but partly also a form of idealism, a sweet conformity to the old teachings of Christianity. With a great expenditure of money and executive energy, we have been effectively taught that the way to avoid conflict is to retreat. This seems to me a dangerous and doubtful plan of action.

The nearest analogy that is ready at hand for war in our domestic experience is the kind of gangster warfare that our newspapers picture, the sort of mob action of which all of us have seen something, or, perhaps, the barroom brawl on the frontier. Every child knows that the mild, retreating bystander in those circumstances is often the least respected, the most trodden, and in the end the most involved.

Fables from Greek days are full of evidence that the bystander who quietly stands his ground in the path of the panic, or the mob, or whatever type of disorder you please to picture, is most likely to escape injury. The neutral who quietly preserves his footing, his dignity and his position is the least likely to suffer in social turmoil. The western movies play on this theme every day in the theaters. The stories our children read are full of it. It is one of the simple axioms of life. I see no more treacherous policy, as I read international affairs, than the conception that by retreat, by isolation and by retirement we can escape the conflicts which may overwhelm our neighborhood.

But history reveals another consideration even more important. Whatever progress has been made in the limitation of war is due to the insistence of neutrals on their own rights and dignity. In the last two centuries the idea that neutrals are entitled to rights, that nobody, because he chooses to make war, is free to upset the whole world, that there are limitations on the privilege of destruction, has made important

progress. What little has been gained is largely due to that insistence.

Yet today I see the American people possessed and commanded by the view that our safety lies in retreat and surrender. The Secretary of State of the United States and his assistants warn us that the experience of the State Department is to the contrary. Many others voice the same opinion. Perhaps we are gaining some conviction but I doubt it.

Another thought, again intangible and a little difficult to express, is constantly in my mind. Another difficulty clouds the decade ahead of us. It seems to me the American people are handicapped just now in the matter of controlling their own emotions.

The testimony of the historians is that, in the period following the Jacksonian régime a hundred years ago in this country, the conduct of the foreign relations of the United States was exceedingly difficult, because of the emotions that had been aroused in the battles under Jackson. Our own period is not only comparable to the Jacksonian period in politics, in many respects, but is day by day being compared in high places with that epoch.

Today the United States is divided into two armed camps. Let us admit the fact, and face it and recognize its consequences. Those two armed camps are fairly evenly divided in population. Each of them is jealous of, suspicious towards and hostile to almost any policy originating in the other camp. Such was the case also a hundred years ago when the grizzled warrior, Jackson, retired from the field of controversy and left the turmoil that his two terms had stirred.

We cannot expect this emotion to evaporate in a year or two, perhaps not in ten years. Any policy which either one of those divisions of our population advocates will instinctively receive an emotional resistance from the other camp. Our people have been deeply stirred, partly, as I see it, by the very false exaggeration into a political doctrine of the kind of misunderstanding that I talked about a moment ago, of economic motives. Whatever the causes may be, our wounds are raw, our emotions sensitive. The man who proposes to advise and guide the American people in the next decade is dealing with an unsettled psychology, deeply suspicious of motives, objectives and policies, and he has ahead of him a serious problem. Nor is that all. We may be impatient of any effort at guidance or control, and after our deep preoccupation with internal reorganization, we are very likely to turn from sheer relief to as keen excitement over external politics.

Only three times in the history of the United States has a national campaign been waged on a point of foreign policy and in each case there seems to have been some connection with an intense excitement which had preceded over internal policy. One phase of this cycle is familiar to everybody. We all know that the dictator or demagogue often turns to foreign adventure when he stumbles and grows weak in domestic policy. The same escape is made by the masses of the people.

Furthermore, a new thought has developed, a new political idea has become prevalent among our people. We have been told that political leaders should be responsive, that they should not lead the people but should be led. A direct democracy is today the image that our people approve. We will not gladly be patient with limited government or independent men. We talk of mandates, not advice.

Let us go back, for a moment, to the Spanish-American War. There is a general agreement among students, I think, that the causes which led to the Spanish-American War were almost identical with the trends that I have been describing. The thunder of the great silver campaign of 1893 to 1896 had only traveled a little way from the scene. Men had been long angry. I can remember as a little boy the intensity of the campaigns over the silver issue which tore the United States and divided every community.

Cleveland had carried on cautiously through his administration. He felt that he was responsible for wisdom regardless of what the people thought. He was succeeded by William McKinley, who was essentially a follower, a responsive politician. We were in war almost overnight.

For thirty or forty years conditions had been much the same in Cuba. Violence and slaughter there had aroused the American people as early as the Grant administration. The "*Virginius* incident", which some of you may remember in detail, had stirred this country to a point where it required the steadiest of heads to keep us out of intervention in the

Spanish colonies. For thirty years the same story of Spanish violence and American sympathy had gone on, over and over again. Suddenly we were plunged into intervention with its consequences running deep into our present history, and into a war not very costly in slaughter or in wealth, but highly involving for another generation. The end is not yet.

We need not trace the history of the World War. Our part in it was in turn a product of emotional strain. The point I am suggesting is that today, more than ever in my lifetime, American emotions seem difficult to control, and American statesmen, who face the problem of guiding the American people, and keeping cool their passions and their resentment if war should break around us, have a task unusually difficult.

These three then have been the thoughts in mind. First of all, I feel that our American idea of war is almost certainly wrong and that we are likely to misunderstand what goes on around us. The second thought is that our current belief in retirement, or retreat, is not well founded. History hardly justifies it. Our experience is against it. My third thought is that in this decade we face a state of public mind difficult to keep temperate.

What can be done to meet these conditions? There is need of steady leadership. I keep wondering whether somewhere in the United States there cannot be developed a group, an institution or an organization to which the people of the United States would be willing to listen in times of international stress. The power of the editorial page, so active a few generations ago, is greatly weakened. The only leadership that I can see today is political. Political leadership seeks to be popular. It rejoices in being responsive. It is impelled by motives which seldom consider simply the welfare of the nation.

Is it possible to create somewhere in the United States organs or institutions which can speak temperately and yet authoritatively on our foreign affairs? None now exist. We have much propaganda. What we need is not more emotion about war, but less emotion about it. We would gain not by more but less crusading. Steady, quiet thinking, restrained speech, temperate approach—there, and there only, lies salvation.

Finally, if war breaks, will the neutrals find a way of limiting its effects? The bystanders in the Spanish war have played a significant part. The effort has not been wholly successful. These things are never glorious successes. There are, in spite of the newspapers, seldom any diplomatic victories. It is not diplomatic to have them.

The Spanish story is not a pretty one. But, on the whole, the flame still remains within the place where it began. Something has been gained, something has been proved in the way of technique. Perhaps a union of neutrals, a combination of the bystanders, may furnish, as in the case of Spain, some helpful check in the event of spreading war.

There is a saying that every war office proceeds to the strategy of a new war on the theory that they are going to win the last preceding war. Part of our difficulty with American thought is that we are entirely concerned with the last war that we happen to have been in. There were wars before the Great War. There have been three or four wars since. It does not necessarily follow that all the conditions of the Great War will prevail in the next one that occurs and that we need be governed by the complete abandonment of the principles of neutrality, of the protection of the bystander, that we saw twenty years ago.

These thoughts amount in the end to a plea for temperateness, for measured judgments, and for discipline in the habit of keeping our heads. Our present Secretary of State, with his devotion to the reciprocal tariffs which have been discussed today, is, in my mind, dealing with a sound principle. He is trying to restore the normal intercourse between nations. In terms of trade, the results are minor. The real gains are made by restoring neighborhood dealing. Neighborhoods that borrow sugar and coffee across their back fences do not readily quarrel. Cool heads and normal interchange are the first prescription of international medicine.

REMARKS BY THE CHAIRMAN

CHAIRMAN RANSOM: It is the privilege and honor of the Academy to welcome as its second speaker a distinguished Senator of the United States, not primarily as a member of the Senate who for several years has had much to do with the development of the foreign policy of the United States, but rather as a gentleman who has long been a student of history and of international affairs and of government, who has written and spoken extensively on those subjects and has taught in a great university of the West, has come into politics from the classroom and has brought into the work which he has done in the Senate the point of view of the student and the scholar. During past weeks, we have had a renewal of demand that in some way the American foreign policy should be made definite and should be disclosed in terms precise. There has been wide divergence of opinion as to what should be that definite policy. Our next speaker suggests his answer in his topic: "The American Peace Policy Need Not Be Definite". Senator Elbert Thomas, of Utah!

THE AMERICAN PEACE POLICY NEED NOT BE DEFINITE

HON. ELBERT D. THOMAS
United States Senator from Utah

WAR is simple; peace is complex. War has but one objective; peace has many. He who thinks that there is a single road to peace must end in disappointment. The way to peace may be in the world, but the paths are still hard to follow. Thus, if ever peace comes, it must come from planning and must be built upon organization which reflects that planning.

Perhaps an international golden rule is, or could be, the broad highway to peace. Perhaps, after all, we do not need to follow many little paths. All we need to do is to have all nations assure all other nations that no nation will ask another to do that which it would not do.

Our problem is ages old. History tells us that nations always have lived *on* other nations. From the first, governments and peoples have rarely questioned the right to live on other nations. The prepositions "on" and "with" are disarming little words, but for our purpose tonight they represent a space as great as the distance from a peaceful planet to Mars.

Nations today are faced with a grave decision. It is a difficult decision for each nation, thinking alone, to make. It would be an easy decision to make in concert. Nations soon must decide whether it is agreeable that one nation shall live *on* another nation, or whether all nations shall live *with* all other nations.

Years of habit are against us. This is an awful fact to contemplate. Universally it has been applied, until it seems to have become a part of my thinking and yours. Isolated, yet quite common, examples of its application have continued to this very moment. Is there, then, no hope?

I think that we may say in perfect confidence that not all nations are willing to feast off the toil and sweat of the peoples

of other lands, and therein is a little gain along a tiny path which leads to the road to peace.

Self-control and self-restraint are terms so Utopian that it is almost impractical to consider them. Even the theories of national self-control and self-restraint are far from universally accepted. An accident, and they are gone; but if nations are learning to live *with* one another, though the paths to peace may be many, varied and uncertain, this is a gain, and there is hope in the world for peace.

Never have we had anything like universal law. There is today no tribunal whose jurisdiction is world-wide. While there is a structural approach to such a judicial body, its judgments are not enforceable against a state unless accepted by that state. There are those who, for this reason, scoff at the very idea of an international court of justice, and point to its limitations and shortcomings. In our own courts, however, there is some sense of uneasiness, when one has been given a trial and has been found wanting, when the eyes of all who know him are turned toward him against whom a judgment has been entered. World opinion is like that, especially if it is a just opinion.

Men in high places are sensitive to public opinion. A recent skirmish between an important city official in America and a soldier-statesman abroad leaves no doubt of this. Of course we are all sensitive to public opinion. I am afraid some of you would smile if I tried to say that every one always stands in saintly awe of the *obiter dicta* of a high tribunal, but a judgment is a judgment, and it does not fail to impress. The judgments of our own courts do not necessarily haye the United States Army behind them, and I am sure the Commander in Chief of the United States Army has not been in accord with all of them lately, but the rendering of acts of Congress unconstitutional has had a greater force behind it than the United States Army. It has had the force of public opinion which, though divided as to the correctness of the court's judgments, cries out today for one of three things; namely, amendment, increase of judges, or popular acceptance of the judgments, but never for nullification, for negation, for rejection. Who, facing these facts of comparison, can say that we do not in truth have a court of virtually world-wide jurisdiction?

There exists today a society of nations, but this society does not include all nations. At the most it can only discuss and recommend. The residents of its membership are not citizens of this society of nations, for it does not have any citizens and does not confer citizenship. It cannot legislate, it cannot enforce. If it is a unity, it is simply because its parts function out of a sense of an ideal of national behavior, and not from any actual or even implied force. But, indeed, it is a unity and, as such, its existence is a path to peace and its progress is measurable.

In the past, when men gave perfunctory service to a more or less unified rule, the titles of potentates demanded an unquestioned obedience wherever the royal name could be thundered. Was there unity? Of course not. Today all states stand theoretically equal to all others, and we have a nearer approach to unity than ever before. It is paradoxical that, when the universal authority was declared, the world had no united will, and today, when it is disclaimed by all, we really have an approach to unity. In this anomaly we have the secret of better world relations.

As I view things today, the greatest problem facing the world in international relations is the same problem that is facing us as a nation. It is the problem of democracy. Without the solution of democracy's status both at home and abroad, we can achieve here, and in an international sense, only that sort of unity which the world has always known. If our country and the world tend away from democracy, unity may be achieved through a Holy Alliance method in defense of hereditary government, or it may arise in a form similar to that at the outbreak of the French Revolution, when the revolutionists turned anti-aristocratic. Such unity would not solve the world's problems internationally, as Americans would like to see them solved.

The isolationist idea in America has become stronger whenever we have been able to point our finger at the rest of the world and say that they are not like us and that, therefore, we should not join with them. Moreover, it would be contrary to American ideals and American theory to attempt to thrust our governmental notions or political theory on the rest of the world. This we cannot do, because democracy does not re-

spond to force. It responds only to persuasion, and the American ideal can be attained only as a result of well-reasoned actions.

There always has been an unconscious unity in the world. It is extremely interesting to block out a given century in past history, and then study different parts of the world during that century and see how world-wide the problems, the ideas, the attitudes and the expressions of widely separated peoples have been. This I have done in a rather formal way, as some of you know, in regard to the twenty-third and twenty-fourth centuries B. C., the sixth century B. C., and the first century A. D., and I am convinced that my little thesis holds even for 1937. I shall explain. In the last month or two I have taken part in a series of talks dealing with international relations. After I had finished one of my talks, the gentleman who followed me submitted for my consideration the manuscript of his next talk, and, after reading it over, I told him that I was more interested in what I might do with one of his paragraphs than with his whole manuscript, although his address was a very splendid one. He was dealing with the problems of a certain foreign country, and in handling this subject he had written a paragraph of description concerning the economic and political conditions in that land. I showed him what I meant by the attractiveness of his paragraph in a consideration of my little thesis. He could not see my point, so I illustrated it. I took his paragraph which was written, let us say, about Japan. I struck out the word "Japan" and I substituted the word "Germany", and together we discovered that that which he had said held just as well for the second country as for the first. We next changed the name of the country to Russia, then to Italy, to China and to England in turn, and then I said, "Let us see if the impossible of impossibles can be true. Let us change it to the United States." Even I did not expect that the paragraph would come out so well, and my friend was astonished beyond words. Therefore, I think I am right in saying that the problem which faces the world today is our problem: Can democracy be made to function?

I know of no land today which has not a real fiscal, monetary and debt problem. I know of no land today which is not concerned with the armament problem. I know of no land today wherein constitutional change is not being agitated. I know of no land today which is not either in the process of solving, or attempting to solve, or completing the solution of labor and industrial ills.

If the individual parts of the world are all struggling with political, economic and social problems, and if the solution of those problems in one place will help in solving them in others, and if the problems of the world are practically the same, is it not obvious that world-wide coöperation in the solution is the only way out? One becomes almost boyish in his outlook for even suggesting it, but still the problem is with us and it is with us, I think, primarily because the establishment of the American government and the bursting forth of the ideals of the fathers were part of a great world movement. Without being conscious of the fact, we assumed that we were leaders in a movement, when we were merely going along with other nations.

The most artificial of all our barriers today are our state and national lines. The most ardent patriot, the most valiant defender of states rights, the most conservative of lawyers in America—the world's most glorious paradise for lawyers—has never gone so far as to suggest that thought, for example, is a matter of strictly local concern. Is there nothing common in the various fascist movements? Is there nothing common in the various socialist movements? Is there nothing common in the various democratic movements? Is there nothing common in the various world organization movements? Is there nothing common in the Pan-American, the Pan-Russian, the Pan-Italian and the Pan-Asiatic movements? Is there not a common aim underlying fifty or sixty international organizations? Does it hurt our sense of national pride when a great judge of our Supreme Court, for example, calls attention to English law or to a decision of the Permanent Court of International Justice? Is religion a matter of a single place, or can we, to the satisfaction of nearly everyone's idea of worship today, offer our prayers wherever we are? Who among your friends has not traveled in foreign lands or studied foreign languages? I have overdone this line of thought, but there is reason in what I have done, for I would dislike to be marked down as a Pollyanna in my philosophical outlook. If I belong

consistently with any school of philosophy at all I am an out-and-out pessimist, so much so in fact that my friends have described me as an optimist in my pessimism, in that I always hold out the idea that no matter how bad conditions are they will surely be worse tomorrow. Yet in spite of that pessimism, and in spite of my outlook, there are so many fine things happening in the world today, and we are getting so close to the solution of many problems, that instead of constantly feeling that the world is slipping back and getting nowhere, I read the opposite in nearly every movement.

Youth is freer than it has ever been. More persons have a chance at the elements of an education than ever before. There is more going and coming than the world has ever known; there is less restraint upon those who go and come. Knowledge, ideas, notions of sanitation and hygiene are far in advance of any point ever before attained; the thoughts of the average man and the standard of the average life, when measured in a world-wide scale, are much ahead of those of any previous time. If man's ability to destroy himself is one of the glories which come with the notion of individual freedom, the ability to destroy is greater than it ever has been. The restraint of law rests more lightly on individuals and nations than it ever did before. This, of course, seems to be an ill, and among many peoples the lack of respect for law is carried to the point where it results in self-destruction and a breakdown of faith. Yet even this, in the light of world-wide cultural and political history, is good, because the law of custom and the law of the state and the law of the family and the law of the church have been in the past the great bonds that have held men back. I say all this without condemning any one of these institutions, for it is in the abuse of law, it is in the pressure of custom, it is in the dulling effect of cultural habits that man has been held back. The individual, in his rights, in his personality and in his ability to project himself, stands today far above the individual of the days gone by. These are things for which we should be grateful.

The best condition of all is that today we know what ails us, whereas heretofore we have not known. There is universal recognition of our ills. It is only in their solution that we find the difference of opinion. Thus, again, we emphasize unity and also diversity. My theme, then, is that we must become united in the solution of our ills as we have become united in the recognition of their existence.

Today, possibly because Einstein suggests it, more likely because it is so and Einstein enthusiasts merely observe it, our ideas of government are as relative as anything else. Sovereignty is becoming widely accepted as a relative proposition; insistence upon the hard rights of sovereignty is everywhere relaxed. The personification of England's Gibraltar has been seen to wink her once solemn and forbidding eye, in order to keep the peace. Again, Italy's forty thousand, rushing sternly to the help of another, have stopped leisurely to light a cigarette, and to smoke it too. If they have crossed the border, they have not done so *en masse* or with bugles blowing. Stalin has found it possible to look upon a new day and endure it, though Trotsky still lives. The German Kaiser continues to chop wood, though the common people of many lands in 1919 were shouting for his head, and might have had it if they had stayed angry.

American battleships, like the wills of some of our bluffing neighbors, no longer seek to protect an American dollar wherever it may be invested. How good, that we all have lost face! Blushing furiously we have rushed to the mirror! How astonished each of us is to find that there is more true character in his face after some of it has been lost!

Yes, we must continue to break down absolutes, if good will is to rule. It is an affront to civilized thinking that we justify an assault on a man simply because he is Anglo-Saxon or Teutonic or Nordic or what not, according to our national mood of the moment. Men and women travel more today. When in each other's lands, they have less sleeve for laughing; with better preliminary education, they have more background for comprehension. They understand what they see and hear more perfectly than of yore; they have better manners abroad, and, consciously or unconsciously, they adjust themselves and give a better report when they come home. Men and women, whether they travel or not today, like their neighbors better. Progress in this direction, insignificant as it may seem, is a path to peace.

Let us consider our closest neighbor, Canada. The heads of our government and hers have hopped so many times across the little hedge which might be a high board fence, or stone wall, that the process almost has ceased to be news. Our President has no more difficulty in feeling at home, and at ease, and even at complete rest in Canada than he has in the White House, at Hyde Park or at Warm Springs. We have had visits from those chosen by Canada's electors and those designated for Canada by the parent nation of us both. A few days ago, we of the Senate bowed pleasantly to the Crown's representative, the Governor-General of Canada, and on the floor of the United States Senate a history-making incident occurred.

Ask yourselves, if you believe in absolutes, whether Canada is American or English? Where is our absolutism? Is Canada Pan-American material? Always we have saved a chair for her in the Pan-American Union. She is free to sit in it if she chooses. She is as thoroughly American as we, whether she sits in her place or not. She is as thoroughly English as a daughter can be, if she occupies it for centuries. Must it matter to anyone that she is friendly to us and at the same time loyal to a mother who wisely recognizes that she has grown up? Must we always be typing every government and, in an attempt to pin a label, making an erroneous absolute in our minds? Must it matter that Canada is American to us—for truly by the Statute of Westminster she is a nation in a commonwealth of nations—and English to England—for just as truly she is part and parcel of the Crown? Do we care that she is a republic or a dependency, monarchy or democracy, and is both, and is neither, and is none of these and is all of these? Canada under English statute is perfectly free, if she chooses, to take her place in the Pan-American Union. Where are our absolutes and why must we look for them? The status of a foreign country is something like the status of a bill in Congress. If we want to know the latter we must ask the bill clerk today. Yesterday's answer may not serve. That absolutes are slipping indicates a forward march on one of the wider paths to peace.

It is within my short lifetime, and within my adult memory, that war was accepted as a necessary part of the life of nations.

I have even heard it said that war was good for business. A few young patriots would go away to a limited area known as the theater of operations, and, on this little stage, with few shifts of scenery, a great sporting drama would be enacted. Nations in hot blood had quickly resented national insults, and that had led to war. Those who had most greatly resented the insult stayed the farthest possible geographical distance from its vindication. The conflict might be short or it might be long, but at least the last two American wars menaced the lives and security of a relatively small number of Americans, in an area pleasantly detached from this continent. Even in the War between the States many parts of the North were scarcely conscious of the conflict. But today's war forces the soldier to learn to charge something for his services. He seems to have lost his reverence for women and children; he seems indifferent to staying within the theater of operations. Moreover, a prisoner is not to be kept, but killed; and the population of a captured community, far from being harbored or driven to the outskirts, is to be decimated. The old sporting elements, that believe in giving a bird a chance to take wing, have disappeared from modern war. In their places are dull, soulless creatures whose idea of the romance of war is no more elevated than the attitude of the nocturnal plunderer whose sportsmanship embraces the dynamiting of fish.

Now, my fellow Americans, here is a pretty picture for even your most intensely nationalistic countrymen to contemplate. Here, at last, is a war which no one can win; the fun, the flash and the glamor go when our own homes are in the theater of war, when our own children are not only accidental but deliberate targets. May I call you a militarist, and you a pacifist, as you insisted each other be called a decade ago? Of course not. You do not want to be labeled, and your old absolutism is gone. You, and you, want to be salesmen of the idea that war does not pay anyone. You want to make it clear to those that hold your country's destiny in their hands, your Congress in part, for example, that every purpose for which modern nations might contend can be accomplished better by some other medium or instrument. Universal recognition of these horrors, if it has come, is more than a few strides on the path to peace.

It is true that the growth of institutions has developed the ability to destroy. It is equally true that it is difficult, and a real military challenge to any nation, to keep scientifically abreast, with defenses, of another's tremendous capacity to destroy. It is shocking that today armies do not fight armies, but whole nations fight whole nations. It is readily seen that, in the event of future wars, individuals will lose every whit of freedom that they ever possessed and private property every form of security it ever enjoyed, and these unusual deprivations will be made by both the alien country and the country which exacts so great a toll of allegiance.

Where, you ask, do we find any enthusiasm for war under such conditions? I think, however, that except for a war-mad ruler, some criminally insane zealot in a position of power, we may assume that no one in power is likely to pick on anyone his size, internationally speaking. We have little reason to hope that a big fellow will not "choose" a little fellow, and the danger is that in so doing he may touch off something bigger. Fortunately the great minds today are in a "penny ante" mood, and have only "chicken feed" ambitions, as present studies indicate. In this situation there is hope; all good nations stand ready to shame, if not to stop, a bully. Is this fact a path to peace? Definitely it is, if we realize that a path may be a path to glory, though its side trails be fraught with danger. It is pleasant to think that the Frankenstein monster of war preparation may destroy itself by its sheer ugliness. It is horrible to think that it may not.

This brings us to a pretty point. What are nations doing with their armies and navies? Introspection at home may help answer this question. For a long time armies and navies have done less fighting than anything else. They are justified, and are justifying themselves, more and more by services other than mere offense and defense. The American army, for example, has given us a pioneer application of social security. Its officers have taken a nebulous C.C.C. idea and have made of it a good civilian product. The service is valuable in harbor work and in succor during flood and other distress. I have asked the national guard to study labor relations, even at the expense of perfecting the hand salute, and in this I am most serious.

What other little avenues of peace have we? We — all nations together — would do well to require one another to speak frankly upon armament needs, to tell others frankly that which now we report among ourselves so secretly; for example, how many guns, ships, airplanes we need and for what purposes. A ridiculous exposition such as most nations would have to give, were they to speak the truth and confess their fears and ambitions, would not likely be made, and a self-imposed restraint might result. Defense would become defense, not potential aggression. How splendid if all defenders merely sought defense!

Imperialism is said never to have been an American policy, but this statement has been questioned with good reason. Today, however, what has become of " the white man's burden ", " dollar diplomacy ", and " a battleship wherever a dollar is invested "? They are not part of our national thinking. May we say today, as an absolute statement, that imperialism is not American? Of course we may. Non-imperialism is not universally accepted; and we still hear that some nations need colonies. But if some of us are backing up from a sure-fire trip down the slippery pavement that leads to a head-on crash into war, does it not follow as a corollary that we are getting that much closer to peace?

Americans are prone to belittle mere international conversations, saying that we are built for action, not for words. We are amazed, therefore, to see our industrialists and labor leaders talking across the table, liking it, and getting somewhere. Wherever and whenever they do so, are they not on a boulevard that leads straight to labor peace? What difference is there between labor peace and any other? Why do many of our people feel that they must regard international conversations as just plain gab? Is it not possible that we have traveled toward peace, on a wide path, each time that we have conversed with our neighbors, and that more and more frequent conversations will take us within sight of the Broad Highway?

How, now, to end my talk tonight? With a bundle of loose ends? Shall I confess that all I know about peace, or, worse still, that all that is known about peace, is a basket of loose ends, and that the only paths to peace are, like the loose ends,

as scattered and incomplete as the ideas thrown out here tonight?

If I should so confess before a lay audience, the effect would be wonderful, for our very helplessness and relative hopelessness would frighten a lay audience into some hard thinking.

But, if we, who already have thought long and hard upon the subject of international relations, finally come to conclusions, as we must, we are not in much better position than the layman in figuring out mere premises. The conclusion is obvious. We must organize and plan, organize and plan, and still do more organizing and planning.

The fragmentary gains, which I have mentioned, are nearly the only gains we actually have made. We have almost the whole job before us; little of it is behind us. We have had little trial and error; and far from making an exact science of our meager findings in the seldom-visited laboratory of peaceful experiments, we have scarcely enough data for the formation of the most inexact science. Seeking peace is a brand new activity. But the rules are about the same as any set of rules for a new project. Like the fool who thought that he could make a steamboat, harness electricity, fly an airplane, cut through America's middle with a canal of water, or build Boulder Dam, we must first really have faith in our dream. We must organize and plan; and, of course, everyone is laughing and will laugh.

They do not know, however, why they laugh. For the first time in the world's history, all the plain people on the face of the earth pray for peace and ask the gods of their destinies to keep war from their lives. With this knowledge, some of us in Congress, and some of us not in Congress, may lay a fairly stable foundation for the world's greatest project.

CAUSES OF WAR CAN BE REMOVED BY IMPARTIAL ADJUDICATION

HON. WILLIAM L. RANSOM
Trustee of the Academy of Political Science

AT the risk of holding you here for a few minutes more, I am so bold as to try to sum up some phases of the day's discussions, and to place before you a personal view of one matter which has not been emphasized tonight, but which seems to me to be of fundamental importance.

In America and Europe, during the past few days, there have been commemorations of the twentieth anniversary of the entrance of the United States into the World War. The occasion has brought a mood of retrospection and of taking stock, to see in what direction and how far we have traveled during the past twenty years.

I do not need to say to you that such a survey shows many things which are disquieting; that fact is confirmed by the discussions of this meeting and by the developments in the world at large. The Gallup poll (American Institute of Public Opinion), published today, indicates that by a wide margin, in every part of the United States and in many occupations, old and young and middle-aged alike have come to hold a feeling of regret that the United States entered the World War at all. To many of our people, the high purposes for which the United States entered the War seem in large part to have been frustrated and to have failed. It is difficult to accept this view, and I do not; but it is difficult to hold faith in a more hopeful view, as we look upon the world scene today. The drums of strife beat again; fear and hate and stark atrocity stalk the highways of lands in which the people, not long ago, sang hymns of liberty.

The League of Nations, erected so hopefully by the idealists of many lands, stands neglected by our own, largely impotent without our participation, and always suspect of being

the tool or plaything of alliances between arbitrary, personal governments. In a world which was to be made "safe for democracy", the rise of arbitrary, dictatorial government everywhere has been rapid and almost complete. A desperate feeling of insecurity and danger now grips millions of people who until lately had felt some sense of security, stability and progress toward higher standards of living. Frantically, the people have stood by while personal leadership or dictatorship has struck down democratic institutions; and there is a nervous insistence that by personal miracle something be done, even though those reaching for power and more power have no clear idea what should be done. In a large part of a world which philosophers of this century had pronounced almost free from "tyranny over the minds of men", independent public opinion is not allowed to function, independent thought is silenced, and independent thinkers are either imprisoned or destroyed. History repeats itself; dictators sit in the places of less arbitrary kings and emperors; they send armies, planes, munitions, in secret to force forms of government on other lands and to destroy economic and political freedom; even peoples at peace are not free from invasions by stealth, invasions of ideas and propaganda to undermine resistance to arbitrary power. And we who cherish liberty are reminded that, as Kipling put it,

> All we have of freedom, all we use or know,
> This our fathers bought for us, long and long ago;
> Ancient right unnoticed at the breath we draw—
> Leave to live by no man's leave, underneath the law.
> Lance and torch and tumult, steel and grey-goose wing,
> Wrenched it, inch and ell and all, slowly from the King.

It is not a quieting picture. There are widespread fears that the remaining free governments cannot survive as democracies and will go the same arbitrary road. Foreign policy and the maintenance of the world's peace have become a matter of dealing with one-man governments, with dictators; and even the people living under the surviving free governments are being led to doubt whether the processes of representative government can cope adequately with one-man governments.

In our own country, too, there are disquieting signs manifest in the public opinion which affects, and may some day control, the foreign policy of the United States. We hear pleas or demands for a willingness to submerge and silence all the traditional sympathy of Americans throughout the years with liberty and with democratic government and with oppressed minorities in other lands — pleas that the voice of America, which has always been eloquent for freedom and oppressed peoples the world over, shall now be mute, lest dictators be offended and our country become involved. We are commanded to desperate efforts, by ourselves, to put our own economic house, our own economic machine, in order, and to ignore the warnings of experience that "you cannot get your own machine into balance without considering the world machine and the world balance." On the other hand, we are urged to take "bold strokes" in order to help settle and stabilize the world economy, which has been so severely disordered, as I see it, by the unsound devices of one-man governments and by their doctrines of national self-sufficiency which have proved explosive rather than helpful to peace.

In most of the discussions today, and particularly tonight, it has seemed to me that the speakers have gone back to fundamentals, have become a bit philosophical, if we may call it that, and have suggested some considerations of spirit and outlook which may be necessary to peace and stability under the new order of things abroad and at home.

As a closing thought for this meeting, may I emphasize one further consideration? It seems to me that the most serious retrogression which has marked these past twenty years is a steady drift away from the orderly adjudication of international disputes according to law, and the substitution of negotiations, alliances and aggressions by individuals as the heads of arbitrary governments.

Thirty years ago, under the enlightened leadership of great statesmen in many lands, the world seemed to have gone a long way toward accepting the idea, and the practical working formula, that all or most of the causes of war or friction between nations could be removed, through arbitration, or through adjudication, by impartial, law-governed and independent courts, responsive to no political or arbitrary control. The United States had itself furnished to the world the outstanding and the most successful example of this, in that, on a

continent made up, at the time of the Revolutionary War and afterwards, of disunited, jealous and contentious colonies or states, with rivalries and controversies between them as serious and provocative as those which arise between nations and lead often to war, the erecting of an independent and impartial tribunal for the adjudication, according to law and justice, of controversies between states and between citizens and government brought one hundred and fifty years of peace that has been broken but once by civil war and has been the sure foundation for security and coöperation and stability and order, and for the ending of controversies which in the international sphere have been provocative of war.

The Royal Institute of International Affairs has lately published, from the Oxford University Press, a little volume by Mr. E. A. Radice, on *Fundamental Issues in the United States*, in which this keen observer points out that "the permanent achievement of the United States lies in the fact that she has evoked a working legal mechanism to settle controversies which in Europe may lead to the use of force, or, at any rate, to friction and ill-feeling"; that "the legal and constitutional problems which loom so large in the United States today, are the result of an attempt to establish the reign of law over a whole continent"; and that the American method of arbitrament by a law-governed court "is no doubt the ideal way of ensuring peaceful democratic rule over a large geographical area."

In England and America, furthermore, as Elihu Root pointed out so well in 1922, the rules of right conduct embodied in international law were "authoritatively declared to be a part of the municipal law of the country, enforceable by the Courts, and in this way the nations founded upon differences have been gradually rescuing from the field of difference and controversy and transferring to the field of common understanding and agreement, one subject after another of national importance in the affairs of the world."

Many of us in recent years reached the conclusion that between nations, as between men, there are and can be no controversies and no conflicts of interest that are in fact beyond the possibility of determination through the ministry of an impartial and law-governed international court.

The tragic thing, in my opinion, is that all of this hopeful headway now seems largely to have been lost or destroyed. The mood and method of fair and impartial adjustment according to law have lost international authority. Economic and political fortunes of nations and individuals are now to be decided by arrangements between one-man governments. Even in our own country, the idea of impartial determination of controversies by independent non-political tribunals is challenged and may be undermined.

Shall we not urge anew an adherence to international adjudication according to law? Cannot a nation which for four years has been a member of the International Labor Office at Geneva, closely identified with the League of Nations, adhere also to the Permanent Court of International Justice, despite its link to the League? I submit to you this question: Can just and lasting peace between nations or security for the rights of men or states be secured in any other way, in the long run, than through the supremacy of orderly and impartial adjudication according to law, sustained by the decent opinion of mankind?

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EXPENDITURES OF THE FEDERAL GOVERNMENT

A SERIES OF ADDRESSES AND PAPERS PRESENTED AT THE ANNUAL MEETING OF THE ACADEMY OF POLITICAL SCIENCE NOVEMBER 10, 1937

EDITED BY

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PREFACE

AT a time when business recession is so much in men's minds, and when taxation is so obviously a primary concern of the Congress, it is reasonable to expect that this volume on "Expenditures of the Federal Government" will arouse more than academic interest. Governmental policy is apparently in process of revision. The remarks of the Secretary of the Treasury, recorded in these pages, may foreshadow a significant change in the administration's use of public funds. During the coming months the relation of relief and public works expenditures to the general program of recovery and reform will be subjected to critical examination. No present calculation can determine the result. Nevertheless, we publish this issue of the PROCEEDINGS in the hope that frank discussion may help to clarify some phases of the complicated budgetary problem.

These papers, representative of the views of men whose opinions command attention in financial, governmental and academic circles, were presented at the Fifty-seventh Annual Meeting of the Academy of Political Science, held at the Hotel Astor in New York City, on November 10, 1937. It is appropriate for the Academy to express its appreciation of the notable public service rendered by the speakers who participated in either the formal program or the informal discussions. To the Committee on Program and Arrangements credit is due for the success of the meeting. Its members included: Wesley C. Mitchell (Chairman), Miss Ethel Warner (Director), Earle Bailie, W. Randolph Burgess, Nicholas Murray Butler, Lewis W. Douglas, Frederic W. Ecker, Leon Fraser, S. Parker Gilbert, Luther Gulick, George L. Harrison, Thomas W. Lamont, Ogden L. Mills, Shepard Morgan, Thomas I. Parkinson, William L. Ransom, Gordon S. Rentschler, George Roberts, David Sarnoff, Carl S. Shoup, Thomas J. Watson, John H. Williams and Owen D. Young.

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THE NATIONAL BUDGETS OF GREAT BRITAIN, FRANCE AND THE UNITED STATES, 1928-1937

INTRODUCTION *

DR. W. RANDOLPH BURGESS, *Presiding*
Deputy Governor, Federal Reserve Bank of New York
Trustee of the Academy of Political Science

THIS is the Annual Meeting of the Academy of Political Science in its fifty-seventh year. Let we remind you that over this period of years, the Academy has held available a forum for the impartial, non-political discussion of public questions.

The subject for our meeting this year is " Expenditures of the Federal Government ", and the session this morning has as its subject, " The National Budgets of Great Britain, France and the United States, 1928-1937 ". The subject implicitly recognizes that these three great countries have a certain kinship in their budgetary problems.

We have come through the inflationary period of the War together, through a deflation, through the great expansion of the nineteen-twenties and through a great depression.

These great economic causes have brought us problems of the budget which are related, and our subject today will give us, in a sense, a comparative conspectus of budgetary problems from which we may learn something for this country.

Let me remind you that at the close of the set program there will be discussion, first, by speakers whose names appear on the program; then the discussion will be open to the house. That has always been a feature of Academy meetings.

* Opening of the First Session of the Fifty-seventh Annual Meeting.

For our three major papers, we have three distinguished economists from three great universities; men who have had considerable practical as well as university experience. They served with tax commissions in the various states of this Union and in foreign countries. They have been advisers to governments, both here and abroad. Their writings are known to all who are familiar with the field of taxation and the budget.

The first speaker will be Professor Harley L. Lutz, Professor of Public Finance, International Finance Section, Department of Economics and Social Institutions, Princeton University, who will speak on the problems of Great Britain with its national budget.

I have great pleasure in introducing Professor Lutz!

ENGLISH FINANCIAL POLICY AND EXPERIENCE, 1928—1937

HARLEY L. LUTZ
Professor of Public Finance, Princeton University

THIS paper deals with some of the more obvious aspects of the English financial record and experience since 1928. In order that the general facts of this record may be more easily visualized, certain statistical tables have been prepared.

The fiscal results of the years 1928 to 1937 inclusive may be expressed compactly as follows:

1. On the face of the record, there was a surplus of receipts over expenditures in the ordinary accounts in six of these years and an excess of expenditures in four years. The surpluses aggregated £64,949,000 and the deficits totaled £75,696,000. The net excess of expenditures over current receipts for the ten years was therefore £10,727,000.

This is not a wholly accurate picture, for some extra-budgetary transactions have modified the apparent results in the direction of a larger total deficit for the period. Such transactions have not been of a magnitude, however, that would completely invalidate the impression of prudence in financial management which is conveyed by the ordinary accounts.

2. The maximum increase in the total deadweight debt was £415,500,000. This occurred between 1930 and 1934. The changes in the composition of the debt have been somewhat complicated, but the total increase does not indicate extra-budgetary expenditures to the full amount thereof. A moderate increase of the nominal debt capital occurred in connection with the conversion of 1932-33 and a substantial amount was borrowed in these years to establish the exchange equalization fund.

On the other hand, there were heavy deficits for certain years in the unemployment insurance fund, and loans were made to provide these payments. Such loans are not counted in the deadweight debt, but in the other capital liabilities of the state.

Presumably it is expected that, over a sufficiently long period, the receipts of this fund may suffice to liquidate the special loans, which would justify treating these obligations as being in the class with those incurred to provide capital funds for other self-supporting enterprises. From time to time substantial payments against the unemployment deficit have been made.

I. *Some Generalizations Regarding the English Finances*

It is worth while to attempt certain broad generalizations regarding English financial policy and experience during the past decade, after which attention will be directed to some more specific aspects of the revenues, the expenditures and the debts, respectively.

First, the traditional regard for a balanced budget continued to exert strong influence upon fiscal policy. From the cessation of the War, the party in opposition, whatever its label, has found the government's expenditure and taxation proposals an inviting point of attack. The criticism has been, at times, captious rather than constructive, but it has always been active.[1] Although vigorous, the post-war budgetary criticism lacked the insight necessary to suggest, and the force required to compel, the adoption of financial and economic policies appropriate to the conditions that had been created by the return to the gold standard in 1925.

The English budgeting process during these years may be likened to a series of moderate oscillations around the norm of perfect balance. Like his fellows elsewhere, the British politician is inclined to temporize, to accept makeshifts, and to rely unduly on the efficacy of expedients. Moreover, he is no better at reading the future than any one else. Mr. Churchill's remarks in closing the budget speech of 1929 strongly resemble some things that were frequently heard here. He said:

> I feel that the corner in our economic fortunes may well now have been turned. There are no causes, apart from fresh causes of our own making, which should prevent the next four or five years being easier and more fruitful than those through which we have made our way.[2]

[1] *Cf.* Mallet and George, *British Budgets, Third Series, 1921-1933, passim.*

[2] Quoted by Mallet and George, *op. cit.*, p. 263.

No one realized then, of course, that difficulties were impending which would make the trying days of the coal strike seem, by comparison, like a fairly prosperous period. While these difficulties disorganized the finances and increased the temptation to rely on expediency, they did not wholly demoralize the fiscal processes nor loosen altogether the British grasp of fundamentals. It is true that the original budget for the fiscal year of 1932 was a "makeshift" affair, the enactment of which constituted a temporary triumph of political expediency which seemed at the moment to brighten the prospects of the Labor Government. As the prospective deficit under it increased, the government continued unwilling to make adjustments along the lines recommended by the May Committee on national expenditure,[3] and in August 1931, a cabinet crisis was precipitated by the split over unemployment policy, itself a fruit of the earlier optimism regarding the future outlook for industry.

In presenting the supplementary budget, Mr. Snowden, who, as chancellor, had been responsible for the earlier makeshift proposals, announced that the revised program contained "drastic and disagreeable" proposals. The significant thing about this crisis and the way in which it was met is that while the British may muddle and temporize and err, they do not altogether lose sight of the chalk line of budgetary balance. The promptness with which drastic and disagreeable action was taken in 1931 reveals the apprehension which any threat to budgetary stability will develop in England.

A second general feature of the English fiscal situation over the past decade has been the comparative steadiness of both the revenues and the expenditures. This is to be expected under a "pay-as-you-go" philosophy. The receipts naturally performed better than the expenditures, for they were under somewhat better control. That is, a government which, at the critical junctures, can muster the political courage to use the taxing power as a means of preserving budgetary equilibrium can take steps, however drastic and disagreeable they may be, to increase its receipts, or to control them in this sense. It has no such control over the effects of a world-wide

[3] *Report of the Committee on National Expenditure*, 1931 (Cmd. 3920), House of Commons Sessional Papers, 1930-31, vol. 16.

depression on the domestic economy and on the volume of the expenditure obligations that may be created by the impact of outside forces.

A third characteristic of the English record is the material reduction of the annual debt service charge. Many nations have taken advantage of the abnormal conditions of the depression capital market to convert or refund high rate war securities into new paper bearing much lower rates. The success of the English conversion of 1932-33 was a factor of the greatest importance in the budgetary improvement from 1934 to 1936. The reduction of more than £100,000,000 in the annual interest cost of the debt provided a shock absorber against the increased expenditures for public relief and in aid of local governments.

A fourth element in the general situation has been the enormous debt total which the English people have been carrying since the War. This has had a tremendously sobering effect on their fiscal policy. From 1919 to the present the deadweight debt has stood above the absolute level to which wild schemes and lavish expenditures have now raised our own national debt. Under these circumstances there has been strong discouragement to any program of liberal spending to be supported by further borrowing.

There must have been some temptation and some pressure to abandon the traditional standards in 1931, despite the debt burden, for at the time that the original budget for 1932 collapsed, there was a prospective deficit of £74,679,000 for 1932 and of £170,000,000 for 1933. The choice of a way out is described by Mallet and George as follows:

> Two paths had stretched before Mr. Snowden—the obvious one of increased taxation and drastic economies, and the other, enthusiastically advocated by certain economists and politicians, the less dismal-looking but unknown and dangerous path of further borrowing, leading to inflation and all it entailed, economically, financially and politically. This path was one which Mr. Snowden, with his orthodox principles of budgetary balancing, would probably neither care nor dare to look at twice, even if an overwhelming majority of his new colleagues and the full force of the City, fearful at the possible loss of the gold standard, had not irresistibly forced him toward the other path, of crushing taxation and rigorous retrenchment—the path of safety and of sacrifice.[4]

[4] *Op. cit.*, p. 392.

The policy of crushing taxation and rigorous retrenchment did not save the gold standard, for suspension occurred within a fortnight after the introduction of the supplementary budget. More than governmental retrenchment was required, and the other, deeper adjustments of the domestic economy were so severe and so extensive as to have been, in all probability, impossible.[5] Nor can we be wholly certain that if England's debt burden had been much less, the path of safety and of sacrifice would have been chosen. The section of the other path that one sees from the entrance to it is lined with some particularly choice and attractive political and economic primroses. The briars and the greasy skids are all farther along the way.

II. *Some Aspects of the English Revenues*

From this brief survey of the situation as a whole we pass to a consideration of the exchequer receipts.

The taxation revenues are obviously of paramount importance. The national government has done little to develop those functions which may be summed up in the phrase, "The State as landlord and capitalist". Even its limited rôle here has not escaped all criticism, for the "Sundry" and "Miscellaneous" classes of receipts have included such things as repayments of loans and advances, transfers of capital reserves to current account, and liquidation of property assets, especially war materials.[6] The treatment of all such proceeds as current receipts has produced a critical reaction similar to that which has been directed against our own policy of dumping R. F. C. and other agency collections into the hopper of current expenses.

The importance of the income tax in the British fiscal scheme is clearly shown in Table I, and the figures reveal, further, that the strength of this tax is in the standard, or as we would say, the normal tax.[7] Since 1928 the proportions of total in-

[5] *Cf.* Frederic Benham, *British Monetary Policy*, especially ch. iii.

[6] In 1932 the miscellaneous revenues included £8,075,000 of capital repayments from the exchange account.

[7] Originally, the additional tax was called the "super tax". The name was officially changed in the Finance Act of 1927, in connection with a scheme of simplifying administration for both the government and the taxpayer.

TABLE I

SUMMARY OF EXCHEQUER RECEIPTS FOR CERTAIN FISCAL YEARS
(Millions of Pounds)

	1928	1929	1930	1931	1932	1933	1934	1935	1936	1937	1938 (Estimated)
Customs	111.6	118.9	119.9	121.4	136.2	167.2	179.2	185.1	196.6	211.3	219.9
Excise	139.2	134.0	127.5	124.0	119.9	120.9	107.0	104.6	106.7	109.5	113.2
Motor Vehicle Duties	24.5	25.4	26.8	27.8	27.5	27.9	30.7	31.5	30.8	32.7	34.0
Estate, *etc.*, Duties	77.3	80.6	79.8	82.6	65.0	77.1	85.3	81.4	87.9	88.0	89.0
Stamps	27.0	30.1	25.7	20.7	17.1	19.2	22.7	24.1	25.8	29.2	29.0
Land Tax, House Duty, Mineral Rights	.8	.8	.9	.8	.9	.8	.8	.8	.8	.7	(d)
Income Tax	250.6	237.6	237.4	256.0	287.4	251.5	228.9	228.9	238.1	257.2	288.1
Surtax (or Super tax)	60.6	56.2	56.4	67.8	76.7	60.7	52.6	51.2	51.0	53.5	58.0
Excess Profits & Corpn. Tax	1.8	1.7	2.3	3.0	2.5	2.2	1.8	2.3	1.3	1.0	1.5
Sub-total, Tax Revenues	693.4	685.3	676.7	704.1	733.2	727.5	709.0	709.9	739.0	783.1	832.7
Post Office (net)	6.2	8.1	9.2	10.1	11.5	10.9	13.1	12.2	11.7	10.9	11.8
Crown Lands (net)	1.1	1.2	1.3	1.3	1.3	1.2	1.2	1.3	1.4	1.4	1.3
Sundry Loans & Investments	24.0	28.1	32.6	32.9	13.8	5.1	4.7	4.4	4.9	4.6	4.3
Miscellaneous	61.4	56.5	36.4	34.3	29.9	22.9	22.1	15.1	21.7	24.6	11.0
TOTAL RECEIPTS	786.1	779.2	756.2	798.7 (a)	793.5 (b)	767.7	750.1	742.9	778.7	824.6 (c)	863.1 (e)

Sources: For 1938, Financial Statement of April 20, 1937. For all other years, the respective Finance Accounts.

Notes: (a) Total includes £16,000,000 from rating relief suspense account. (b) Total includes £3,990,000 from rating relief suspense account. (c) Total includes £100,000 from post office fund. (d) Included with excess profits and corporation tax. (e) Total includes £2,000,000 from National Defense Contribution.

come tax yield have been quite steady at 80 and 20 per cent, for the standard and the surtax, respectively. This is in striking contrast with the results of personal income taxation under the federal law, where the surtax rates regularly produce much more than the low normal tax. The disposition to rely heavily on severe rates, that under the most favorable circumstances can be levied against only a small proportion of the total number of taxable incomes, intensifies the fluctuations of federal income tax yield. The maximum product of the British tax during this period was £364,607,000 in 1932, one of the worst depression years, and the minimum was £280,042,000, in 1935. The maximum was 1.3 times the minimum. In the United States the peak yield of the income tax between 1928 and 1935 was $2,348,500,000 on the returns of the year 1928, and the lowest yield was $615,500,000, on the returns for 1932. In our experience the maximum was 3.8 times the minimum. The English know how to use the income tax to get revenue, and they do not complicate or distort its operation as a fiscal instrument by undertaking to make it serve various non-fiscal purposes at the same time.

While England depends on the income tax in far greater degree than is the case in this country, she does not rely exclusively on it, by any means. It is the largest single source of revenue, and even after taking account of the local rates, it provides a handsome proportion of all national and local tax receipts. But this proportion is well below one half of all national tax receipts, while it is at times more, and again somewhat less, than a third of all national and local tax receipts. Indirect taxes, viz., customs, excises and stamp taxes, have achieved together a degree of importance in the English fiscal scheme that may surprise some who have assumed that the better-publicized income tax is not only the foundation, but also a large part of the superstructure of British finance. In fact, the customs receipts have been the only branch of the revenue that has shown an uninterrupted increase year by year over the past decade. Various factors in the economic situation of Great Britain have contributed to this result, and the about-face toward a nationalist tariff policy has apparently not been accompanied, as yet, by rate increases so severe as to interfere seriously with the revenue possibilities of the tariff.

At the beginning of the period under consideration, the Colwyn Committee was submitting its elaborate report on National Debt and Taxation.[8] This report is of interest in the present connection because of the emphasis given to continued debt reduction and the divergence of views within the committee over the proper kind of tax policy. The majority conceded the theoretical superiority of direct taxation but took a realistic view of the need and advantage of a broader tax base than is possible under this method of taxation alone. It also rejected the capital levy. The minority vigorously criticized the indirect taxes, stoutly upheld the idea of still heavier taxes on incomes and estates, and defended the capital levy in the form advocated by the Trades Union Congress.

Nevertheless, when we include with the income tax the estate duties and that part of the motor vehicle licenses paid on vehicles used for personal rather than for business purposes, it is still possible to regard England as the great exponent of direct taxation. Together, over the past decade, these forms of direct taxation have accounted for more than one half of the national revenues.

This high proportion has been achieved, however, only through the levy of severe rates. In 1928 the standard rate of income tax was 4 shillings in the pound, or 20 per cent. By 1932 it had been advanced to 5s., or 25 per cent, and after a slight reduction in 1935 and 1936, this rate is now again 5s. The personal exemptions have varied inversely with the standard rate and the minimum exemptions have been as low as £125 of earned income or £100 of investment income for an unmarried person. Additional allowances for dependents and for various other claims establish somewhat higher minima for the average British taxpayer, and the present tendency is to lessen the tax on small incomes. Thus, in 1937, a married man with two children could earn £375 before becoming liable to tax. But the tax begins to bite, and bite hard, at a much lower income level than we are accustomed to reach. The surtax begins at £2,000 and finishes its progression at £50,000. The maximum rate on income above this figure has been as high as 8s.-3d., or 41¼ per cent.

[8] *Report of the Committee on National Debt and Taxation*, 1927, (Cmd. 2800).

There are two major forms of death duty. The more important of these is the estate duty, levied on the net value of the estate at rates ranging from 1 per cent when the value is between £100 and £500, to 50 per cent when the value is £2,000,000 or more. The rate appropriate to each bracket applies to the entire estate and not simply to that portion within the bracket limits, as is the case with our own use of tax rate progressions.

The second major form of death duty is a tax on the share received by the beneficiary. It is called legacy duty when the property transferred is personalty, and succession duty in so far as this property consists of real estate. The rates are graduated from 1 to 10 per cent according to the degree of kinship between the heir and the testator and the size of the bequest. The relative importance of the estate and inheritance taxes is shown by the following statement of net receipts for the year 1935.[9]

Estate duty	£71,591,000
Legacy duty	8,632,000
Succession duty	1,106,000

Only the most cursory reference can be made to the remaining forms of taxation. The bulk of the customs revenue is derived from the imports of alcoholic beverages, tea, sugar, tobacco, oil, and the groups of goods covered by the Ottawa duties and the Act of 1932. In 1935 the oil duty produced £47,800,000. The rates have been deliberately adjusted to provide from this source at least enough to cover the grants to local governments. The most productive excise duties are those laid on liquors, sugar, entertainments, matches, artificial silks, and various dealer licenses.

The chief bone of contention in these taxes has long been the taxation or exemption of the English breakfast table. In the years following the War the motion to repeal the tea duty became as fixed a part of the budget consideration as the address from the throne. Each year the chancellor would express his sympathy with the purpose and his deep regret that the state of the finances did not permit granting the request. In 1928,

[9] From the *Seventy-eighth Report of the Inland Revenue Commissioners*, 1934-35, p. 10. An additional succession duty raises the maximum to £11-10s. per cent, and there are other minor death duties which raise the total of such levies to seven.

variety was added by a medical member who opposed the exemption on the ground that tea is not a food and that the drinking of stewed tea three or four times a day was producing a race of nervous dyspeptics. Hence a reduction of the price would be contrary to public policy.

Nevertheless, the tea duty was repealed the next year and the fact that a general election was at hand led to violent attack on the motive. The financial pressure compelled restoration of the duty in 1931 and it has since been good for some six to seven million pounds of revenue yearly.

The motor vehicle licenses are also severe, by our standards. The rate for ordinary vehicles is now 15s. per horse power or fraction thereof, which helps to explain why the English refer to the Ford V-8 as a " big car ".

The diversion of part of the motor vehicle revenues from the road fund has been a source of sharp debate for years. A similar controversy has emerged in more than one of the states. There, as here, the motor car owners, the good roads organizations, and their several allies, have demanded full and complete dedication of this tax to the highways, while the harassed budget officers have been unable to resist the temptation to divert part of this ready cash to other purposes. The situation is aggravated in England by the complete diversion of the oil import duty, which naturally includes the gasoline tax, to other purposes. But neither in England nor the United States can the issue of a dedicated road fund be settled dogmatically. Everywhere vast sums will be required to correct the mistakes of earlier hasty road building, in the interest of greater traffic convenience and safety.[10] On the other hand, some matters may be more urgent than the gains to be made in the highway program through the use of the diverted part of the funds.

The latest tax proposal, offered in connection with the budget for 1938, was a graduated tax on recovery profits, to be known as the National Defense Contribution.[11] This plan aroused a

[10] In *The Economist* of August 21, 1937 (vol. 128, p. 371), the estimate is given that £800,000,000, would be required for the completion of an adequate program of road construction and improvement.

[11] The text of the proposal may be found in the *Statement of Revenue and Expenditure*, April 10, 1937. *Cf.* the criticisms of the proposal in volume 127 of *The Economist*, April-July, 1937, *passim.*

TABLE II

SUMMARY OF ENGLISH EXPENDITURES ON THE BASIS OF EXCHEQUER ISSUES FOR CERTAIN YEARS
(Millions of Pounds)

Expenditures	1928	1929	1930	1931	1932	1933	1934	1935	1936	1937	1938 (Estimated)
A. Consolidated Fund Services											
1. National Debt											
a) Interest	312.0	310.1	304.9	291.9	287.6	280.1	215.2	210.6	210.5	209.8	209.8
b) Management	1.8	1.4	2.3	1.3	1.9	2.1	1.1	1.0	1.0	1.1	1.1
c) Sinking Fund	65.0	57.5	47.7	66.8	32.5	26.3	7.7	12.4	12.5	13.1	13.1
Sub-total, Debt	378.8	369.0	354.9	360.0	322.0	308.5	224.0	224.0	224.0	224.0	224.0
2. Road Fund	19.7	21.1	21.9	22.9	22.5	22.9	25.5	26.4	25.8	27.4	(a)
3. Local Taxation Accts.	15.4	15.2	13.3	.3	(b)	(b)	(b)	—	—	—	—
4. North Ireland Exchequer	5.3	5.1	5.5	6.4	6.3	6.9	6.6	6.8	7.2	8.0	8.0
5. Other Consol. Fund Serv.	3.7	2.8	3.3	2.6	3.0	3.2	4.1	3.6	5.6	3.2	3.2
Sub-total, Consol. Fund Serv.	422.8	413.2	399.0	392.2	353.9	341.7	260.2	263.2 (c)	263.7 (c)	263.1 (c)	235.5 (c)
B. Supply Services											
1. Army (incl. ordnance)	44.2	40.5	40.5	40.2	38.5	35.9	37.6	39.7	44.6	54.8	63.7
2. Navy	58.1	56.9	55.8	52.6	51.1	50.0	53.5	56.6	64.8	81.1	78.1
3. Air	15.2	16.1	16.8	17.8	17.7	17.1	16.8	17.6	27.5	50.1	56.5
4. Miscellaneous Civil	229.8	222.5	246.5	307.4	320.1	342.9	338.7	345.6	361.9	367.7	405.2
5. Revenue Admin.	11.7	11.6	12.0	11.9	11.8	12.4	12.1	12.6	13.1	13.4	13.9
Sub-total, Supply Services	359.0	347.6	371.6	429.9	439.2	458.3	458.7	472.1	511.9	567.1	627.4 (d)
GRAND TOTAL, Expenditures	718.0	760.8	770.6	822.1	793.1	800.0	718.9	735.3	775.8	830.2	862.9 (e)
Surplus +, or deficit —	+4.3	+18.4	—14.5	—23.4	+ .4	—32.3	+31.2	+7.6	+2.9	—5.6	+ .2

Sources: See Table I.

Notes: (a) Road Fund abolished. Appropriations included with Civil Votes. (b) Less than £100,000. (c) To Post Office Fund: 1936, £1,127,000; 1937, £421,000; 1938, £300,000. Included in totals. (d) Total includes £10,000,000 for supplementary estimates. (e) Exclusive of £89,000,000 to be raised under National Defense Act of 1937.

fierce storm of protest and criticism. It was finally withdrawn, to be replaced later in the session by a revised version which omitted some of the most objectionable features of the first draft, but which was, none the less, a steeply graduated tax on British profits.

III. *Some Aspects of English Expenditures, 1928-1937*

The summary facts of the English expenditure record are given in Table II. They are arranged under two major headings, the Consolidated Fund Services and the Supply Services. The former are provided under permanent appropriation acts and the latter are voted annually.

The changing relative importance of the two groups is striking. The Consolidated Fund Services have declined, absolutely and relatively, owing to the saving through debt conversion, the reduction of sinking fund payments under the stress of the depression, and the substitution of the block grants for the payments to local taxation accounts. The appropriation to the North Ireland Exchequer represents the residue of taxes collected there after deducting certain administration expenses and a contribution from that area to the general imperial government.

The defense expenditures must be passed over without comment, since we cannot, at this distance, form a sound judgment either as to their necessity or as to their adequacy to assure the ultimate objective of all such expenditure. The marked overall increase in this group for 1937 and 1938 takes no account of the special defense expenditures to be financed by loans.

The item, "Miscellaneous Civil Votes", includes the cost of the general civil functions. Further details for this group are given in Table III, under a combined departmental-functional classification that was introduced in 1928.

An examination of Table III reveals three matters of importance. These are: first, the growth of the contributions to local revenues since 1930; second, the rising importance of the social services; and third, the absence of padding in the strictly overhead services.

Grants to local revenues. Extensive changes in the grant-in-aid policy were made in 1929, accompanied by equally extensive changes in local government and taxation. Since Miss

TABLE III

CLASSIFICATION OF PURPOSES UNDER MISCELLANEOUS CIVIL VOTES
(Thousands of Pounds)

Class	1927/28	1928/29	1929/30	1930/31	1931/32	1932/33	1933/34	1934/35	1935/36	1936/37	1937/38
I. Central Gov't. and Finance	1,993	2,038	2,096	2,042	1,812	1,791	1,905	1,922	1,987	2,290	2,549
II. Imperial and Foreign	7,681	5,580	5,471	6,032	5,581	7,904	8,432	8,044	8,573	9,236	8,989
III. Home Dept., Law and Justice	12,625	12,123	12,358	15,770	16,028	15,333	15,742	16,234	17,239	18,738	23,940
IV. Education	53,258	49,456	50,070	55,116	55,436	51,589	51,062	52,840	55,875	58,502	59,931
V. Health, Labor and Insurance	72,867	75,905	85,763	107,660	121,273	151,662	150,727	150,819	161,861	161,481	170,167
VI. Trade and Industry	9,948	9,145	10,416	12,612	14,077	9,196	9,289	15,504	16,937	17,816	31,383[a]
VII. Common Services (Works, Stationery, etc.)	8,488	8,230	7,973	8,732	8,911	8,066	7,628	8,090	8,226	9,445	9,899
VIII. Non-effective (Pensions)	58,661	56,184	56,184	54,644	52,122	49,496	49,160	46,787	45,917	45,011	43,934
IX. Miscellaneous (Expiring Services)	665	1,353	909	351	46	—	—	—	—	—	—
X. Exchequer Contributions to Local Revenues	—	—	15,294	44,487	44,819	44,882	45,284	45,400	45,278	45,192	54,392
TOTAL CIVIL VOTES	229,815	222,493	246,535	307,445	320,105	342,920	338,683	345,640	361,923	367,711	405,184

Sources: See Table I.
Notes: (a) Road Fund abolished. Road appropriations to be included in Group VI.

Newcomer has so recently described the new system and its effects, this subject must be passed over with a reference to her work.[12] The one observation that may be added here is based on the course of the local rates. In 1929 the amount collected by all local authorities totalled £188,389,000. After the derating of agricultural and other property, this total fell to £163,678,000 in 1933. Then it began to rise and the estimated total of the rates for 1937 was £191,812,000.[13] In other words, the gain from tax exemption through derating and increased grants has already been swallowed up by the increased taxes on other classes of taxpayers. It is a made-to-order illustration for a taxpayers' association in its campaign against taxation without economy.

The social services. The second significant thing revealed by Table III is the great relative importance of the social services. The further details of England's payments for such purposes are given in Table IV.

This table, which is in three sections, embraces more than the national budget. It assembles the expenditures by all public authorities, central and local, under various welfare acts. One section is historical, the others are analytical.

Historically viewed, education and poor relief were the primary social services in 1900. The principal addition by 1910 was the old-age pension. Another decade brings unemployment insurance, war pensions, and definite activity in housing, hospitalization, mental treatment, maternity and child welfare. The one further addition by 1930 is the transitional benefit, which is paid to those who have used up their unemployment insurance benefit but are not yet on a payroll.

The unemployment benefits from 1930 to 1935 throw interesting light on the cabinet crisis of 1931. The Labor Government fell because the party refused to support a cut in the

[12] Mabel Newcomer, *Central and Local Finance in Germany and England* (1937), pp. 161 *et seq.*

[13] *Cf. Financial Statement*, 1937-38, p. 10. Land and buildings used in agriculture were completely exempted from local rates. Property used in mining, manufacturing and transportation was to be rated at 25 per cent of annual value. Railroads had already had a reduction of annual value to 25 per cent for the levy of certain rates, hence the new arrangement meant an assessment basis of one sixteenth of annual value for these rates. *Cf.* Newcomer, *op. cit.*, p. 184 and note.

TABLE IV

TOTAL NATIONAL AND LOCAL EXPENDITURES ON SOCIAL SERVICES IN CERTAIN YEARS
(Millions of Pounds)

Operating Expenditures on Social Services, England, Wales, Scotland						Sources of Receipts, 1935				Character of Expenditure, 1935			
Purpose	Fiscal Years					Specific contributions, fees, rents, interest	Parliamentary votes	Local rates and block grants	Total receipts	Debt service	Administration	Benefits, etc.	Total
	1900	1910	1920	1930	1935								
Unemployment Insurance													
1) Insurance Benefits	—	—	10.8	81.3	52.9	42.1	21.0	—	63.1	4.9	4.1	43.9	52.9
2) Transitional Payments	—	—	—	20.3	46.2	—	46.2	—	46.2	—	4.0	42.2	46.2
National Health Insurance	—	—	29.8	38.6	36.7	33.8	6.7	—	40.5	—	5.6	31.1	36.7
Widows', Orphans', Old Age Contributory Pensions	—	—	—	34.6	43.2	23.6	(b)	—	23.6(b)	—	1.3	41.9	43.2
Old Age Pensions	—	7.4	20.8	37.5	42.4	—	42.4	—	42.4	—	.7	41.7	42.4
War Pensions	—	—	100.9	49.2	41.2	—	41.2	—	41.2	—	1.0	40.2	41.2
Education	20.1	34.2	90.3	104.9	106.3	8.7	49.1	48.5	106.3	6.7	4.7	94.9	106.3
Housing	.5	.9	4.7	40.0	46.1	27.5	15.7	2.9	46.1	32.9	.3	12.9	46.1
Poor Relief	12.4	16.2	34.3	38.5	49.2	3.4	.4	45.4	49.2	.7	2.6	45.9	49.2
Public Health Acts, relating to													
1) Hospitals and Treatment of Disease	1.6	2.2	8.6	10.5	13.8	(			)	1.3	(a)	12.4	13.8
2) Maternity and Child Welfare	—	(a)	2.1	3.2	3.4	(2.8	.4	20.8	23.8)	.1	(a)	3.3	3.4
Lunacy and Mental Treatment	1.1	2.2	4.4	5.8	6.6	(			)	1.0	.1	5.5	6.6
TOTAL	36.0	62.9	306.6	468.3	488.0	141.9	223.0	117.5	482.5	47.6	24.4	415.9	487.9

Source: *Public Social Services* (Total Expenditure under certain Acts of Parliament) November, 1936. (Cmd. 5310.)
Notes: (a) Less than £100,000. (b) There was an Exchequer contribution of £13,000,000 to the Treasury Pensions Account.

insurance benefits. These were cut later by the National Government and in 1935 nearly £30,000,000 less was paid under this head. But the transitional benefits, paid to substantially the same group of recipients, had increased in the same time by more than £25,000,000.

No comment is needed on the record of the war pensions except to say that a reduction of this relative magnitude is the reasonable and logical trend for the expenditure on such a service, as the war period recedes in time. In 1936 we were still paying some pensions on account of the War of 1812, and we may be profoundly thankful, therefore, that no American troops were used in the Battle of Waterloo.

Poor relief expenditure increased steadily to 1935, notwithstanding the large sums that were being spent under all of the other welfare categories. The explanation probably is that the various types of insurance benefit payments represent the central government's struggle to aid those who are normally gainfully employed, while poor relief represents the activity of the local units in caring for the unemployables, the young, and various other groups of dependents outside the national program.

The preëminence of education among the social services conforms to our own experience. Housing has forged rapidly to the front and it is likely to be an outstanding activity for some time. The foreign observer is in no position to judge the quality of the social results obtained through either of these services, but some hearsay evidence indicates that the standards of new housing construction are none too high. In housing as in highways, the immediate urgency of the problem may encourage jerry-building, which gets the quickest results although it costs more eventually when the earlier mistakes must be corrected. Apparently England has not had to endure, however, the gratuitous extravagance of a Resettlement Administration.

The English reports tabulate the numbers of persons benefiting directly from the several services. Naturally there is much duplication since the same individual may be receiving benefits under several acts at the same time. The most comprehensive feature of the whole program, from the standpoint of the number affected, is national health insurance. This applies to virtually the whole wage-earning community be-

tween the ages of 16 and 65. In 1935 the total number of enrollees was 18,481,000. In this year the number receiving unemployment or transitional benefits was 12,540,000. This figure does not imply an unemployment problem of such magnitude, but it does indicate the very large proportion of wage-earners who are affected in some degree by the fluctuations within their respective occupations. The difference between a benefit system which acts simply as a cushion against the irregularities of employment, and a relief system which must carry a certain group more or less permanently, is shown in the fact that only 1,886,493 persons were supported in 1935 under the poor relief acts, but the cost of their support in this year was third largest among the whole list of the social services.

The second section of Table IV indicates the sources of the funds spent in 1935. The principal point of interest here is the distribution of the burden of each service among individuals, the exchequer, and the local governments. To some extent the local share is borne by the exchequer through the block grants, but no segregation can be made between the local funds derived from this source and those obtained from local rates. In the aggregate, about 70 per cent of the whole cost for 1935 fell on government, that is, on taxpayers. An interesting line of speculation, which can only be suggested here, is an examination of the practical and theoretical relationships that should prevail between the character of the expenditure and the character of the tax system. One group demands heavier direct taxes to support larger welfare expenditures, while another group finds, in the purpose of modern government as revealed by its expenditures for different services, a good case for substantial indirect taxes. A third angle of the problem would be the proper relative proportion to be provided by contributions from beneficiaries rather than by taxation of any sort. This is a very old problem, but it is a perennially new one as the pattern of governmental activities changes.

The third section of Table IV analyzes the expenditures for 1935 according to character. The value of this exhibit is in disclosing the distribution of the relative costs of providing the various benefits, especially for debt service and administration. The heavy debt charge for housing means mortgage interest and amortization, and not a public debt charge. The small administrative expense for housing suggests the extent to which construction and operation must have been relegated to private hands, backed by public grants and guarantees.

The only other debt item in the list that calls for explanation is under the unemployment fund. The burden on this fund during the twenties had swamped it and the excess of payments over fund receipts was borrowed. The readjustment of benefit payments inaugurated in 1931 did have the merit of putting this feature of the welfare system on a more nearly sound fiscal and actuarial basis, even if it did not greatly reduce the over-all cost of unemployment relief.

The general administrative costs. Reverting again to Table III, it is worth while pointing out that such expansion of governmental functions and costs as has occurred in England over the past decade has not occasioned any material increase in the cost of the general governmental framework. There has been no great army of clerks and other employees added to the public payroll in order to perform this work. It cannot be said that political patronage is nonexistent in England, but it is kept within close bounds. There is no conscienceless raiding of the taxpayer by the spoilsman.

IV. *The English Debt Situation*

The essential facts in the English debt situation over the past decade are summarized in Table V. In the main, this table tells its own story, with the aid of the explanatory notes. A few loose ends should be gathered up, however, to clarify certain transactions having a bearing on the actual budgetary results.

The occasional use, for current purposes, of capital funds which had been obtained through loans, and the necessity of borrowing, until 1932, to meet the full obligations of the unemployment insurance fund, have been mentioned. A matter that is rather obscure is the treatment of the accrued interest on National Savings Certificates. Like our own Treasury Savings Bonds, the interest on these certificates is accrued and paid at maturity, unless they are presented earlier for cash. In practice, the treasury uses the money realized from the sale of new certificates to redeem those presented for redemption. Occasionally, the interest on redeemed certificates has

TABLE V

THE ENGLISH NATIONAL DEBT FOR CERTAIN YEARS

Year	Internal Debt					External	Gross total dead-weight debt	Other capital liabilities	Aggregate capital liabilities
	Funded debt	Terminable annuities	Unfunded Debt						
			Floating	Other	Total unfunded				
1914	586.7	29.6	13.0	20.5	33.5	——	649.8	56.4	706.2
1920	315.0	19.3	1,312.2	5,006.5	6,318.7	1,178.7	7,831.7	46.9	7,878.6
1928	1,350.0	12.6	688.8	4,464.4	5,153.2	1,095.2	7,610.9	103.2	7,714.1
1929	1,478.3	12.5	737.3	4,272.7	5,010.0	1,084.7	7,595.5	120.5	7,716.4
1930	1,456.0	12.2	637.4	4,393.7	5,031.1	1,074.2	7,573.4	127.2	7,700.6
1931	1,425.0	12.0	594.3	4,431.7	5,026.0	1,066.7	7,529.7	169.6	7,699.3
1932	1,467.1	11.7	612.0	4,375.9	4,987.9	1,090.8	7,557.4	214.0	7,771.5
1933	3,376.3	11.9	810.5	2,508.7	3,319.3	1,060.4	7,767.8	215.9	7,983.7
1934	3,374.3	12.1	844.7	2,677.5	3,522.2	1,036.5	7,945.2	208.1	8,153.3
1935	3,368.1	12.1	833.4	2,672.0	3,505.4	1,036.5	7,922.1	102.0	8,023.1
1936	3,366.5	12.1	782.2	2,839.7	3,621.9	1,036.5	7,916.5	105.8	8,022.2
1937	3,364.9	12.1	698.1	2,808.8	3,506.9	1,032.6	7,916.5	112.6	8,029.2

Source: *The Finance Account* of the respective years.

Notes: The *funded debt* is that which has no definite maturity date; the *unfunded debt* is that which matures at a definite future time. The *floating debt* is the total of Treasury bills and Ways and Means Advances. The other unfunded debt includes various bond and note issues.

The finance account deducts from the deadweight debt the bonds and notes tendered in payment of estate and other taxes. Such paper is held by the National Debt Commissioners until it is drawn or paid off otherwise. Inasmuch as there is no immediate cancellation of obligations tendered in payment of taxes, it must be regarded as part of the nation's debt burden. The above table does not take account of such deductions from the debt total.

Other capital liabilities includes loans for capital equipment under various acts particularly for the extension of postal, telephone and telegraph systems. Through 1934 it also includes the accumulated borrowings for the unemployment fund. The drop of the total in 1935 resulted from a separate funding of these loans as an obligation of the Unemployment Fund. The Exchequer stands as ultimate or contingent guarantor.

exceeded the appropriation for this purpose from the Consolidated Fund, and the difference has been borrowed. Such loans were made in 1930, 1932 and 1933, to an aggregate of £15,906,000.

The government's liability on outstanding certificates is not clearly stated, in that it is uncertain whether the certificate capital liability which is included in the unfunded debt takes account of accrued interest or not. A footnote is always appended giving the amount of this accrual, and as of March 31, 1937, this was approximately £124,000,000. *The Economist's* discussion of the debt position as of March 31, 1936, indicates that the accrued interest is not included, for the final tabulation of the debt load includes the accrued certificate interest as an additional item.[14]

V. *Conclusion*

In conclusion, three points that are suggested by the foregoing discussion will be mentioned, although there will be no opportunity for elaborating upon them.

The first is the question of the wisdom of the choice made in 1931, when England deliberately turned away from the allurements of borrowing and inflation as the way to meet the depression obligations. Devaluation, which was in no sense a result of deliberate choice in 1931, had particularly significant effects since it was not quickly followed by a corresponding readjustment of the internal price level.[15]

As we look back now over the record, it is difficult to question the wisdom of the English policy. The special obligations of the depression were met, not on the scale that some would have preferred, perhaps, but on a standard of minimum adequacy. The great argument for our own extravagance was that no American family should be allowed to starve. The English death rate from starvation since 1930 has been no higher than ours.

The English and the American ways of handling a great economic depression are in striking contrast. It is too soon

[14] *Cf. The Economist*, vol. 127, p. 8 of Budget Supplement to issue of April 10, 1937.

[15] *Cf.* M. Fourre-Cormeray, *L'Equilibre Budgetaire en Grande Bretagne*, 1930-1936. The author stresses the transformation in England's position which resulted from the depreciated currency, the adoption of protectionism, and the control of national industry in the interest of greater social security.

to measure finally the relative merits of the two plans, but it is not too soon to express unstinted admiration for a fiscal policy which avoided so many of the foolish, expensive and dangerous errors that have been evident in our own policy.

The second question is the ability of England to carry her load, a load which is primarily the result of the War, but with heavy additions imposed by post-war developments, both external and internal. Statistics of the so-called national income are somewhat suspect, but no better basis of measurement exists. In 1929, total expenditures equaled 17.6 per cent of estimated national income. The combination of declining income and rising expenditures raised this ratio to 20.8 per cent in 1932, but it had dropped to 17.1 per cent in 1936. The estimate for 1937 is 18.1 per cent.[16]

The long-run effects of the present fiscal load upon the national productivity should be, and probably are, a matter of concern to informed Englishmen. The present severe rates of income and estate taxation are certain to affect, ultimately, the growth of capital and the volume of the nation's productivity, although these effects may be imperceptible over short periods. England, like the United States, has her advocates of wealth redistribution through increasingly severe taxation. Nowhere does this group recognize the necessity of shortening the financial sails as their goal is achieved, in order to get the budget and the debt whittled down to a scale appropriate to the time when there will be no large estates or large incomes to tax.

Finally, the immediate outlook is darkened by the cost of the rearmament program. A natural question is whether this departure from the traditional standard of the balanced budget is to be permanent or only temporary. In favor of the latter interpretation is the fact that the increased expenditure is based rather on necessity than on a specious rationalization of the great domestic benefits to be realized from a substantial increase of the public debt.

REMARKS BY THE CHAIRMAN

DR. W. RANDOLPH BURGESS: Thank you, Professor Lutz.

The next speaker will be Professor Robert Murray Haig, McVickar Professor of Political Economy, Columbia University, who will discuss French budgetary problems.

[16] *Cf. The Economist, loc. cit.*, p. 12.

THE NATIONAL BUDGETS OF FRANCE, 1928-1937

ROBERT MURRAY HAIG
McVickar Professor of Political Economy, Columbia University

IN this rapid review of the budgetary experiences of the three great democratic nations during the depression, we turn from the cheerful and inspiring picture of Great Britain to the tragic and depressing picture of France. For our sketch of the French situation, a background of bold pencil strokes is supplied by this paragraph of a British commentator:

> Judged by British standards, the French financial machine continuously creaks. In some ways too, it has to carry a heavier load. France has had to meet the cost of the last war and the reconstruction of the devastated areas. Today she also has to meet the cost of rearmament and of the new social programme. All this has to be met out of a national income which has been depressed by the war, by the post-war inflation and by the trade collapse and deflation of 1929-36. She has to do all this in an atmosphere of distrust, born of the inflation of the early twenties and the devaluation of 1926-28 and fostered by the financial losses and difficulties of recent years. She has to carry on with a monetary and banking system which makes uneconomical and wasteful use of her gold reserves, with a fiscal system which never succeeded in preventing tax evasion, and with an absence of confidence which is only too ready to translate itself into a flight of capital abroad. Today the country is starved of liquid funds, of working capital, and this is the bane of Government finance, and of the general trade and industry.[1]

At the outset of the period under review, there were high hopes that the budgetary picture for the ensuing decade would be a brilliant and attractive one. It was true that France had only recently emerged from the valley of the shadows of bankruptcy; but, in 1926, the country, under the leadership of Poincaré, had at long last abandoned hope that Germany would pay all war and reconstruction costs and had reconciled herself to the necessity for meeting these costs herself, chiefly by sacrificing four fifths of the value of her franc. This plan involved tremendous burdens, especially for the great middle

[1] *The Banker*, London, vol. 43, no. 138 (July 1937), pp. 6-7.

class, but it was carried through with resolution and spirit. By utilizing both retrenchment and tax adjustments, the public fisc was put in order, and in 1926 and 1927, for the first time in a decade and a half, the budget showed a small favorable balance.[2]

[2] Definitive figures of aggregate receipts and expenditures of the ordinary budget for the period 1926-1935, as set forth in the *lois de réglement*, are summarized in the 1937 budget *Projet*, submitted July 24, 1936 (No. 822, ler volume, Chambre des Députés, Seizième Législature, Session Ordinaire de 1936, *Projet de Loi portant fixation du Budget Général de L'Exercice 1937*, Paris, Imprimerie Nationale, 1936, p. xii), as follows:

	Receipts	*Expenditures* (*Figures in millions of francs*)	*Surplus* (+) *Deficit* (—)
1926	43,064	41,976	+ 1,088
1927	46,086	45,361	+ 725
1928	48,177	44,248	+ 3,929
1929 [a]	64,268	58,850	+ 5,419 [c]
1930	50,794	55,712	— 4,918
1931	47,944	53,428	— 5,484
1932 [b]	36,038	40,666	— 4,628 [d]
1933	43,436	54,945	— 11,509
1934	41,070	49,883	— 8,813
1935	39,485	49,868	— 10,383

[a] Fifteen months ended March 31, 1930.
[b] Nine months ended December 31.
[c] An official estimate of the surplus for this year, reduced to a twelve-month basis is 4,335 million francs. *Ibid.*, p. xlvi.
[d] An official estimate of the deficit expanded to a twelve-month basis is 6,171 million francs. *Ibid.*

In connection with the above table the operations of the extra-budgetary Autonomous Amortization Fund should be studied. This fund was established in 1926 to assist with the servicing of the public debt. It was endowed with certain revenues that had formerly alimented the ordinary budget, some of which were now definitely earmarked for amortization. The precise manner in which the items of receipts, expenditures and surplus (in the above table) should be modified, if one desired to consolidate the accounts of the ordinary budget and the accounts of the Autonomous Amortization Fund, is not always clear, the situation being complicated by such considerations as these: the receipt of substantial sums from the budgetary surpluses (1927, fr. 490,000,000; 1928, fr. 1,500,000,000; 1929, fr. 2,000,000,000); and the receipt of proceeds of loans (1932, fr. 1,174,100,000; 1934, fr. 124,200,000). In discussing the surpluses and deficits of France it would certainly appear proper to take into account the net amount of the debt amortized by the Fund. Indeed, writing in 1933, Hugh Dalton (*Unbalanced Budgets*, p. 437, footnote) contends that, taking sinking funds into account, "in the last few years there have been no deficits." In the 1937 *Projet* (p. xlvi, *vide supra*) the following figures are given as the payments made by the Autonomous

In 1928, the first year of our period, the budgetary surplus was increased to very substantial proportions, nearly 4 billion francs in excess of expenditures of approximately 44 billions, and, in the following twelve months, another surplus of a similar magnitude resulted.

However this fourth successive surplus, that of 1929, proved to be the last of the sequence. In 1930 mounting expenditures (not declining revenues) produced a deficit of nearly 5 billions. At this point the revenues began to feel the full effect of the depression and reductions in expenditures could not be made to keep pace with the diminished tax collections. The budgetary deficits for the three years 1930, 1931 and 1932 averaged about 5 billions annually and for the next three years,

Amortization Fund for contractual redemption of the public debt (in millions of francs):

1931	1,094
1932	1,853
1933	1,877
1934	1,981
1935	2,823

Corresponding figures published by the Economic Intelligence Service of the League of Nations (*Public Finance, 1928-1935*, XI, France, p. 15) differ somewhat from those cited above. These are given below together with the figures for "other redemption operations" of the Fund (in millions of francs):

	Contractual redemption	*Other redemption operations*
1928	—	5,783
1929	—	8,992
1930	—	4,898
1931	1,043	6,046
1932	1,784	7,040
1933	1,812	3,063
1934	1,920	953

With the materials at his disposal in this country, the writer has not been able to analyze the operations of the Fund in sufficient detail to enable him to suggest the definite modifications which should be made in the budgetary deficits to take account of the amortization accomplished by the Fund.

The 1937 *Projet* (p. xlvii) also gives the following figures for the military expenditures financed on a special basis by the treasury (in millions of francs):

1931	208
1932[a]	836
1933	1,134
1934	749
1935	2,118

[a] Nine-month figures adjusted to a twelve-month basis.

1933, 1934 and 1935, they averaged double that figure, or about 10 billion francs annually. The year 1935 is the last for which the accounts have been definitively stated; but it is known that the deficit in the ordinary budget last year (1936) was in excess of 8 billions[3] and that there were additional uncovered expenditures for public works and rearmament of 9.5 billions.[4] When Blum resigned a few months ago the outlook for this current year, 1937, was for another deficit in the ordinary budget of about 8 billions plus an item of more than 22 billions for rearmament, public works, etc., to be financed outside the budget.[5] To what figure Bonnet may succeed in reducing this prospective deficit before the year closes remains to be seen.

At the beginning of this current year, 1937, the aggregate of the seven annual deficits accumulated in the ordinary budgets since 1930, when the present series of deficiencies began, thus amounted to about 54 billion francs. If one tries to refine this figure, by taking extraordinary items into account, he is led to the conclusion that the true aggregate deficiency instead of being 54 billions is probably somewhere in the neighborhood of 70 billion francs, the unfavorable item of extra-budgetary expenditures apparently being substantially in excess of the favorable item of extra-budgetary amortization of debt.[6]

[3] At the time of writing, the latest available reports regarding the ordinary budget give the following figures for 1936 (in millions of francs):

	Receipts	*Expenditures*	*Deficit* (—)
1936	38,446	46,531	—8,085

These figures are published in the *La France Économique en 1936*, p. 89, and are based on data which appeared in *J. off.* du 28 février, 1937 and *J. off.* du 11 juillet, 1937.

[4] *Ibid.*, p. 93.

[5] *Projet*, 1938 Budget, p. xiii. The "credits opened" relating to this class of expenditures for the *exercice* 1937 aggregated nearly 20 billions when the 1938 budget *projet* was submitted. No. 2697, Seizième Législature, Session Ordinaire de 1937, *Projet*, 1938, p. 97.

[6] This estimate is based on these facts. Between March 31, 1930 and December 31, 1935, the total domestic debt rose from 280 billions to 333 billions (see League of Nations, *op. cit.*, p. 18 and 1937 *Projet*, p. 196), an increase of 53 billions during a period when the deficits in the ordinary budget aggregated less than 46 billions. Apparently the figure of 53 billions should be increased by 3.2 billions, representing the permanent advances of the Bank

An aggregate accumulation of deficits amounting to 70 billions of francs will probably not seem particularly disturbing to most Americans, particularly in view of the fact that French budgetary revenues have been averaging about 40 billions annually during the depression. Our aggregate of federal depression deficits is about five times our average budgetary revenues; in France such deficits aggregate less than twice their annual revenues. This suggests that the French situation is more sensitive than our own. Our "road to ruin" is a highway on which we have been able to travel a long distance at high speed without reaching the terminus. France's "road to ruin" is relatively short; she cannot travel far or fast on that road without soon finding herself in the environs of disaster.

Although the economic depression began to make itself felt in France soon after the date of its impact in America, it was less rapid in its development and less severe in some of its effects. For example, the income of the people of France fell 30 per cent in the six years after 1929; in America the figure of "income produced" fell 51 per cent in three years.[7] While the decline in wholesale prices in France was roughly equivalent to the American decline, the American decline

of France, an item included in the 1930 statement but excluded from the 1935 statement. But this increase was probably largely if not completely offset by a reduction in the amount of the foreign commercial debt, which between 1930 and 1932 declined 2.5 billion francs (League of Nations, *loc. cit.*). There should be added to the 1935 figure of 53 billions the 1936 deficit.

[7] The estimates of "Les Revenus Privés" given by L. Dugé de Bernonville (*La France Économique en 1936*, p. 61) and the Department of Commerce estimates of national income produced in the United States (*Survey of Current Business*, June 1937, p. 12) are as follows:

	In billions of francs	*In billions of dollars*
1929	245	81.0
1930	243	68.0
1931	229	53.6
1932	206	39.5
1933	199	41.8
1934	184	49.6
1935	172	55.0
1936	189	63.8

Contrary to what might be inferred from the heading, the French figures do not exclude all governmental figures. For example the pensions covered by the public budgets are included.

reached its low point in 1933, whereas the French price level continued downward until 1935.[8] Moreover in France the unemployment problem did not develop to proportions such as ours; as late as February 1934 only 351,000 persons in France were in receipt of unemployment relief, and at its peak, in February 1935, this figure was less than a half-million.[9]

So gradual was the onslaught of the depression that hopes were seriously entertained in many quarters that France would prove to be insulated against some of its most chilling blasts. However, whatever frail foundations there may have been for such hopes were rudely blasted away by the depreciation of the pound and the dollar which transformed the franc from an overvalued to an undervalued currency. With memories of the inflation of the twenties still fresh among her people, France chose what was probably the only course of action that was politically feasible, namely, one designed to balance the budget and defend the integrity of the Poincaré franc. After four years of struggle, with one government after another trying its hand at the compression of expenditures and the expansion of taxation, while prices melted and the economic mechanism moved at a diminishing pace, only last year it fell to the lot of a radical government, specifically pledged against currency depreciation, to acknowledge the struggle to be hopeless. With two strokes the Poincaré franc was cut in half and now, with general economic conditions less favorable than in almost any other country, France is settling down for another attempt to end her régime of unbalanced budgets.

Let us glance for a moment at the outstanding features of the budgetary problem as France passed through the various phases of the depression. As we have seen, a budget balance was achieved by Poincaré which persisted until 1930. But this balance was established only at the very peak of a curve of prosperity and only at the cost of deferring a major readjustment of governmental salaries, made inevitable by the loss in the purchasing power of the franc. The large budgetary

[8] *La France Économique en 1936*, pp. 16, 36.

[9] Sir Robert Cahill, *Economic Conditions in France* (dated June 1934) No. 581, Department of Overseas Trade (London, H. M. Stationery Office 1934), p. 635. *Bulletin Economique, Chambre de Commerce de Paris* May 1937, p. 7.

surpluses of 1928 and 1929 furnished the occasion for the accomplishment of this readjustment and, largely because of increased costs ascribable to this step, the budgetary expenditures rose from 44 billions in 1928 to nearly 56 billions in 1930. Because of the lag in tax collections, 1930 was a banner year for revenues, nearly 51 billions being collected, but the depression was already well under way and the series of unbalanced budgets had begun. Although prices were rapidly falling, the French civil servant was loath to relinquish his hard-won salary adjustment. The whole expenditure schedule was difficult to compress, the large items of debt service and pensions being especially rigid. Thus, as late as 1933, with the national income at 199 as compared with 245 in 1929, and with revenues down to 43.4 billions, the expenditures of the ordinary budget remained practically at the 1930 peak, at 55 billions. Even two years later, in 1935, in spite of the strenuous measures of Doumergue and Laval, which included repeated salary reductions and cuts in pensions and in the interest on government bonds,[10] budgetary expenditure had been reduced only slightly below 50 billions; and by this time the revenues, in spite of all efforts to bolster them, had faded to 39.5 billions, a sum too small to have balanced even the Draconian budget of 1926. Direct taxes, which produced 10.2 billions in 1929, yielded only 5.5 billions in 1935 and even the revenues from indirect taxes and monopolies dropped nearly one-third in the same period.

In the meantime the accumulation of budgetary deficits and extra-budgetary expenditures had begun to make serious trouble for the treasury. Signs of an exhaustion of borrowing power began to appear in 1934. In connection with the Poincaré stabilization, careful safeguards had been thrown about the Bank of France and these began to make difficulties in connection with the absorption of the treasury paper.[11] The great commercial banks showed a reluctance to increase their holdings of treasury bills when they could not be rediscounted at the Bank of France. The government then brought pressure

[10] Pensions and debt service alone account for approximately one-half the expenditures in the budgets of recent years.

[11] For a good account of these difficulties, see William H. Wynne, "The French Franc, June, 1928–February, 1937", *The Journal of Political Economy*, August 1937, pp. 501 *et seq.*

on the bank to consent to a relaxation of standards and safeguards. In the ensuing struggle the bank lost first its governor, then its safeguards and, ultimately, its character.

By June 1936, it had become fairly evident that the continuance of efforts to pare expenditures and to plug up holes in the tax system would not suffice to achieve budgetary equilibrium and France was ready for some new line. Casting her eye across the waves she saw in these United States not, forsooth, a balanced budget, but at least a high rate of business activity and a rising national income. Moreover she saw that, even in a depression, steps toward a more abundant life for the masses were being taken. She was impressed and, through a union of the parties of the Left, she put Léon Blum into power. Blum's attitude toward the policy which had previously been followed in France is made clear in the following sentences taken from the budget *Projet* submitted in June 1936:

> To the extent that it has succeeded in achieving its objectives, the policy of deflation, by reducing purchasing power, has impaired the chances of recovery.
>
> To each new burden, to each new retrenchment, to each new swoon of our national economy, the response has been new fiscal deficits. The economic deficit has aggravated the fiscal deficit. The fiscal deficit has dried up the sources of loans while multiplying the needs for loans. And the repeated resort to credit has burdened the money market, has increased the interest rate and has crushed simultaneously the budget and the economic life of the country.[12]

Blum determined to attempt to break this vicious circle, so familiar to all depression budgeteers, but he had other worthy aims as well. In his own words, recently uttered:

> The Government's primary need was naturally to bring to an end the state of crisis with which it was faced. This implied the revival of the French economic system which had been weakened by five years of depression. . . . The Government, however, did not intend to rest content with the mere rescue of the country from the depths of the depression and the restoration of the years of relative prosperity experienced after the War. It desired the restoration of prosperity, it is true, but it also wished to combine prosperity with justice. This meant the elimination, as far as possible, of all the inequities of the present economic régime, leaving only the utmost possible measure of justice and well being.[13]

[12] No. 822, Chambre des Députés, Seizième Législature, Session Extraordinaire de 1926, p. xiv.

[13] *The Banker*, July 1937, pp. 9, 10.

In addition, the threatening foreign situation made it necessary simultaneously "to provide the means needed to protect France's frontiers and to enable France to fulfil her international engagements", in other words, to finance an extensive rearmament.

The practical program evolved to achieve this objective may be fairly accurately described as a faint carbon copy of the New Deal. Its history is well summarized in an epitaph from the pen of the Paris correspondent of the London *Times:*

> Where the Government erred was in pursuing a financial policy whose aim was reflation, that is to say, the increase of purchasing power, while at the same time introducing social reforms whose effect was to retard output and reduce the supply of commodities available to buyers whose incomes had been increased. . . . Equally disastrous was M. Vincent Auriol's truculent attitude towards employers and capitalists; he does not seem to have realized that within the framework of the capitalist system social reform can be paid for only out of the profits of industry and that if the entrepreneur is frightened out of his wits profits disappear and with them the basis itself for eleemosynary legislation.[14]

No comment is offered other than to point out that, under French conditions, which are more sensitive and restricted than our own, our prescription did not bring the results hoped for.[15] Last June Blum resigned and Ambassador Bonnet was called from Washington to assume command in the red-plush chambers of the Louvre and to deal with a situation in some respects more desperate than that faced by Poincaré in 1926. A few weeks after his arrival Bonnet confided to the voters in his home town of Perigneux that his policy and program also found its inspiration in the land across the waves. He said that his last interview in Washington was with Mr. Roosevelt and that the last words said to him by Mr. Roosevelt were, "Whatever else you do, balance the budget!"[16] There is no record of Blum's reaction to this address. Perhaps he comforted himself with Bernard Shaw's obviously unjust aphorism,

[14] Issue of August 23, 1937.

[15] Another factor of probable significance for the Blum experiment is the degree of the dependence of the economy upon foreign trade, which is greater in France than in the United States. See speech of Léon Blum, *Le Populaire*, September 20, 1937.

[16] *New York Times*, August 23, 1937.

that "those who can, do; those who cannot, teach." In any case we can comfort ourselves with the thought that in the hour of France's extremity we were able to offer her assistance both by our precept and by our example and that, finding them in direct conflict, she has listened to our advice and has followed our precedent.

Bonnet has been granted wide powers. He thinks he has succeeded in balancing the ordinary budget. He has relieved the stress on the treasury and has arranged an enormous credit at the Bank of France. He has secured from Ministerial Council a declaration that is currently interpreted as an abandonment of efforts to secure social reform at this juncture and has appealed to the country to save its currency "by a great national effort of industry, of discipline and of unity."[17]

The picture we have sketched is not a cheerful one. It has been justly charged that the financial policy of France during the last depression has been vacillating and hesitant; but it must also be conceded that the task faced by the finance ministers of the last decade has been appallingly difficult. Certainly the depression, with its series of seven consecutive budgetary deficits, has taken a heavy toll. There has been a serious deterioration in the strength and stability of her financial structure. The Poincaré franc, which was considered impregnable in 1928, and which was tenaciously defended until 1936, has lost half its value in a little more than a year. Recently prices have rocketed upward, the general index of wholesale prices, which stood at 400 on September 10, 1936, being reported at 611 on October 30, 1937.[18] The price rise carries with it the seeds of another salary adjustment for the civil service. The depression persists. The outlook is not reassuring. Nevertheless let us hope that the efforts of Bonnet to prevent a further impairment of the French national economy will be crowned with success, and that our great sister republic will soon achieve that measure of tranquillity which is essential for full economic and financial recovery.

[17] *Le Temps*, October 3, 1937.

[18] *New York Times*, November 8, 1937.

REMARKS BY THE CHAIRMAN

DR. W. RANDOLPH BURGESS: Thank you, Professor Haig.

Against this backdrop, beautifully painted, we can now bring on the stage the subject of our particular interest, the budgetary problems of the United States.

It gives me great pleasure to introduce Professor Fred R. Fairchild, Professor of Political Economy, Yale University.

THE UNITED STATES BUDGET IN THE PAST DECADE

FRED ROGERS FAIRCHILD
Knox Professor of Political Economy, Yale University

IN this paper I make no attempt to delve into the intricacies of technical budget making. My task is rather to explore the recent financial experience of the United States government for the sake of the broad picture of national finance and the significant conclusions that may be drawn therefrom.

There is however one technical matter which may not be disregarded and which I wish to dispose of once for all at the start. In dealing with government financial operations it is essential always to distinguish those receipts which represent real revenue from other receipts, and similarly distinguish between the true costs of government and other payments. Adherence to this rule compels departure from the official figures at one point. The Victory Liberty Loan Act of 1919 set up machinery for retiring the World War debt by requiring certain annual appropriations to the sinking fund, beginning July 1, 1920, to be expended for debt retirement. Since this is a definite obligation imposed by Congress, the treasury treats these retirements of debt like cost payments, classifying them under "expenditures chargeable against ordinary receipts". These are obviously not cost payments, since they result in equal reductions of the national debt. In order to show the true picture of governmental costs, I shall exclude these statutory debt payments from my figures of costs.[1] Their inclusion in the official reports makes the governmental costs and the annual deficits appear greater and the surpluses smaller than they really are. So much for technicalities.

I shall confine my inquiry chiefly to the finances of the United States government during the decade just past, although

[1] *Cf.* F. R. Fairchild, "The Government's Financial Reports", *American Economic Review*, March 1935, pp. 31-43.

to get a good running start I may have to take my first position a bit earlier.

Every war occasions extraordinary expenditures during the period of actual conflict and generally for a year or two thereafter. The United States may fairly be said to have reached a stage of financial equilibrium after the World War with the fiscal year 1922. Whereas the total expenditures of the national government (excluding debt retirement) were eighteen and a half billion dollars in 1919, six and a half billions in 1920, and five billions in 1921, they dropped down to $3,373,-000,000 in 1922 and continued between three billions and three and a half billions through the following nine years.

During this period the national finances were in flourishing shape. What with the rising tide of business activity and economic prosperity, official inclination toward economy, and conservative budgeting, each year generally turned out better than previously estimated, and the generous budget provisions for debt reduction were thus substantially exceeded. In the eleven year period from 1919 to 1930 the national debt was reduced by the extraordinary sum of ten and a half billion dollars.

This happy chapter was interrupted by the panic of 1929. However, since the income taxes and certain other revenues rest chiefly on bases in the previous year, the decline in business and in personal incomes did not affect the public revenue materially until the fiscal year 1931. In that year the total revenue receipts dropped to $3,190,000,000, being almost a billion dollars ($988,000,000) less than the previous year. Expenditures had been gradually increasing since 1926, and attempts to combat depression by government financial action appeared in 1931, causing further expenditure. But it was chiefly the drastic shrinkage of revenue which was responsible for the year's closing with a deficit of 462 million dollars.

The succeeding record of deficits and mounting public debt, uninterrupted from 1931 to the present time, is in its broad lines familiar to us all. The national revenues continued to shrink, finding their low level in the two fiscal years 1932 and 1933. In each of these years the revenues—barely over two billion dollars—were just about half of the annual revenues of the eight year period from 1923 to 1930.

In the meantime expenditures began a more rapid upswing, jumping over a billion dollars in 1932, to four and three-quarters billions, and reaching a maximum of eight and a half billions in 1936. They were just over eight billions in 1937 and are officially estimated at seven and a third billions for the current fiscal year, 1938.

In 1932 an important revenue act was passed, and other tax measures followed, notably the Revenue Acts of 1935 and 1936. But it is noteworthy that these tax measures generally had regulatory and administrative objectives quite as much in view as the desire for enlarged revenue, and there has not been during this period any vigorous attempt to secure an increase in taxation proportional to the rise in governmental costs. However, thanks to the turn of the economic tide plus the moderate revenue results of tax legislation, the public revenues increased by about a billion dollars in 1934 and continued their rise till in 1936 they were back to the pre-depression level of about four billions. In 1937 the revenues were five and a quarter billions, and the President has predicted six and two-thirds billions for 1938.

Budget making in the decade just passed has labored under extraordinary difficulties. Discrepancies between the presidential budget estimates and the actual results of each year's finance have generally been large and sometimes on their face grotesque. For example, the actual revenues of 1932 were barely half the predicted sum. In 1936, revenues actually exceeded slightly the budget estimate. Expenditures have consistently run far beyond the estimates—by nearly two billion dollars in 1937, for example. The budget of 1932 predicted a surplus of $440,000,000, and the year finally closed with a deficit of $2,750,000,000. Deficits have generally been far greater than predicted.

I have sought thus to pass in review—all too hastily, I realize—the pageant of national finance during a period of extraordinary disturbance in general economic and political conditions. Of the many significant features that stand out in this review I propose to select two or three for special comment.

Most obvious of all is the rather frequent inability of our budget marksmen—not, shall we say, to hit the bull's eye—but to come anywhere near the target. From 1923 to 1930 we find revenues invariably underestimated, at times by discrepancies ranging from a quarter to a half billion dollars, representing errors of nearly 10 per cent in some years and 20 per cent in one year. During this period the predictions of expenditures were closer, though tending generally to be too low.

After 1930, the estimates become more erratic. Revenues are generally, though not always, overestimated—in 1931 by over a billion dollars (25 per cent) and in 1932 by nearly two billions (nearly 50 per cent). Expenditures are consistently underestimated—in each of four years by more than a billion dollars, in 1934 by three and a half billions. These represent errors of 30 per cent in some cases and over 100 per cent in 1934. The deficits have been correspondingly underestimated. The budget predicted a surplus of $440,000,000 for 1932; the year closed with a deficit of $2,735,000,000. For 1933, the budget deficit was 923 millions, the actual deficit over two and a half billions. The budget prediction of a 494 million dollar deficit for 1934 materialized as an actual deficit of more than three and a half billions. Mr. Roosevelt's first budget predicted a deficit of just over three billions. The deficit in 1937 was more than five times the amount predicted in the budget.

Of course every student of public finance realizes that no administration in this country can be expected to reach anything approaching an exact prediction of revenues and expenditures, or even any such precision as is obtained, for example, in Great Britain. In the first place we do not have that unity between the executive and the legislature which, as in Great Britain, permits executive enforcement and control of the budget. In America the President makes the budget estimates, but the Congress has the final say as to revenues and expenditures, and it may take action upsetting the fiscal plan of the executive. Thus Congress added an item of $1,673,000,000 to the expenditures of 1936, contrary to President Roosevelt's plan and over his veto. In this connection it is worthy of note that for more than three years we have not had a full-fledged director of the budget; a part-time acting director has been in charge.

Decisions of the Supreme Court may throw out a revenue measure upon which the President counted, as in the case of

the processing taxes in 1936, although here it would seem that the administration must bear some responsibility at least for not having made a better guess at the constitutionality of its fiscal proposals. Again, the President can hardly be held accountable for failure of his budget estimates when control passes to another president and a Congress of different political complexion. Mr. Hoover obviously had no control over the finances of the fiscal year 1934, for which he made prediction in December 1932.

It is also to be remembered that the period I have chosen for study was a troublous one, and we must recognize that predicting revenues and expenditures, for a period ending eighteen months in the future, has been no easy task these past seven or eight years. He would be a captious critic who would condemn the administration for not always forseeing accurately the course of the depression that started in 1929. Mr. Hoover can hardly be blamed for failure to know, in December 1929, that the general business situation would knock a billion dollars off the national revenues in the year ending on June 30, 1931. On the other hand, it is difficult to be quite so charitable in connection with his missing the 1932 revenues a year later by nearly 100 per cent, though even here there were extenuating circumstances. Mr. Roosevelt has done rather better in predicting revenues, but the depression had already passed its low mark when he took charge. And his forecasts of expenditures and deficits have been generally very wide of the mark.

After all is said, I think we might fairly have asked a somewhat better showing. A good deal of our budget workmanship, especially in recent years, has a distinctly amateurish flavor. It is not easy to avoid a suspicion of bias when we find predictions erring so consistently on one side. The Republican administrations before the panic laid themselves open to the charge of underestimating revenues in order to accomplish conservative financing and rapid reduction of debt, and there is reason to think that Mr. Roosevelt may have been willing, by overestimating revenues and underestimating expenditures, to put as good a face as possible on the finances of his "New Deal". The American people are, I believe, justified in demanding from those intrusted with the conduct of their national finances a higher standard of budget making and a more scrupulous regard for sincerity in financial statements than has recently been shown.

Beginning with the first budget of the Roosevelt administration, that of 1935, the annual budget estimates of expenditures have been divided into two parts, known respectively as the "General Expenditures" and "Emergency" or (as in the later budgets) "Recovery and Relief Expenditures", and the Treasury Department follows the same division in its reports. Into the "emergency" budget were put, for example, the expenditures of the Reconstruction Finance Corporation, the various emergency public works administrations, the Agricultural Adjustment Administration, Emergency Conservation Work, Farm Credit Administration, Federal Land Banks, and some dozen other agencies whose names have in these last years become more or less household words.

This division is intended to mean, by implication if not by official declaration, that the "emergency—recovery and relief—expenditures" are such as have been necessitated by a state of emergency and that the general budget shows what the cost of government would be were no such emergency present. On this assumption the annual deficit assumes a different face. President Roosevelt has frequently called attention to the fact that the receipts are equal to or in excess of the "general" budget. The "general" budget is in balance, and the year's deficit is relegated to the "recovery and relief" budget. Thus in his estimates for the then current year 1934, the President pointed out a surplus in the general budget of $214,000,000. At the same time the anticipated expenditures for "recovery and relief" were such as to indicate a deficit for the whole budget of $7,309,000,000. The actual figures of revenue and expenditure for the years 1934-1937 and the budget figures for 1938 show revenues in excess of the "general" expenditures in every year but one (1936).

Without charging any intent to deceive, it can readily be shown that the use of the double budget has tended to obscure the true picture of the national finances. It has been a natural inference that the enormous deficits of recent years have been wholly the result of emergency expenditures and that when, at some future date, the "emergency" is over, the total of

ordinary expenditures will drop to a level indicated by the "general" budget—easily covered by existing revenue sources.

Any such inference is quite erroneous. After every period of extraordinarily increased expenditure, the United States has found its federal government on a new level of permanent costs far above that which existed before. Up to the time of the Civil War the annual per capita cost of the national government was never much more than two dollars; after the Civil War it never fell below four dollars. In 1916 the total ordinary expenditures of the United States government were $742,000,000. Since the World War they have never been below three billions except in one year (1925, when the amount was $2,931,000,000). No one with any knowledge of fiscal history should have been so naïve as to suppose, in 1934 or 1935, that at the close of the existing "emergency" the cost of the national government was destined to drop back to the level of three billion dollars, more or less, at which it had stood for the decade ending in 1931 and which was still the amount of the "general" budget.

By now the facts are gradually becoming clear. The peak of expenditure for "recovery and relief" ("emergency") was in 1934, when the amount was four billion dollars in a total expenditure of six and three-quarters billions. Since then the so-called "recovery and relief expenditures" have been steadily declining, till in the budget prediction for 1938, as revised to October 18, 1937, they stand at $2,016,000,000, barely over half the figure of four years ago. Does this perchance indicate that, as the emergency is passing, we are getting back to the pre-depression level of expenditures? Let us see.

A considerable part of the decrease in the "recovery and relief" costs is due to transfer of certain expenditures from "recovery and relief" to the "general" budget. The Tennessee Valley Authority's expenditures were transferred about half to "general" costs in 1936 and are entirely there in 1937 and 1938. The Emergency Conservation Work was transferred entirely, under the title Civilians' Conservation Corps, to the "general" budget in 1936 (though the Treasury Department still reported it under recovery and relief), and it has since remained in the "general" budget. Such transfers obviously reduce the total expenditures reported in the " recovery and relief " budget, but they do not bring any reduction in the cost of these projects. For the sake of a true picture of the trend, these items should be added to the " recovery and relief " costs as officially reported in each year since the transfers were made.

A further distortion of the reported cost of " recovery and relief " comes from certain practices in official accounting. Several of the special " recovery and relief " agencies, engaged primarily in making loans, are now showing net income over and above their expenditures. The official reports enter only the net receipts for such agencies and combine them with the net expenditures of the other agencies in the total cost of " recovery and relief ". This means that in the total figure, not only is no account taken of the sums actually expended by these particular agencies, but their net receipts are allowed to reduce by so much the net expenditures of other agencies. There may be some question whether the actual expenditures of these agencies should not be included and their total receipts elsewhere recorded; but there is, I think, no question that the net expenditures of all agencies should be included regardless of the net receipts of others. This correction may be made by adding to the official reports of " recovery and relief " costs the sum of the credits that entered into the reported totals.

If we make these corrections for net credits and important items transferred in later years to the " general " budget, we find the following record of expenditures for recovery and relief:

Year	*As reported*	*Adjusted*
1934	$4,002 mil.	$4,002 mil. (no adjustment)
1935	3,657 "	3,855 "
1936	3,291 " [2]	3,702 "
1937	2,846 "	3,827 "
1938 (estimate)	2,016 "	2,527 "

[2] C.C.C. expenditures were already included, in accordance with Treasury Department reports.

Here we have a very different picture. The real costs of " recovery and relief " have diminished only slightly from their peak in 1934 to the last completed year, 1937—a decline of only $175,000,000 dollars, or less than four and a half per

cent. The 1937 cost was actually greater by $125,000,000 than the cost in 1936. The year 1938, it is true, shows still an impressive reduction; and it is only reasonable to anticipate in this current year a considerable real decline in the cost of unemployment relief. But we must remember that the figures for 1938 are only the budget estimates and that this year has still seven and a half months to run. Already the official estimate (combining " recovery and relief " and revolving funds) has been raised by $200,000,000, and past experience should warn us to look for further substantial increases before the year's books are closed.

If it is an error to take the apparent decline of " recovery and relief " expenditures as proof of any substantial reduction of the " emergency " costs, it is equally erroneous to regard the figures as indicating a return to the pre-depression cost of government, or indeed any substantial reduction at all. Reductions in the so-called " recovery and relief " costs have been offset by increases in the " general " budget, partly on account of the transfers to which I have referred, partly by actual increases. For example, the " general " expenditures of 1936 increased over 1935 by more than two billion dollars, or nearly 65 per cent. The budget estimate of " general " expenditures for 1938, $5,330,000,000, is greater by about two billion dollars than the total cost of the national government in any year from 1922 to 1930. There is no longer the slightest ground for pretending that the present heavy cost of government is due alone to the demands of emergency. In the 1938 estimate, almost half of the increase that has come since 1930 is in the " general " budget, as officially reported.

The total cost of the national government in 1936 was eight and a half billions, exceeding the previous year by one and a half billions. For 1937 the total cost is still over eight billions. The present budget estimate for 1938 is seven and a third billions, and we may confidently anticipate substantial increases before the year is over. I claim no clairvoyant powers and wish to make no prophecies. But the record of the past decade and the lessons of previous fiscal experience would indicate that, so long as present policies prevail, we may count on a future level of annual expenditures somewhere between seven and eight billion dollars. This is considerably more than double the total cost of government in the decade before the depression.

The budgetary record of the past decade deserves some special scrutiny from the viewpoint of the general conduct of the nation's finances. That a regular current balancing of expenditures by revenues is sound financial policy will, I think, be generally accepted. It must be admitted, on the other hand, that a deficit is sometimes unavoidable—the result of some extraordinary combination of circumstances involving either a drastic decline of revenue or an overwhelming increase in expenditure. Generally it is war that brings about such a situation; but it is conceivable that a severe economic depression might be the cause. I think that we can consider a budget deficit unavoidable only after (1) all proper efforts toward economy in expenditures have been taken and (2) strenuous efforts have been made to add to the revenues, especially from taxation.

The foregoing are, I believe, sound principles, which few would be disposed to question. It will be worth our while to inquire how far these principles have been regarded in the recent conduct of our national finances.

In the late depression the United States government adopted the policy of spending ourselves out of the depression, "priming the pump", lavish expenditures for relief, especially by means of public works rather than the more economical method of direct relief. Whether this was sound policy is a fair question; also open to question is the policy of social and economic reorganization that has run parallel. But these questions are not part of the subject of my present inquiry. The fact is that a depressed economic condition of the country and the economic and fiscal program of the government tended to bring about a condition of falling revenues and rising expenditures, out of which have come the recent large deficits in the national budget. The question to which I now invite your attention is not whether governmental policies causing a deficit were sound, but to what extent the deficit may be regarded as unavoidable.

When, on December 2, 1929, President Hoover presented to Congress his budget for 1931, the magnitude of the coming depression was not foreseen, and the question of a deficit was not considered. The President announced that "our estimated

expenditures for this and the next year are well within our expected receipts."

A year later the President was compelled to forecast a moderate deficit ($190,000,000) for the then current year, 1931. This he did not consider alarming, especially in view of the very large surpluses of recent years. He foresaw a balanced budget in 1932. He took occasion to warn Congress against entering upon new government activities involving cost but did not see the necessity of proposing new tax legislation. As we now know, the event was destined to prove his 1932 forecasts altogether wide of the mark. We may criticize Mr. Hoover for an optimism not justified by the situation in December 1930, but no blame can attach to his fiscal policy once his estimates were accepted.

In the budget message of 1933 (presented to Congress on December 7, 1931) there is recognition of the disastrous effects of depression upon the nation's finances. The deficit of 1931 was now a historical fact, and large deficits were evidently in store for 1932 and 1933. The budget message contains this paragraph:

> We can not maintain public confidence nor stability of the Federal Government without undertaking some temporary tax increases. It is obviously impossible to impose a degree of taxation which will balance the budget for the current fiscal year (1931). We should endeavor by increase of taxes and rigid curtailment of expenditures to balance the budget for the next fiscal year, except to the extent of the amount required for statutory debt retirements. We should assume its balance, including statutory debt retirements for the fiscal year following.

To carry out this purpose the President recommended taxes to raise $390,000,000 in the fiscal year 1932 and $920,000,000 in 1933.

A similar attitude is shown in the budget message for 1934 (presented December 5, 1932). Faced with increasing deficits, the President urged continuation of the provisions of the Economy Act of 1932, together with some further reductions in expenditures, and proposed additional taxation to raise $492,000,000 in 1934 and balance the budget, except for debt retirement. He stated: "I can not too strongly urge that every effort be made to limit expenditures and avoid additional obligations, not only in the interest of the already heavily burdened taxpayer but in the interest of the very integrity of the finances of the Federal Government." Of course the President knew that the conduct of the government's finances would be in other hands during the fiscal year to which this budget related.

The new administration came into power on March 4, 1933. The "New Deal" program was promptly set in motion, involving heavy expenditures entirely beyond the scope of Mr. Hoover's budget for 1934. By the time President Roosevelt presented his first budget message (January 3, 1934), for the fiscal year 1935, his program called for expenditures for the then current year, 1934, amounting to the colossal sum of $10,569,000,000 (not including debt retirement). The predicted deficit was seven and a third billions for 1934 and nearly two billions more for 1935. The President described the situation in these words:

> Therefore, the total debt, if increased by the sum of two billion dollars during the fiscal year 1935, would amount to approximately $31,834,000,000 on June 31, 1935. It is my belief that so far as we can make estimates without present knowledge, the Government should seek to hold the total debt within this amount. Furthermore, the Government during the balance of this calendar year should plan to bring its 1936 expenditures, including recovery and relief, within the revenues expected in the fiscal year 1936.
>
> Let me put it another way: The excess of expenditures over receipts during this fiscal year amounts to over 7 billion dollars. My estimates for the coming fiscal year show an excess of expenditures over receipts of 2 billion dollars. We should plan to have a definitely balanced Budget for the third year of recovery and from that time on seek a continuing reduction of the national debt.
>
> This excess of expenditures over revenues, amounting to over 9 billion dollars during 2 fiscal years, has been rendered necessary to bring the country to a sound condition after the unexampled crisis which we encountered last spring. It is a large amount, but the immeasurable benefits justify the cost.

Yet, except for incidental reference to certain tax measures then under consideration, estimated to produce altogether some $200,000,000, this budget contains no suggestion for additional taxation and on the economy side only the recommendation of further reduction of salaries of government employees.

In his budget message for 1936 (January 3, 1935) the President called attention to the fact that in the year 1934

the revenues had about balanced the "general" expenditures, leaving the four and a quarter billions of emergency expenditure responsible for the year's deficit. It was apparent that the President's hope of a balanced budget in 1936 (expressed a year before) was not to be fulfilled. Instead, the budget faced a deficit of four and a quarter billion dollars for 1935 and nearly four billions for 1936. In the face of this situation, no new economies were suggested—only the continuation of certain economy provisions already in effect. And beyond the recommendation that certain internal revenue taxes, due to expire in June and July, be continued, along with the three cent postage rate, there is no disposition to propose taxation. In the words of the message: "I do not consider it advisable at this time to propose any new or additional taxes for the fiscal year 1936." It will be recalled that, since the date of the last budget message, the Revenue Act of 1934 had been enacted. But its results were included in the estimates now presented.

The budget message for 1937 (January 3, 1936) took a most congratulatory tone. It presented estimates—soon to be shown surprisingly wide of the mark—for the expenses and deficit of the current year, 1936. It stressed the predicted balance of the "general" budget for 1936, except for debt retirements. Actually the year 1936 was destined, only six months later, to show a deficit even in the "general" budget of more than a billion dollars and a total deficit of four and a third billions. As to 1937, the President predicted a balanced budget in these words: "The state of national recovery is such that receipts from prevailing tax sources on the basis of present rates appear adequate for financing the ordinary operations of the Government in 1937, including service on the public debt; and no new or additional taxes are proposed." In connection with the forecast of the future occurs this remarkable paragraph: "Our policy is succeeding. The figures prove it. Secure in the knowledge that steadily decreasing deficits will turn in time into steadily increasing surpluses, and that it is the deficit of today which is making possible the surplus of tomorrow, let us pursue the course that we have mapped." I venture to suggest that here is not breathed the spirit of sound finance.

The budget for 1938 (January 5, 1937) is of the same general tenor. Although since the last budget message, the Revenue Act of 1936 had been passed, it was now apparent that the current fiscal year 1937 would show a deficit of more than two billion dollars. Actually it was destined to be $2,707,000,000. Nevertheless, without suggestions of economy or new taxation, the President predicts a balanced budget in 1938, including provision for the statutory debt retirements. This estimate was quickly revised on account of an increase in the sum asked for " recovery and relief ", making the 1938 budget barely in balance (a surplus of $37,000,000) without provision for debt retirement. A complete balance was predicted for 1939.

Since then the estimates for 1938 have been twice revised by presidential statements. The latest statement, that of October 18, 1937, now predicts a deficit of $695,000,000, without provision for debt retirement. The changed situation is due chiefly to recognition of the over-optimistic prediction, in January, of the yield of income and social security taxes.

In the light of this analysis of recent budgetary policy, it is not easy to regard the deficits of 1932-38 as entirely unavoidable. Without raising the question of the soundness of the government's economic policies, one can scarcely avoid the conclusion that economy in expenditure has not been the rule, that taxation has not been called upon to contribute as it should, and that, during a part at least of this period, the budget has not been managed with entire regard to established principles of sound finance.

REMARKS BY THE CHAIRMAN

DR. W. RANDOLPH BURGESS: Thank you, Professor Fairchild.

We now proceed to the discussion of the subject matter of these excellent papers.

The first speaker in the ten-minute discussion is a graduate of Yale University and the Harvard Law School. He comes from Ohio, and is a partner of the firm of Taft, Stettinius and Hollister, of Cincinnati. He is known to us chiefly for his distinguished service for three terms as a member of the House of Representatives Committee on Currency and Banking.

We have great pleasure in calling on Mr. John B. Hollister.

DISCUSSION: THE NATIONAL BUDGET OF THE UNITED STATES

JOHN B. HOLLISTER
Former Congressman from Ohio
Partner of Taft, Stettinius and Hollister, Cincinnati

NOT having had a chance to study Professor Fairchild's address before reaching here this morning, the few remarks that I had intended to make in opening this discussion may not perhaps be entirely responsive to everything he has said.

I find myself a little in the position of the young student who took the " cinch " course in Old Testament History—took it because for five years in the annual examination there had been a question concerning the names of the Kings of Judah in order. That counted fifty per cent and if he got the answer correct, he would pass. He was somewhat dismayed to find as the chief question in the examination, " Distinguish between the major and minor prophets." He wrote in answer: " Far be it from me to distinguish between such great and wise men, but the Kings of Judah in order are as follows."

A budget has been defined as a fiscal plan to balance expenditures against income. Stated thus simply, there is no difference between a budget for a government and for a person. Incidentally, the government seems to have as much trouble in meeting its budget as some of us personally have in meeting ours.

However, a government budget is a highly complicated thing from the point of view of preparation and from the point of view of administration, particularly in a form of government such as ours, where the executive branch, theoretically at least, does not control the legislative branch. It is the duty of the executive to prepare and present a budget that can be understood by everyone. It is the duty of the legislature to examine it, change it where it sees fit, and adopt it. Then it again becomes the duty of the executive to administer that budget and make a clear accounting of it. That part of the work is attended to by the chief executive in public utterances and through the treasury in making its accounts and statements.

We must make Congress responsible if it exceeds a proper budget as presented, and make the President responsible if he does not present the proper kind of budget or fails to account for it properly. Unless the executive presents the budget clearly, so that it can be grasped easily, and accounts for it clearly, so that all items of expenditure can be understood, it is impossible to hold him responsible. Unless we can place responsibility for these functions where it belongs, we are not going to be able to change the existing alarming situation.

I want to make a few comments today on some of the improprieties in the form in which the budget is submitted and in the methods of accounting for it.

Professor Fairchild examined in considerable detail the difference between the regular and emergency budgets. What you must keep in mind is that early in the budgeting of the present administration, the great majority of new expenditures were thrown into the emergency budget. Admittedly, there was an emergency and something had to be done about it. Extraordinary expenditures were necessary, and these were carried outside the regular budget. Then, as enlarged expenditures were demanded by the regular departments, they were carried into the emergency columns, apparently so that the "regular" budget would not show such a great increase over normal times.

The tendency has now been reversed—many of the "emergency" items have become the regular thing and are placed in the regular budget. Discretionary funds have been given to the President which he may switch back and forth, and it has become almost impossible—certainly for the layman—to find out what expenditures are for what purpose, or to make comparisons with other years.

Professor Fairchild has pointed out the concealment of the fact that large sums of money used for current expenses are really the repayments of some of the funds previously loaned by various governmental agencies, the money for which had been borrowed from the treasury and for which the treasury

had to raise the money by taxes. At the time these sums were borrowed, they were called "recoverable assets" and the argument was made that they should not be considered as current expenditures because they would soon be repaid. However, when the time comes to pay these sums, instead of making the announcement that these are the sums which unbalanced the budget in the past, we call them general receipts, put them in the general fund, and they reduce the spread between receipts and expenditures, thus showing a smaller deficit.

No reference has been made this morning to the guarantee of obligations. Where private finance is concerned, plenty of stress is placed on obligations which are guaranteed, for they have a serious effect on credit. Certainly the Securities and Exchange Commission insists on such things when it comes to a private corporation.

Our government is the guarantor of principal and interest of some $4,700,000,000 of obligations. These ought to be accentuated by the treasury rather than put in fine print in the complicated monthly treasury statement which is our only way of following these things. You need a fine-tooth comb and a magnifying glass to dig them out.

These are obligations which some time must be met, and while there will be substantial recoveries, everyone knows that there will be enormous losses in the $3,000,000,000 of Home Owners Loan Corporation bonds and the $1,500,000,000 of Federal Farm Mortgage Corporation bonds which the government has guaranteed, and a large part of which it will some time have to pay.

Another item to which attention should be given is that of currency manipulation. I am not talking about the effect of that on the general economic situation, but on the public expenditure. When gold was devalued, it is true that the greater part of the so-called "profit" was put into the stabilization fund, which is secretly administered and therefore nobody knows what has happened to it, but a certain amount of this paper profit went into the general fund and was spent.

It is also true that we are buying silver steadily and we now have more than $1,300,000,000 of silver certificates outstanding. We buy it at a certain price and issue it as silver certificates at a higher price; the difference is a sheer profit for the government, and I defy the average person to dig this out of the treasury statement.

The Social Security Fund is another matter which is perhaps the most serious defect in present governmental accounting. Under the Social Security Act, taxes are collected by the treasury. They are then paid into a special fund which in turn is invested in some particular kind of government obligations issued for that purpose by the treasury. These funds thereupon lose the trust impress placed on them when gathered for a special purpose, and they become general funds to be spent by the treasury for general purposes. The trust impress is placed on the bonds which are carried in the fund. The September 30, 1937, Treasury Statement shows $390,000,000 of 3 per cent treasury notes due in 1941 and 1942, known as the Old-Age Reserve Account Series, and $457,000,000 of 2½ per cent certificates of indebtedness due next June, known as Unemployment Trust Fund Series. All we have to meet future obligations, to those expecting to be looked after when old age and unemployment occur, are the promises of the government to pay itself. The taxes which have been collected for this purpose have been in turn spent and will continue to be spent unless the Act is changed. It is true that the Act requires the treasury to handle matters in this way, but the treasury ought to make clear what is happening and ought to point out the fact that, if it were not for the social security funds which are coming in, the spread between receipts and disbursements would be even greater than it now appears to be.

It seems to me that the only way we will save the situation is to bring home to the people exactly what is happening. We are not going to be able to bring home to them what is happening unless there is some clear presentation of the facts and unless the chief executive is willing to face the situation squarely and explain to the people in simple words, that any layman can understand, the chief items of receipts and chief items of disbursements, distinguishing between those which are ordinary and those which are truly emergency, between those which are matters of bookkeeping and those which are true revenue receipts and true expenditures.

The budget itself is an enormously complicated thing. Outside of the budget director and a few assistants, I do not believe

anyone has a broad grasp of the whole picture. I do not believe that the executive and the treasury have a full grasp of it. I do not believe that the Appropriations Committee of the House, or of the Senate, has a full grasp, because these committees are divided into a number of subcommittees, each taking up one department. Each subcommittee knows the expenditures of its own department and checks them carefully, but no one on the Appropriations Committee in either the House or Senate knows all about all of them, and the result is a sort of hit-or-miss thing. Each chairman of a subcommittee jockies his part of it through his house, and after additions are made—seldom subtractions, practically always additions—the House committee and the Senate committee sit together and agree on a bill which is nearly always an increase in the particular budget, and that is put through. So when the total appropriations are made and adopted, the total is whatever it may happen to be and has no reference, perhaps, to the original totals submitted.

If we are going to have responsibility, we must understand what Congress is doing. To accomplish this, there is a duty on the part of the executive to present a clear budget and, when he presents it, to defend it and not be in the position we are in today of having the executive call a special session of Congress to pass laws which will put out of balance by several hundred millions the budget he presented.

If the executive defends his budget and accounts properly to the people through his own statements and through his right arm, the Secretary of the Treasury, we are going to be able to fix responsibility for budget excesses in the future.

Remarks by the Chairman

Dr. W. Randolph Burgess: Among the required readings of the banker or the businessman in this country, almost second to the daily paper, comes the London *Economist*. The editor of *The Economist*, Sir Walter Layton, who is one of the Trustees of the Academy, has appeared before us on a number of occasions.

We are fortunate today in having with us his associate, Mr. D. Graham Hutton, assistant editor of the London *Economist* and former lecturer at the London School of Economics, who will now continue the discussion.

DISCUSSION: THE NATIONAL BUDGET OF GREAT BRITAIN

D. GRAHAM HUTTON
Assistant Editor of *The Economist*, London; former Lecturer, London School of Economics

I must confess to a certain embarrassment at the praise given to those responsible for the financial prestidigitation in my country. As a consequence of having to follow the results of their practice and watch the rabbits emerge from the hat, I am not quite as happy as some earlier speakers seem to be about English finances; and for these reasons:

In the first place, if you look at the remarkable tables produced by Professor Lutz, you will find there has been a considerable change-over in the composition of the British budget during the last eight to ten years. Not only has that change-over been observable as between direct and indirect taxation, but there has also been a hidden turnover between budgetary and non-budgetary expenditure. That is to say, there is at the present time a considerably greater amount of government-controlled expenditure, apart from the revenue-based expenditure, through non-budgetary channels today.

A very interesting study has been made by Professor N. F. Hall. He shows that a considerable number of important funds and institutions are controlled through the government departments, beside those of the treasury and exchequer. The Auditor and Controller-General is not concerned with all of these. You find that the government today has control over about a hundred million pounds' worth of expenditure a year which, ten or fifteen years ago, would certainly have been covered in the normal ordinary budget. New funds have been set up to administer subsidies, et cetera, and the balances of these funds can be used in the medium- and short-term money market, and are so used. Their accounting years do not run for the same period as do the budget years; and all sorts of financial prestidigitation is possible to the tune of some millions

of pounds *per annum*—and you are not even sure which *annum* it is.

A second feature, rather puzzling to the English student of his own finances, is that a very great increase has taken place in the percentage of national expenditure passing through the budget. Professor Lutz touched on that in passing, but the percentages are really very striking. It runs something like this, at a rough computation: From 1904 to 1910, for instance, you get total budgetary expenditure at 7.1 per cent of the national income, rising, as Professor Lutz said, to 18.1 per cent in the estimates for 1937. If you take that together with the local expenditures of local authorities in England, you find that a much greater amount of what one might call corporate government finance, that is both central and local government, is now passing through annual budgets. Not all the items in these annual budgets, however, are amenable to ordinary public or parliamentary scrutiny. There is a considerable opportunity for diversion in local expenditures from one branch of expenditure to another within one and the same year. This is not possible in central expenditures for statutory reasons.

A third point is that the composition of the national debt has changed very much in the last seven years, together with the reduction in the rate of interest on that debt. Thus the charge of carrying the annual service on that debt has been reduced by 33⅓ per cent. This has set free possibilities of expenditure in other directions. At the same time, however, a problem has arisen which was not foreseen and for whose solution no provision can yet be made. As Professor Lutz's tables show, we have now funded really one-half the debt; but the unfunded debt has changed from remote-dated to near-dated debt. This has been achieved by bringing the dates for the falling-due of the national debt very much nearer to the present; so that, whereas twenty years ago or before the War a smaller percentage of the unfunded national debt was falling due farther ahead, today a much larger percentage is falling due much nearer ahead. You will at once observe the importance of movements in the rate of interest. For these movements, as far as one can judge, no provision whatever has been made. Yet it is a potential source of embarrassment. For if the rate of interest on short- and long-term debt moves up 1 per cent, the change will greatly embarrass the budget, as debt has to be "converted upwards". The rate of interest has already moved up over a half a point in eighteen months. What if it moves up 1 per cent or 1½ per cent? Already seven years have gone by since the first incidence of the financial depression on English finances. It is quite possible, in another five years for example, that a considerable proportion of debt will be falling due at much higher interest rates. No provision has been made for that.

The fourth point is the financing of our defenses, which Professor Lutz quite understandably passed over. But you will not expect me to pass over it.

Defense borne by the normal budget has increased by 90 per cent in three or four years. In addition to that, England now has an extraordinary budget. We do not say it is an extraordinary budget; but it is one, nevertheless. The total has risen from 107 millions in the ordinary budget to 200 millions or, to be precise, 198 millions *plus* an unknown quantity of supplementary estimates.

In addition, there is 80 millions borrowed, not borne by revenue. That 80 millions is for the "capital" purposes of defense. Such "capital" purposes are, we presume, battleships, and I suppose a certain amount of mechanization for the land forces; but by far the greater part is for factories and permanent capital works like aerodromes and various other undertakings in connection with the armament program.

That, of course, is an extraordinary budget. But that is not the point that concerns English economists. The point that worries them is this: not only is a considerable proportion of the increase in normal revenue (covered by expenditure) of a rapidly obsolescing kind, but the 80 millions which is borrowed in addition to that is also of a very rapidly obsolescing kind. And no provision is being made to meet the incidence of this second type of "capital" obsolescence during the next five years.

To take an obvious example—an aircraft factory and the aircraft it turns out are both obsolescing; in the case of aircraft, 33 to 50 per cent *per annum* when they are finished. Battleships take very much longer—15 to 20 years' life—but the cost of three or four refits in that period is almost three times

the cost of the battleship; and no provision is being made for the incidence of this kind of obsolescence on future budgets, or for the retirement of any of the capital borrowing of 80 millions for five years. That sum amounts to 400 millions, or 2 billion dollars.

The future incidence upon the budget of this unknown obsolescence factor is causing British economists some perturbation. It is possible that the national income will go on rising in terms of money for a considerable time. I think, in fact, it will in the United Kingdom; but the national income is already bespoken to the extent of 5.4 per cent in the current year for defense purposes alone, as compared with 3 per cent two years ago, and 2.6 per cent five years ago. It has more than doubled. This kind of unknown incidence is very difficult to budget for on the revenue side in future; and we concluded in *The Economist's* last Budget Supplement that something like another hundred million pounds of revenue must be found somewhere, on a budget of only 800 million pounds' revenue, in order to cover all the normal, orthodox financing of the defense expenditure and of other expenditures. I do not know where the other hundred millions is going to be found. If you look at income tax history, you will find that the yields of income tax and super tax have risen, but not in proportion to the rates of tax; nor has the yield per penny of tax risen to anything like the same extent. We seem to be reaching the upper tax limits and the lower limits of those who can qualify for paying income tax. It is difficult to see what else can be done in that direction; and in the customs revenue it is difficult to see what can be done. If we put duties up for revenue purposes, they will certainly become protective, and we shall not get the revenue.

I want to conclude, however, with two general observations quite apart from the British budget. The first is on the French budget. There you notice at once the difference in the French and British budgets during the last six years. The percentage of the normal French budget falling to the service of the national debt is 50 per cent. In the case of Britain it has been reduced by 33⅓ per cent, from about 45 per cent down to about 24 per cent—something like that. This reduction, of course, is beneficial as long as the authorities can control the money market and keep interest rates down. The French, however, owing to the export of capital, have not been able to get their money market fluid, reduce their interest rates, and so convert the interest rate on the national debt. The main problem is the problem of carrying the national debt, not so much as carrying the extraordinary budget, defenses, telegraphs, railroads, etc.

The next point is common to all of us—French, British and American. We have all devalued our currency; but there has not been a movement in prices toward the equilibrium that you would normally expect from a 40, 42 or 45 per cent devaluation. Is it not to be expected that, if you devalue your money and get the money market fluid and alter the whole relation between capital and income, your budget should tend to move in the same direction? I hope that some American economist will enlighten me today why Americans seem so terrified at the proportions of their national debt. I am surprised when I compare our country's finances with yours and find that it takes twenty months of our national income to buy up our national debt and only eight months of yours.

Remarks by the Chairman

Dr. W. Randolph Burgess: We thank you, sir for that very pleasant thought. We have almost half an hour remaining for discussion. For purposes of this discussion, we have a five-minute rule, so there may be an opportunity for a number to speak, or, if you prefer, to ask questions of those who have spoken.[1]

[1] Space limitations make it impossible to print in these Proceedings the interesting discussion by several members who spoke from the floor under the five-minute rule.—Ed.

PART II

THE FUTURE OF THE FEDERAL BUDGET

INTRODUCTORY REMARKS *

WESLEY C. MITCHELL *Presiding*

Professor of Economics, Columbia University
President of the Academy of Political Science

In opening this afternoon's session, it is fitting to recall that the Academy hoped to have another presiding officer. Those of you who received the earlier edition of our program noticed that the Honorable Ogden L. Mills, than whom there could be no fitter chairman for a meeting considering the federal budget, had promised to take charge. Through the untimely death of Mr. Mills, former Secretary of the Treasury, the country has lost one of its most valuable citizens and the Academy of Political Science has lost one of its wisest counselors.

At the morning session we had reviews by three distinguished authorities of recent changes in the national budgets of the three great democracies of the present day. Our speakers gave us illuminating accounts of the extraordinary expenditures that the Great Depression forced upon the governments of Great Britain, France and the United States, and of the various devices that these governments used to meet these additions to normal budgetary requirements which were already heavy.

With these reviews in mind, we are now to hear the future of the federal budget in the United States discussed by speakers as eminently qualified to treat their several topics as were the speakers at the morning session.

I have the pleasure of introducing first Professor Alvin H. Hansen, formerly of the University of Minnesota, then of the Department of State, now of Harvard University, who will speak upon "The Consequences of Reducing Expenditures". Professor Hansen!

* Opening of the Second Session of the Fifty-seventh Annual Meeting.

THE CONSEQUENCES OF REDUCING EXPENDITURES

ALVIN H. HANSEN

Professor of Political Economy, Graduate School of Public Administration, Harvard University

THE current fiscal year presents a crucial stage in the development of industrial recovery in this country. For several years the government has been pouring out funds into the community in excess of the funds which it has taken back from the community in the form of tax receipts. The current shift in deficit financing represents an order of magnitude sufficiently large to have very considerable repercussions upon the economy. Whereas, in previous years the net contribution made by the government to the growth in community expenditures amounted to some three billion dollars, in the current fiscal year the balance of governmental receipts and expenditures is expected to effect some net contraction, when account is taken of the social security taxes. It is this sudden shift, its implications and its consequences, to which I wish to direct your attention.

In order to appraise the consequences of reducing governmental expenditures it will be helpful, I think, to consider the character of the recovery thus far achieved in the United States.

Everyone will agree that this recovery has been on many counts a very unusual and exceptional one. In many respects it does not follow the pattern of recovery movements in the past. One could differentiate it from earlier recovery periods in various ways. I wish, however, to direct attention to one special characteristic which I regard as of primary significance, particularly with respect to the topic here under consideration.

The recovery which we have been experiencing in the United States thus far may be characterized as a consumption recovery. By that I mean that the expansion in income, employment and output has been based mainly on a rise in consumption. There has occurred, to be sure, a very considerable increase in real

investment, but investment has for the most part followed consumption; it has not, except in limited degree, led the way.

Let us consider very briefly the history of the revival to date. It was of course quite impossible for any sustained recovery to get under way until the banking system had been placed in a position which commanded the confidence of depositors. Without this rock-bottom foundation the economy could only sink deeper and deeper into the morass of a cumulative deflation. Moreover, the change in the foreign exchange value of the dollar definitely removed a powerful price depressant and brought about an internal readjustment of prices in favor of agricultural and raw material producers. This realignment materially improved the balance in the general price structure and in the relative purchasing power of different branches of our economy. On the basis of these two changes, the reconstruction of the banking system and the realignment of the internal price structure, a foothold was secured from which recovery could go forward.

The speculative inventory boom of the second quarter of 1933 quickly collapsed at the mid-point of the year. It had been caused mainly by the prospective rise in prices indicated by the new monetary policy and partly by the prospective rise in costs indicated by the N. R. A. A fresh start on a more modest scale, but also on a firmer foundation, was made at the turn of the year. Two factors were of primary importance. The first was the rise in the demand for durable consumers' goods of which automobiles was the most important single category; the second was the income-stimulating expenditures of the federal government. Both developments indicated a rise in the rate of consumption—the first in the durable goods field, the second in the sphere of current consumption needs.

The prolonged deflation had restrained many people from buying new automobiles, household appliances and other durable consumers' goods. Instead they had chosen to hold in suspense, for subsequent use, available or potential purchasing power. The improved psychology following the banking and monetary reforms combined with the growing need for replacements—a need more and more urgently felt as the existing stock became increasingly obsolete—released an accumulated backlog of consumers' demand for durable goods. In large measure this new demand was financed by an expansion of installment credit. Thus it was consumption and not investment which led the way toward revival. As the purchase of durable consumers' goods increased, new investment in plant and equipment had indeed to be made not only in the industries directly supplying these products but also in all the underlying contributing industries from steel to machine tools.

Coincident with this development with respect to durable consumers' goods, the government began on a large scale to pour out new funds into the community—funds which went directly into the hands of needy consumers and which at once swelled the volume of consumer purchases. This in turn forced necessary renewals and replacements and finally some expansion in capital expenditures. Thus, the initial rise in consumption caused an increase in real investment and this in turn, through the ensuing increase in employment and payrolls, lifted still higher the level of consumption.

The demand for durable consumers' goods rose through 1935, 1936 and early 1937 to ever higher levels, carrying with it an expansion of investment, income and employment. Governmental net contributions to consumption rose sharply from the close of 1933, pumping new funds into the consumers' markets at the rate of about three billion dollars per annum. Finally in 1936 the soldiers' bonus lifted the stimulating expenditures to still higher figures. In the meantime, beginning with early 1935, another major durable goods industry—residential building—began to make a belated, but halting and limited, contribution to recovery.

For our purposes it is not necessary to fill in the entire picture detailing the recovery to date. It is sufficient to press home the point that this recovery has been peculiarly one based on a rise in consumption. Some considerable increase in real investment did indeed follow, as indicated, but I think it is common knowledge, and quite generally agreed upon, that throughout the upswing period new investment in plant and equipment has been geared rigorously and narrowly, in a quite unusual degree, to the immediate requirements of consumption. Business men have avoided as much as possible long-term capital commitments. They have cautiously restored and expanded their production facilities to the bare limit severely

required by the current and immediately prospective level of consumption. There were of course exceptions, but taking a general view of the matter, the statement just made may be fairly said to describe the significantly outstanding characteristic of the current recovery.

In sharp contrast with the recent development is the record of recovery movements in the past. I do not wish on this occasion to enter into the controversy regarding the order of precedence of consumption and investment in the very first initiating stage of revival. On purely *a priori* grounds there are strong reasons for believing that in a predominantly non-interventionist economy the upswing is likely to be initiated by new investment, with consumption following behind as income and employment rise. On balance the historical record supports this view. Especially is this true if one rules out the "terms-of-trade" argument, which has the serious defect of viewing the problem from the standpoint of a single section of the world economy. But whatever the facts with respect to the initial period, I think a consensus can be reached on the proposition that former recoveries have typically been carried forward on a wave of new investment which was *not* narrowly gauged by the current and immediate level of consumption purchases. Large bold projects looking far into the future have typically been undertaken in the upswing period. They were launched, not on narrow calculations with respect to current demand. Daring investments based on important technological advances, on innovations, cost-reducing improvements, and on the discovery of new resources, were projected in the faith that the forward march in capital accumulation and productive equipment would itself call forth an enlarged purchasing power. Had the rate of investment always been narrowly geared to the current rate of consumer demand, we should never have witnessed the material progress achieved in the nineteenth century.

Investment in upswing periods has typically *led* and not followed consumption. It was of the very essence of the boom that a great forward thrust was made into new frontiers of technical equipment and productive power. The developments of the boom had no relation to the then prevailing level of consumption. They were based instead on future expectations, on a dynamic conception of economic life. Revolutionary changes in technique, innovations in productive processes, the development of new products, the exploitation of new resources—these are the factors that, from time to time, have caused important capital expenditures. The industrial revolution, the waves of railway construction, the booms based on electricity and automotive power had no relation whatever to the current volume of consumption.

"Ah yes", someone will say, "but that's just the rub." Always these bursts of investment have spent their force and left the economy prostrate and depressed. New investment had indeed lifted consumption, income, output and employment to higher levels, but these levels were never for long maintained. The advance had come by spurts and the bucket of capital formation, to borrow an apt simile from Spiethoff, had been filled to overflowing. It was now only necessary to keep it full. Investment had indeed led the way but the violent forward leap too frequently ended in disaster. Sustained recovery, yes; but ultimately at the high cost of instability. And, it will be asked, is it at any rate not true that a recovery such as the present, in which consumption has led the way, and investment has followed after like a dutiful handmaiden, is much to be preferred to one in which investment, like a dashing but reckless knight, goes forward to conquer worlds so vast as to preclude peaceful assimilation into a stable and settled society?

We are now coming to the gist of my thesis. Unfortunately, a recovery resting almost exclusively on a rising tide of consumption can go forward only so long as the consumption stimulus is applied. Worse yet, it cannot even maintain the level reached, once new funds are no longer poured into consumers' markets. For it is a peculiarity of business activity, geared closely to consumption demands, that once consumption ceases to rise, there are forces at work causing contraction. Thus, it is not true, as some have asserted, that the current reversal from large income-creating governmental expenditures to a cessation of such stimuli will at the worst have no more serious consequence than a tapering off of the trend of income, employment and business activity. In a peculiar sense a recovery based on consumption cannot stand still.

The analysis which I have just made is, of course, merely an application to the current phase in our recovery of the familiar principle of acceleration. But there is one aspect of the matter which I think has not been adequately recognized by economists. As I have elsewhere[1] stated, the principle of acceleration has probably played a minor rôle in the past in the causation of the turning point from expansion to contraction. And a main reason for this is that in the typical upswing movement the rate of investment has proceeded in large part quite independently of the rate of consumption. On the other hand, what needs to be strongly emphasized is just this: if the recovery movement is of such a character that the rate of investment is closely geared to the rate of consumption, it then follows that the principle of acceleration operates with full force, subject, however, to certain qualifications with respect to variations in the degree of excess capacity, the age of the capital equipment, et cetera. These qualifications at the moment probably weigh on the whole more heavily on the side of contraction than on the side of expansion. Therefore, it may be asserted that substantially the full implications of the principle of acceleration must be taken cognizance of in the situation immediately confronting us.

The implications of this principle, once firmly grasped, are very clear. So long as consumption is rising there is need for renewals and for more plant and equipment to satisfy the growing consumption demand; but as soon as consumption flattens out there is no need for any new investment in plant and equipment. To supply the current level of consumption one has only to maintain intact the existing equipment. The output of investment goods, therefore, falls to the level of mere replacement which indeed in many lines may, for a considerable period, be wholly deferred, especially if existing equipment is relatively new. It follows that as consumption flattens out, net investment ceases and there remain only repairs, upkeep, and some essential replacement. As net investment ceases, employment declines in the capital goods industries, and in the succeeding period consumption itself, from having flattened out, begins actually to fall off. This is the dilemma which

[1] See my article on "Harrod on the Trade Cycle", *Quart. Jour. Economics*, May 1937.

confronts a recovery reared on the stimulus to consumption. Such a recovery can proceed no farther than it is pushed. It has no momentum of its own. It has no inner power to complete its own development.

We are currently witnessing a rapid shift in income-creating expenditures both public and private. The props which have been lifting the level of consumption are being withdrawn. The automobile boom has tapered off. We are moving toward a saturation point in installment sales. The government stimulus to consumption is in process of being completely withdrawn in a dramatic reversal from a plus of three billion dollars to a minus of four hundred million dollars within a single year. The full force of this sudden change upon our recovery has perhaps not been adequately appraised. One explanation for this is probably that the public has fixed its eyes on the formal balancing of the budget. And since this is not yet balanced, the impression is abroad that the government is still lavishly spending more than it is taking from the public in tax receipts. But this is looking at the form and not the substance. From the standpoint of consumption stimulation, the " economic budget ", so to speak, in contradistinction to the formal fiscal budget, will already in the current year, according to the President's estimates, be more than balanced. In other words, when we take account of the social security taxes, including both old-age and unemployment insurance, it is found that the government in this fiscal year is actually exerting a deflationary pressure on the volume of consumption.

I do not draw the conclusion that there is inevitably impending a major recession. But I do say that if we are to avoid some considerable recession, either consumption must be pushed forward or else investment must be pried loose from the narrow limits imposed by the immediate requirements of the existing volume of consumption.

We cannot lightly assume that consumption, unaided by government spending, will of itself continue to rise. Unsupported by the government it can go forward only on the basis of a further extension of consumer credit. But this involves obvious difficulties. There is, however, one important thing which could be done quickly, and without disturbing the balancing of the fiscal budget. We could remove the deflationary

pressure currently exerted by impounding the old-age insurance taxes into a Reserve Account. We could place this Account on a pay-as-you-go basis. This should be done. It is difficult enough to cope with recessionary tendencies in any case without inviting additional trouble; and there is no escape from the conclusion that the impounding of these funds adds strength to the deflationary forces.

But this is not enough. We cannot facilely expect that the recovery will just automatically complete itself. There is no assurance that business will surely carry on to a full measure of prosperity. For " carrying on " means that new investment shall no longer be starved as has hitherto been the case. Indeed, unless something positive is done, there is widespread evidence that the requisite investment will in point of fact not be made.

Many reasons have been assigned for the currently low level of new investment. There are those who are convinced that the basic cause goes very deep; that it is to be sought in a fundamental change which it is believed our social order is undergoing. It is said that we are passing through a transition period—the implications and significance of which history alone can appraise—a transition from a free economy to a controlled economy. The framework in which private enterprise is permitted to function is becoming more narrowly circumscribed. It is said that business chafes in the new " harness "; that like a " bucking broncho " it refuses to function until its old freedoms are restored. Thus, it is alleged, we are confronted with an irreconcilable conflict between business and government. Private enterprise, operating in a free market, can, it is said, function with a high order of efficiency and even with reasonably full employment. At the opposite extreme it is conceded that a highly centralized collectivism could command and direct the productive resources. But a hybrid economy, an economy which is neither free nor regimented, cannot, it is argued, function at anything like full employment. This limping hybrid system continues to rely on private enterprise, yet the motivating and energizing forces are dampened down and at times almost wholly suppressed. From this point of view, there can be no escape from a deadlock which can be broken only by driving on toward a completely authoritarian state. The present recession is thus regarded as only a preliminary demonstration that a hybrid society, half free and half controlled, can succeed only to a very limited degree. Such a society, it is said, quickly gets all snarled up in its own processes. Every attempt at a solution involves it in a maze of contradictions. Every artificial stimulant saps its inner strength. Every new measure conjures out of the ground a hundred new problems.

It is safe to say that a fairly large part of the American public subscribes to the thesis just stated. It appears to be the view of a very considerable section of the business community. It is, of course, the view of the communist and the thoroughgoing collectivist. What the verdict of history will be depends upon a great many imponderables. At any rate I do not regard the indicated development as a necessary or inevitable one.

Stepping down very far from this rather abstract level, we encounter a much more practical bit of speculation—one concerned with more immediate considerations. The current recession, it is said, is due to certain *specific* governmental interferences which, even granting most of the basic aims of the New Deal, could have been avoided. The regulations of the security market, the undistributed profits tax, the capital gains tax, it is alleged, have had the effect of rendering the capital market quite impotent to perform its necessary function. It is this that has prevented the desired volume of new investment. The budget deficit is regarded as having been continued over an unnecessarily long period of years. Governmental issues have supplanted private issues in the capital markets. Investors have become accustomed to holding assets which offer an exceptional measure of liquidity. The capital market has lost its capacity to serve enterprise. It can no longer function as the medium through which the stream of savings is able to find an outlet in ventures that involve considerable risk. The possessors of loanable funds have been driven to shelter, to high liquidity and security. The market regulations and the capital gains tax, it is alleged, have rendered the stock market so erratic as to preclude the issuance of new securities. Modification, but not abandonment, of the machinery of governmental control is, from this point of view, believed to be

adequate to bring about the necessary volume of new investment.

Such is the analysis which has recently preoccupied the public mind. No doubt it deserves careful consideration, particularly that concerned with the assumption of risk. Respecting the mechanism of the stock market, while it may indeed explain, in part, the jerky and erratic fluctuations in security price movements, it can never explain a sustained level of valuations. These ultimately rest, not on the character of the market machinery, but upon anticipations of future yield. From this standpoint it has not yet been demonstrated that the market has done much more than to correct an earlier inflated optimism based on the expectation of a continued rapid rise in the national income and in commodity prices.

Yet even though the market mechanism were perfected, there still remains a fundamental difficulty. We are compelled to face squarely the question of how far the stock market can perform its essential function of connecting the flow of savings with investment outlets, in a situation in which the desire for a high degree of liquidity alternates with an intense desire to speculate, and in which, moreover, so large a part of the investing public is regimented into like-mindedness under the influence of the ubiquitous forecasting services—the drill sergeants of the modern speculative community.

I turn now to something which is admittedly highly problematical and which raises many difficult problems. It may be that the particular manner in which the deficit has been managed, with reference to the composition of the federal debt, makes it peculiarly difficult for private investment to expand in the amount required for full employment. Business expansion beyond a certain moderate limit finally evokes demands upon the banking system whether in the form of loans or investments. As these alternative employments open up, banks begin to unload their governments. This depresses bond prices. If it is anticipated that long-term government bonds will fall still farther, renewed selling occurs. Thus there is danger that the interest rate as reflected by bond yields will rise far more rapidly than justified by the economic situation. The prospect that such a rise is imminent may prevent flotations and thus check expansion. We are thus caught in a dilemma. The more private investment expands, the greater the demands on bank credit; the greater the demand for credit the more banks tend to unload government obligations; with the prospect of higher interest rates there develops a scramble to sell long-term bonds; and finally, the disturbed conditions in the bond market render any further expansion of private investment difficult. Thus deficit financing through long-term bonds, in so far as such bonds are held by the banks, imposes a limit on the expansion of private investment beyond a fairly moderate amount. If this is true, we shall have to revise our views with respect to the assumed merits of long-term government obligations, at least in so far as fiscal operations are designed to play the rôle of a compensatory device.

I turn now to an even more fundamental matter. The failure of new investment in this recovery is due in large part to a tendency to push costs up higher than the level of income justifies. This is due partly to governmental policies beginning with the N. R. A., partly to corporate price policies and partly to labor policies. It is notorious that building material and labor costs have been pushed to a level that prevents the construction of new houses on a scale commensurate with current requirements. In addition to the uneconomic construction costs there is the current cost of borrowing. The 6¼ per cent rate offered under the government guarantee plan is high beyond reason in view of the abundance of savings and loanable funds seeking investment outlets. It is true that private funds can be obtained at somewhat lower rates, but it is not clear that even these are as low as the current conditions justify. Interest rates at all commensurate with the low rate on long-term government bonds are simply not available for residential construction. The various parts of the interest rate structure are not sufficiently closely interrelated. Each is locked up altogether too rigidly in a water-tight compartment. In an era of easy money, the rates at points crucial for new investment have remained at uneconomic levels. The capital market is organized to handle certain types of financing, but we have not succeeded, with all our easy money, in furnishing capital at low cost at many points where new investment is most needed.

In a larger way the problem of high costs ramifies into every nook and corner of our economy. It is partly a question, as I have said, of corporate price policies. Public utilities hesitate to risk developmental rates designed to tap potential

demand. Business through so-called fair-trade regulations and neo-monopolistic practices imposes a limitation on output and employment. In the case of the railroads the failure of a thoroughgoing program of rationalization together with high labor costs prevents investment expansion. In our basic industries there is danger that continued increases in wage rates may place our cost structure in a disequilibrium position with respect to the outside world. The administration, and with it public opinion, has never faced the utter fallacy of trying to boost income, output and employment by raising costs. The question may well be asked whether certain types of federal expenditures have not in large part had the effect of boosting costs when the real purpose was to increase income and employment. We have apparently yet to learn the lesson that high *wage rates* do not of themselves guarantee a high labor income and full employment. We have too often put the cart before the horse. The all-important desiderata are total income and employment. Had governmental expenditures been combined with a planned program of cost reduction, there might have followed an expansion of income and employment not only via a stimulation of consumption, but also via a stimulation of new investment. This program we have not adequately achieved, and now that the consumption stimulus is being withdrawn, the forbiddingly high level of costs renders it difficult for investment to hold back the receding tide. Thus we are left without the necessary volume of total expenditures, whether for consumption or investment, to carry us on toward full recovery.

This is the fatal error we have made. But I must not overstate the case. For there is one other consideration that troubles me and raises uneasy doubts whether, though we had managed our affairs ever so wisely, we should even so have been safely and securely on the road to full and sustained recovery. I refer to certain technological and other conditions which in part determine the volume of investment outlets. For it is not true, as is sometimes alleged, that technological conditions have been uniformly and at all times equally favorable for new investment outlets. Not every period can be characterized as a kind of new industrial revolution. The introduction of power-driven machinery was followed by a prolonged period of difficult readjustment. In a later age, as the curve of railway construction eventually flattened out, it was discovered that there was no adequate ground for the easy optimism that plenty of promising investment possibilities would surely appear to fill the gap. In point of fact they did not appear in adequate volume, and so there ensued toward the close of the last century a prolonged period of secular stagnation. It is true that in the course of time technology gave birth to the electrical and automobile age and with it a new era of highway construction. Altogether these developments swallowed up vast sums of capital; but it is not difficult to see that this latter episode is nearing completion and, as has happened before, nothing else of equal magnitude has so far appeared above the horizon. Add to this the wholly new fact of a rapidly approaching cessation of population growth. Let the perennial optimist reflect on the enormous masses of capital that found investment outlets during the nineteenth century for no other reason than that the population of England quadrupled, that of Europe trebled, while that of the United States increased fifteen-fold. For these and other reasons we shall do well to ponder deeply the problem of the long-waves, or, if you prefer, the problem of secular stagnation, the magnitude of which may well, in the period which lies before us, quite overshadow that of the business cycle. Viewed against this background, governmental expenditures take on a new significance.

From being purely a cyclical compensatory device, designed to stimulate consumption, public expenditures may come to be used increasingly as a means of directing the flow of savings into real investment. In this connection it may not be amiss to note that the modern network of highways, unlike the old, is publicly financed and publicly owned. It is not difficult to see that a major change in the savings-investment process is already upon us. This implies, moreover, a substantial shift in the rôle of taxation and of public debt in the functioning of the whole economy.

REMARKS BY THE CHAIRMAN

PRESIDENT MITCHELL: I have the pleasure of introducing General Hugh S. Johnson, Former Administrator of the National Recovery Act, and even more widely known since his retirement from that post for various other reasons.

VESTED INTERESTS IN GOVERNMENT SPENDING

GENERAL HUGH JOHNSON
Former Administrator, National Recovery Act

MY assigned subject is "Vested Interests in Federal Spending". Difficult as it will be, because of my strong convictions to keep off other aspects of this critically vital subject of spending, I shall try to keep in this single corner.

Legally, except as they may be created by direct engagements, there are no vested interests in federal spending. Practically we have been investing classes with such interests at a slowly increasing rate from the Civil War to the World War. From the latter epoch to the New Deal, the rate of increase in vested interests went up slowly. Since 1933, the curve of increase has risen like a rocket. At least one third of the population seems now so clothed.

George Washington's kind of federal government cost this population $1.09 a head. In the seventy years to the Civil War, it did not rise above $2.50 a head. The Civil War left us our first great vested interest in governmental spending—the pension system. But, even with that, the cost of federal government per capita never rose above $8.00 until the World War.

That war left us a new crop of vested interests in bonuses, pensions and care of veterans. But from 1920 to 1932, including those and also payment of the war debt, we kept our per capita cost below $35.00. Now the lid is off—and perhaps permanently. The cost per head of the Washington government is now about $70.00 and as the depression recedes it continues to increase.

This amounts in actual spending to an increase over budget levels, before the new philosophies came in, to more than double the old bill for federal government—to the humanly inconceivable sum of five billion dollars a year or more for the "vested" interests, newly created in federal spending, than in all functions of government, formerly considered legitimate, since the beginning of our history.

It could be considered with far less apprehension if any respectable opinion believed it could be continued without eventual collapse or complete remaking of our political and economic systems. I know of no such optimistic belief which is also respectable.

What is a vested interest in federal spending? It is a very definite thing. If a principle is once firmly established in government that, in any set of circumstances, any class of people or any particular area is entitled to some benefit, then in equal justice, any other class or area in the same circumstances can justly demand the same benefit. Vested means no more than "clothed with a claim of right" and you can hardly get away from the conclusion that any kind of class spending creates a vested interest in all persons in the same class.

The danger here comes not from acknowledgment of these secondary claims against the public purse. It comes from concession of the original claim.

Mr. Roosevelt went into office with no idea of changing the essential rights and obligations between government and its citizens. I sat in at the formation of the original New Deal. I speak from no conjecture. Except in two particulars, there was no idea of any new concept of the burdens and benefits of citizenship.

We were at such an extremity that, as an emergency principle, "nobody was going to starve in this country." Beyond this the only novelty—if novelty it were—was that farmers were somehow to be accorded a "benefit" on the portion of export crops consumed at home, equivalent to the tariff benefit long enjoyed by industry.

The country seemed to approve those departures and, except perhaps the farm promise which, after all, was an offset to a special tariff subsidy applied at our very beginnings, there was no purpose to change the fundamentals governing the duty of government to people.

But many of them are changed now—changed from cellar to garret. Even the Supreme Court went out of its way to settle a century-and-a-half old controversy and decide that the power to tax is not restricted to revenue raising to carry

out the specific constitutional federal functions. At last it is clear that it may be used for anything that promotes the general welfare. That can mean practically anything at all and it will probably be held to mean whatever Congress *says it means*. It had already been decided that the taxing power need not be restricted to the object of raising revenue. It is the power to destroy. If it can be used to destroy, it can probably be used for any lesser purpose—such as to punish, prevent, restrict and regulate anything within the now infinitely broadened scope of the taxing power. What I am trying to say is that relief in the future from increases in vested interests in federal spending, if any, will have to be found at the polls and not in the courts.

With so hastily sketched a background of recent fundamental relaxations of old restrictions, we can consider some of the precedents set up, in the past four years, to create new vested interests in federal spending.

First—relief. The 1932 doctrine that, in an emergency, the federal government must see to it that nobody starves in this country is out the window. We now have the much broader Hopkins' doctrine, that this country owes every person not merely an equal chance to work but an actual guarantee of a job and that, if the economic system does not provide it, the federal government will.

That is established New Deal doctrine. It creates a vested interest whenever and wherever unemployment exists and as long as it exists. It seems to have been accepted that we must now get ready to take care of some amount of unemployment forever—and, what is still more astonishing, that this is not a duty of the local communities, not a duty of the states, but solely of the federal government, regardless of where the unemployment is, of what local conditions caused it, or of anything but the fact that it does exist.

That is vested interest in federal spending No. 1. It is overwhelmingly clever. It automatically ranges behind itself, and vests with an equal interest, not merely the unemployed themselves but the civil authorities of every state, city or county wherever they may be.

For these are charges against federal revenue; but all federal revenue comes from the states. What a "sap" any governor or mayor would be to let taxes run out of his locality to the federal government and not get back at least his own locality's just proportion in federal relief of unemployment. If he did, he would be permitting his tax-paying people to support the unemployed in distant states. Also, there would be charged up to the debit of his political administration the additional charge for whatever local taxation was needed in his own locality to take care of its own unfortunates. No local political officer could support that criticism.

Think of the implications of this system. It not only creates a vested interest in federal spending in the unemployed themselves, but it also creates a vested interest in every locality and every local official and government for its share of the federal plunder and, of course, that tends to multiply the expense.

But this system does something much worse. It binds every local government and every locality by the strongest possible bondage of arbitrary patronage to the existing federal administration. The struggle is not to get a new gift but only to get back a fair share of the federal tribute which has been taken away and which, if not so taken, could have been applied as its own taxpayers saw fit.

It binds local politics to national administration in a way that would have been impossible except for this gratuitous and unprecedented assumption by the federal government of a responsibility for local unemployment and local relief. Why, that has no warrant whatever in anything in American constitutional law, traditions or inhibitions. It is one of the most powerful, far-reaching, vicious and subversive departures in our recent history.

In addition to creating a vested interest in federal spending in the unemployed and in every local government in the country, it creates a corollary vested interest in the federal government, in the political domination of states, counties and congressional districts, in the destruction of local self-government everywhere and in the centralization and personalization of government in Washington, D. C.

That, coupled with the surrender by Congress to the executive of the constitutional power of the purse, through lump sum appropriations permitting the executive their local allocation, is one of the most dangerous developments of recent

history. It subjects not only every congressman and senator but every governor and mayor to an almost compelling domination by the national administration in power.

A good deal of the same thing is seen in the evolution of agricultural legislation. We started out to right an early inequity in our system. Tariffs automatically fail to protect the domestic price of export farm crops. The surplus had to be sold abroad at world prices. The best obtainable price for a surplus of any product invariably becomes the price of the crop. The tariff did not protect the farmer on these crops, but it highly protected the domestic price of all the industrial products the farmer had to buy. Therefore, agriculture has always been forced to buy in a protected market and sell its export crops in a free-trade market. It seemed only justice to promise it a benefit equivalent to the tariff benefit to industry or that part of any export crop consumed at home.

There were several ways to apply this principle. The 1932 election made that a vested interest—not necessarily in federal spending but in the price the consumer must pay.

But this vested interest is not only being shifted to federal spending. It is being tremendously expanded beyond its original justification. It now applies not merely to export crops but to all principal farm products. It is no longer merely a benefit equivalent to the tariff, but a more or less binding guarantee of a fixed relative farm income from all crops. It has been worked out to provide not merely a benefit differential in domestic price but a surrender to the Secretary of Agriculture of the farmer's right to plan and execute his croppage, move his product to market at will, or store or ship it at his pleasure.

Like the new federal unemployment dogma, it not only gives the farmer a tremendous vested interest in federal revenue, it gives the federal government a greater vested interest in the farmers' private economic freedom and, more sinister and subversive still, in the internal political affairs of every farm state. It practically delivers them bound hand and foot to political centralization—and perhaps perpetuation—in Washington.

Why? Because this so-called farm democracy is managed, and this tremendous federal subsidy is allocated and distributed by thousands of interested committees guided by hundreds of political county agents of the Department of Agriculture.

That vast organization and political pie-counter is represented in every farm township and is potentially the most powerful agency for patronage and politics centered on Washington executive and political control that was ever erected in this or any other country.

These two massive examples of vested interests in federal spending in exchange for federal vested interest in local political control and government are only typical of an entirely new political and economic philosophy.

The federal government moves into the Tennessee Valley to make it over by the expenditure of hundreds of millions of dollars in dams and hydroelectric installation in return for a vested interest of the federal government in the control of the internal economic and political affairs of at least four states, through a kind of economic province, responsive to executive control and called a T. V. A.

But the Tennessee is not the only great river system in the United States. If that great basin is accorded, as of right, a steam-shovel dip into federal funds and revenue to recondition the whole countryside, then, under the equitable principle of equality, we have created a vested interest in all the other great river systems. Exactly that is alleged. We are to have six other great economic provinces in some of which there are no river systems capable of development for hydroelectric power or navigation at all.

That makes no difference. If the Tennessee Valley has such a right to federal treasure, they also have a right to similar spending to offset this generosity to their neighbors. The St. Lawrence, the Columbia, the Mississippi, Missouri, Colorado, Arkansas and the Southeast outside of T. V. A.—all have a vested interest in federal spending, whether they need it or not, and incidentally must concede a similar tribute to federal concentration of political power.

These are only three outstanding instances of new vested interests lately and precipitately created by New Deal precedent and acknowledgment of federal obligation and all accompanied by a vast increase in federal political centralization and power. We also have vested interests of youths in C. C. C. and the National Youth Administration—of age and unemployment in Social Security. We have vested interests of people un-

thriftily located geographically in Rural Resettlement, and of people poorly housed in Federal Housing. Puppeteers, mummers, adagio dancers and piccolo players have a vested interest in federal theatres. About the only class that has no vested interest in federal spending is the taxpayers. The whole thing has been so swiftly and so cleverly done that the most heavily burdened of them—the millions of workers earning less than $2000 a year—have been led to approve and applaud this tremendous and growing burden on their backs—this gutting of their pocketbooks up to 20 per cent of their pitiful incomes—this appalling mortgage on their futures—they have been fooled into regarding it as something in their interest.

What are all these vested interests in federal spending going to do to us before we get through? The total federal spending from 1932 to 1937 is just under 42 billions or 7 billions average. It now is running at a rate of 24 millions a day—or more than 8 billions a year. Of the total amount of 42 billions, 16 billions is accounted as for " relief and recovery "; but that classification is almost meaningless. The accounts have been so qualified, scrambled and arbitrarily divided that about all that can be said is that whereas, before we created these new vested interests, government was costing 3.5 to 4 billions, it now costs 8 to 8.5 billions. In other words, vested interests in federal spending are taking somewhere around 5 billions a year.

What are the prospects of reduction? In my opinion, nil. Nearly all the talk of a balanced budget has centered on increased revenue due to increased business—not on decreased spending. Total spending has steadily increased, is still increasing, and many vested interests have not yet been served.

With a grave business recession there can be no increased revenue. Revenue will decrease. With probably greatly increased unemployment, and all these vested interests not yet provided for, talk of a balanced budget is as vain as hope for decreased spending.

There is an unarguable practical reason why there is no relief in sight. The political power of this administration now rests almost wholly on the creation of these vested interests in spending. The midwest farmers are congenital Republicans. They are New Dealers with their tongues in their cheeks—as long as the checks arrive and not one moment longer. The same is true of many of the unemployed and of many benefited regions.

When, if ever, those interests in spending are divested the New Deal is done. Therefore, they will not divest as long as New Dealers control government, taxation and spending.

I am not saying that many of these interests did not have to vest. I am for some of these measures and bitterly against others; but, as I understand it, I was not asked here to discuss private opinions on the merits of federal policy. I am here solely to discuss the condition as it is. It is just about the biggest and most dangerous subject in our national life, and I have not skimmed its surface—but that is all I can skim in twenty minutes.

Remarks by the Chairman

President Mitchell: The next subject on the program is one that may add to the gloom. Professor Hansen found himself under the necessity of pointing out some sad consequences of reducing expenditures. General Johnson has pointed out that, greatly as these expenditures have grown, there is little chance of reducing them. If they are not reduced, it would seemingly be necessary to increase taxes, and the horrid results that would follow from this alternative are now to be explored by a high authority.

Mr. May is one of the most distinguished accountants in this country and Great Britain, a counselor of the United States treasury during the difficult years of war financing, a man whose contributions to the literature of his own profession and of economics have been so important that his occasional papers have been republished in book form, and one who lightens the often arid literature of economics with felicitous touches for which all readers are deeply grateful. I have the pleasure of introducing Mr. George O. May.

THE CONSEQUENCES OF INCREASING TAXES

GEORGE O. MAY
Senior Partner of Price, Waterhouse & Co.

THE effects of increased taxation can hardly be discussed satisfactorily without reference to the method of taxation employed. I propose, therefore, to consider mainly the increases put into force in the last two years, some of the results of which, I think, we can already clearly perceive.

Two important aspects of the question we are considering today are: the deflationary influences of taxation, and its effect on industry and enterprise. Since our time is limited, I would merely say upon the first point that, in my judgment, any adverse deflationary (or perhaps I should say "un-inflationary") influence of financing wholly through taxation instead of partly through borrowing would, at the present stage of our affairs, be small compared with the benefit from the increase in confidence which an actual balancing of the budget would be likely to produce.

Upon the vital question of the effect of taxation on saving and enterprise it is necessary to say a little more; but before doing so, I should like to touch briefly upon other consequences of our high taxation, some of which, if less important, are perhaps also less generally apprehended.

One effect is the uncertainty and instability of the revenue. This is strikingly illustrated by the difference between the estimate made in January and that made in October of the yield of the tax system for the year now current. The percentage of difference between the two estimates of the yield of the same taxes for the same year is as large as the percentage of difference between the highest and the lowest aggregate yield of the British tax system over a period of thirteen years, and there *seems* to be reason, now, to doubt whether even the October estimate will be realized.

The notable difference between our system of income taxation and that of Great Britain is that Great Britain has refrained from raising maximum rates of tax to the levels which we have put into force—not (as the report of the Colwyn Committee makes clear) out of consideration for the taxpayers directly affected, but in the interest of the people at large. On the other hand, they have made the tax on moderate incomes much steeper than we have. I believe a readjustment of our rates along similar lines would be advantageous, and I further believe that those, like myself, who would feel the immediate burden of such a revision, would be more than compensated by the indirect benefits that would flow from a sounder and more stable tax policy.

Such a readjustment would find ample support in the writings of American economists. From the War days, when the income tax first became a serious element in our fiscal policy, I recall the insistence of Dr. T. S. Adams on the desirability of raising the tax rates in the lower brackets to much higher levels than even in that emergency the Congress was prepared to consider. Among other advantages of such a course he believed that it would make easier a downward readjustment all along the line when the emergency had passed. It was perhaps the chief merit of the Mellon tax plan that it restored a more reasonable relation between the rates of taxation in the higher and those in the lower brackets, and thus afforded a better basis for a general increase in time of need than previously existed. However, when the new emergency came the error of the earlier days was repeated, and once again the effort was made to raise the necessary revenue by taxation that would fall, at least in the first instance, on the very rich.

Other inevitable consequences of our very high rates of taxation on income are a growing complexity of the law, growing costs of administration, and a constant tendency of the tax administration to attempt to prevent evasion by the enactment of special provisions which, even if effective for the purpose designed, impose unjust and unreasonable burdens on taxpayers who have been guilty of no attempt to evade taxes. Experience has already shown that the provisions of the 1937 "loophole" law have imposed heavy burdens on taxpayers whom the treasury, probably, and Congress, certainly, never contemplated as being subject to the new provisions.

The commonly accepted justification for a highly progressive income tax is the principle of ability to pay, or, as it is

sometimes called, the principle of relative equality of sacrifice. Up to a certain point, the amount of income may properly be used as a rough measure of ability to pay; but when taxes are not merely five per cent or ten per cent, but fifty per cent or seventy-five per cent, the difference in the ability to pay represented by different types of income must be recognized or gross tax injustice will result.

The truth of this statement is sufficiently illustrated by consideration of a number of forms of income, all of which are treated on a substantially identical basis under our law—such as the income from a holding of gilt-edge bonds maturing a hundred years hence; the salary or professional income of an individual who has reached and can expect to maintain for only a short span of years his period of maximum earning capacity; the evanescent income of the artist who happens for the moment to be the popular favorite of a fickle public; or the income derived within a short period from the completion of work or studies which have occupied a period of many years.

In the congressional hearings held this spring as a result of the failure of the revenue to reach the expected level, the treasury called attention to the discrimination which results from the existence of community property laws in some states and not in others, and from the special relief provisions applicable to the taxation of those engaged in exploiting the natural resources of the country. The list could be extended indefinitely. There is, for instance, the so-called gain which reflects nothing more than a fall in the purchasing power of money.

The attempt to secure a closer approach to tax justice necessarily results in a more complex law, and this complexity further adds to the cost of administration. It is, I think, an error to measure the cost of administration of the income taxes by the amount of expense incurred by the government itself in the collection thereof, especially under a system which imposes a very large part of the work of determining the tax upon the taxpayer or upon experts employed by him. The real cost is surely the difference between the total outlay by the taxpayer, including both the tax and the expense incidental thereto, and the net amount available to the government after deducting its own expense of collection. Thus measured, the administrative costs of the tax are far from being the inconsiderable figure sometimes put forward.

Along with increased income taxes we have enacted laws imposing very high maximum rates of tax on transfers by gift or upon death, and I should like to draw particular attention to two consequences which are not, I think, adequately recognized. Both grow out of the difficulty of determining the value of a business enterprise. As I have pointed out on other occasions, the limits of legitimate difference of opinion in regard to the value of a privately owned business may be so great that in some cases taxation on the basis of the higher limit of value would result in a tax substantially in excess of the lower limit, and, therefore, in complete confiscation. May I cite an illustration I used before the Senate Finance Committee? A Commissioner of Internal Revenue valued a holding of stock originally at $47 a share, and subsequently reduced it to $12 a share, and the Board of Tax Appeals fixed it at $7 a share.

This has two results: first, that in the circumstances I have outlined, taxation becomes, in practice, taxation at the discretion of the taxing authority, subject only to such limitations as may be imposed on it by the taxpayer's right of resort to the expensive and unsatisfactory process of determination of value by courts necessarily ill-equipped for the purpose; second, the hazards of leaving a private enterprise as a part of one's estate are so great as to create a strong incentive to the elimination of this type of organization (which has in the past been regarded as the backbone of our American system) through conversion into publicly owned companies in which management is divorced from beneficial ownership. The private owner becomes a salaried employee. This tendency has developed in England; and the London *Economist* of October 9, 1937, contains an interesting discussion of some of the consequences.

I now turn to the vital question of the effect on saving and enterprise of the present high taxes on income, including the undistributed profits tax. That taxes on income, if raised to excessive levels, profoundly discourage saving and enterprise is, I take it, agreed by economists of almost every school of thought. I would quote only a single passage from an English

socialist source—the report of the New Fabian Research Bureau on *Taxation under Capitalism*. After discussing the doctrine that "all our troubles arise from an excess of saving and of fixed capital", the report says:

> The results of a failure to invest afresh, or of a failure to keep old capital efficient and up-to-date, are not easy to exaggerate. To anyone not obsessed by the entirely erroneous doctrine we have just discussed, it is clear that the ability to offer more employment and higher wages depends upon the existence of factories which are up-to-date and properly equipped, and this in turn depends upon the adequacy of the supply of new savings, and the complete reinvestment of monies set aside for depreciation. Equally, the exploitation of our increasing power over nature, and provision of employment for those set free by the increasing mechanisation of the older industries, depend alike on the investment of savings at an adequate rate in the development of those new industries which, in a progressive society, are always springing up.

High income and estate taxes have been in force in England longer than here, and their effect on saving and enterprise can be observed there more clearly. Apparently they have affected both the amount of savings and the form of investment sought by the saving that is made. Colin Clark reaches the conclusion that the sources of new capital there are now practically reduced to undivided corporate profits, institutional savings (by building associations, insurance companies, etc.) and governmentally provided capital. The change from saving by the well-to-do to institutional saving has naturally resulted in an increased demand for prior charge securities in established companies and a reduced supply of capital for investment in equities and new undertakings. From the standpoint of the people as a whole, this change is regrettable.

How high taxes may be put without exerting a restrictive effect that is seriously prejudicial to enterprise is a question on which disagreement no doubt exists. I am among those who would put the limit higher than many others; but I think no one can study the English evidence, including that presented before the Colwyn Committee or the report of that Committee, without being convinced that we have reached and passed this danger point in our taxation.

In its approach toward a more nearly balanced budget, the administration in its original estimates anticipated in the year now current a yield of approximately three billion, four hundred million dollars from income taxes. This large estimate was predicated on the expectation that the new law would force within the ambit of the personal income tax a large, probably an unwise, distribution of corporate profits; but it also rested fundamentally on the expectation of larger profits. If that expectation was to be realized, and the administration's other recently reiterated objectives of increased wages, shorter hours and lower prices were also to be attained, the result could only be achieved by a large increase in production, which, if we take any but the shortest of views, must imply a large investment of capital in new enterprise. I believe that today enterprise is greatly discouraged by the existing level of income taxation, and by a widespread feeling that this taxation is neither just nor justly administered.

In the last paper on taxation which he wrote, the late Dr. T. S. Adams, after an allusion to Adam Smith's four canons of taxation, said: "Taxes should not only be equal, certain, economical, and convenient, but they should be temperate. Personally, I should assign more practical importance to certainty and temperance than to equality." Without attempting to decide the question he raised, we can at least agree that the higher taxes are, the more important it is that they should be certain and equitable. Doubtless in a great emergency even these qualities may have to be sacrificed to necessity and immediate productivity. But, if our present system of income taxes, which are extremely high, manifestly unjust in many respects in operation, and uncertain in administration, was justifiable on the ground of absolute need at an earlier stage of the depression, surely the time has come when the defects should be remedied.

That the income tax law (which includes the undistributed profits tax) is unjust in concept can scarcely be denied, in view of the provisions which tax capital gains while making only nominal allowances for capital losses, and which subject to the regular income taxes and the undistributed profits tax the gains of profitable years without regard to the losses of the unprofitable years.

Few, I think, realize with what harshness the present taxes fall on corporations whose operating results fluctuate at all

widely. I was looking, a few days ago, at the figures of a company formed in 1927 to combine two comparatively small businesses in the capital goods industry. In the ten years that have elapsed, it had had six profitable years, during which its income amounted to a little more than three million dollars, and four unprofitable years, in which its losses had totaled just about two million dollars. I asked one of my tax associates how the company would have fared if the present taxes had been in force for the ten years and if it had reserved enough profits in the good years to meet the losses of the bad, and had paid out all the remaining profits, after taxes, by equal annual dividends over the decade. His answer, when he worked it out, was that of the net profits of, roughly, $1,050,000, over $450,000 would have gone in income tax and no less than $525,000 in undistributed profits tax, leaving less than $75,000 or $7,500 a year, available for distribution to stockholders. This is neither an exceptional nor an extreme case; and not even that hardy optimist, the American business man, can be expected to enter a game in which the odds are so heavily against him.

It should be observed that these adverse effects fall most heavily on industries which require large investments in capital equipment.

If I may resort to analogy, it seems to me that the administration originally contemplated that the race against the forces of depression would be a relay race, in which government spending would carry the baton for the first lap and private industry for the second. In relay racing, smoothness in the transfer of the baton is of vital importance. Unfortunately, as it seems to me, the administration at the critical moment allowed its attention to be distracted to other objectives, and in the enactment of the undistributed profits tax law took a step which threw industry out of stride and caused confusion, in which the baton was dropped, with the result that the forces of depression regained much of the advantage which had been wrested from them. The question, now, is whether the administration will adhere to its original plan and take steps to aid industry to make up the ground that has been lost, or whether it will attempt to carry the baton through the second lap itself. I hope it will choose the first of these alternatives.

This seems to me to involve, among other things, the repeal or substantial revision of the undistributed profits tax law. There has never seemed to me to be any reason to regard that law as a valuable producer of revenue, nor has it seemed to me to be a suitable instrument for producing such redistribution of the national income as may be deemed desirable. I am convinced, however, that it has discouraged, is discouraging, and will continue to discourage employment and the production of income. It seems to me to have no proper place in the fiscal scheme of an administration whose first concern is to add to the well-being of the less prosperous of our people, for their position can only be improved materially and permanently through increased employment and increased production.

Remarks by the Chairman

President Mitchell: The fourth paper on our program, " Will Revenues Be Adequate to Balance the Present Scale of Expenditures and to Keep It Balanced? ", will be presented by Professor Roy Blough, Professor of Economics at the University of Cincinnati.

Professor Blough has been a statistician with the Wisconsin Tax Commission; more recently he has been one of the advisers of the federal treasury. Through long professional occupation with problems of public finance, he is admirably equipped to discuss this problem which involves in a sense the summing up of the two sides of the federal budget that we have already heard discussed, expenditures and taxes. Professor Blough!

WILL REVENUES BE ADEQUATE TO BALANCE THE PRESENT SCALE OF EXPENDITURES AND TO KEEP IT BALANCED?

ROY BLOUGH

Associate Professor of Economics, Graduate School of Public Administration, University of Cincinnati

MAY I preface my remarks by saying that no work that I have done with the federal treasury has been concerned with the problem that I am about to discuss. To venture a definite forecast in answer to the question put by the assigned subject would be indeed foolhardy, especially in view of the frequently large errors in the estimates of treasury experts. Forecasting is based on statistical regularity. The operations of the present economic order, and especially of the tax system in the economic order, are subject to wide variations from any regular pattern and are increasingly controlled by the unpredictable decisions of a relatively few persons within and outside of government. Less hazardous than forecasting is the attempt to analyze some of the factors that affect federal revenues and the probable operations of those factors under different sets of reasonable assumptions. Such is the task undertaken here.

The wording of the subject involves three questions. (1) What is meant by " adequate to balance . . . and to keep . . . balanced "? (2) What is the " present scale of expenditures "? (3) What will the " revenues " be?

The first question is one of definition. The term " adequate to balance . . . and to keep . . . balanced " cannot mean " balance only occasionally ". It might mean " balance every year ". If this is the intended meaning, one may say with almost perfect safety that the revenues will not keep the present scale of expenditures balanced unless there are not going to be any more major depressions. However, the term probably refers rather to balancing over a period of years, more particularly over a business cycle. The question then is, will revenues on the average be equal to the present scale of expenditures?

The second question—what is the "present scale of expenditures"?—necessitates the definition of "present" and of "scale of expenditures". Does the word "present" mean the estimates for fiscal 1938 in the President's budget statement of October 18 or the actual expenditures recorded in fiscal 1937 or an average of expenditures for the past few years? The estimates for fiscal 1938, which are substantially less than expenditures in fiscal 1937, can scarcely be accepted at the present moment as the present scale, since they may or may not be realized. Average expenditures are a safer basis. There is little difference in amount between a two-year average of expenditures for 1937 and 1938, and a three-year average for 1936, 1937 and 1938. The three-year average of 1936, 1937 and estimated 1938 is accepted here as the most usable meaning of the word "present", in the absence of a more satisfactory basis.

Several questions arise in defining "scale of expenditures". The first of these is whether the amount appropriated for statutory debt retirement or the amount actually paid should be included as part of the scale of expenditures. Neither item is included here chiefly because, by omitting debt retirement, any surplus or deficiency of revenue has a more clear-cut meaning. Two other considerations support this position. One is that inclusion of statutory debt retirement sets up a rate of payment—approximately 2.5 per cent a year—which may be greater or less than is most desirable. The other is that, beginning as early as 1936, part of the appropriation for statutory debt retirement was not actually applied to that purpose. In 1937 only $104,000,000 of an appropriation of $572,000,000 was so applied, while the estimated debt retirement for fiscal 1938 is $200,000,000. The appropriation is meaningless when it is not followed.[1]

A second question to be decided in defining the scale of expenditure is whether federal loans to individuals, organizations or governmental units should be included. In fiscal 1937 repayments of such loans exceeded new loans by $243,000,000,

[1] Expenditure and tax figures for 1937 and estimates for 1938 presented in this paper are from President Roosevelt's budget statement of October 18, 1937, and from the annual budgets; figures for preceding fiscal years are from the reports of the Secretary of the Treasury and from the annual budgets.

while in 1938, loans are expected to exceed repayments by $140,000,000. Since the disbursements are loans rather than governmental cost payments, and the amounts of loans and repayments may be expected to vary greatly from year to year, neither loans nor collections are included here. Greater accuracy would be achieved by counting as expenditures an annual charge for uncollectible loans made, but this has not been attempted here.

An amount equal to "miscellaneous receipts" is also deducted from the expenditures in order to eliminate from the scale of expenditures those that are financed from other sources than taxes or loans. The amount of such receipts estimated for fiscal 1938 is $210,000,000.

A further problem of deduction grows out of the fact that payroll taxes under Title VIII of the Social Security Act and the taxes on carriers and their employees are being invested in the old-age reserve account and the railroad retirement account respectively. The most desirable method of handling these items appears to be to treat them, in effect although not in law, as trust funds, eliminating both taxes and investments, as well as benefit payments, in arriving at the present scale of expenditures financed from general taxes.[2] The elimination is of little significance except that the scale of expenditures would otherwise have to be changed year by year as the yield of the taxes increased. The Social Security Act does not require tax collections to be invested in the old-age reserve account but any other course would be essentially dishonest, since the taxes are publicly proclaimed as being for old-age insurance and are of a type not suited for financing general governmental functions. The federal share of the payroll tax under Title IX of the Social Security Act, which tax was imposed to encourage adoption of unemployment compensation systems, is not deducted, since no trust fund is established for its investment.

In fiscal 1938 the estimated investment in the old-age reserve account is $425,000,000 and in the railroad retirement account $138,000,000, a total of $563,000,000.

[2] The hope that they may remain inviolate is rudely disturbed by recent proposals to use the old-age reserve account as a guarantee fund or otherwise in stimulating business.

Other factors deserve consideration although neither deduction nor addition has been made on their account. The first concerns interest paid, which is estimated at $925,000,000 for fiscal 1938. In 1936 the average computed rate of interest was 2.6 per cent while in 1929 it was 3.9 per cent or one half higher. An increase in interest rates from current low levels might substantially increase interest charges on approximately one half of the debt since it matures in the next few years.

The second problem is raised by undertakings of the federal government that will increase its expenditures from year to year. For example, the federal government has offered to match state payments for aid to the aged, aid to the blind, and aid to dependent children. The grants to states for these purposes totaled $144,000,000 in fiscal 1937 [8] and will almost certainly increase as more states adopt approved programs and as standards of payment in low level states increase. Somewhat similar are the congressional authorizations for various purposes, such as construction of public works, which authorizations have not yet resulted in appropriations but will so result in the normal course of events.

Still another factor concerns the fact that expenditures in dollars would fluctuate if the present policy of expenditures were kept stable, since recovery and relief needs as well as other demands run in cycles. A similar problem is met in changes in the price level. Since changes in the national income, discussed below, might arise from changes in the price level, there may be some question whether it is logical in this discussion to hold to a present level of dollar expenditures rather than a fluctuating level based on stable expenditure policies. However, the uncertainty of knowing what such policies are, or of applying them when known, probably makes any such computation impracticable.

The position taken here is that since Congress can, if it chooses, hold total expenditures at the present scale in dollars by decreasing some appropriations as others are increased, the factors just discussed should be disregarded in estimating the present scale of expenditures.

[8] Social Security Board, Bureau of Research and Statistics, *Selected Current Statistics*, August 1937, pp. 86-87.

The calculation of estimated net expenditures to be financed by general taxes (or loans if taxes are inadequate) in accordance with the foregoing discussion is as follows for fiscal 1938:

		Millions
Total estimated expenditures		$7,545
Deduct: Debt retirement	$200	
Revolving funds	140	
Miscellaneous receipts	210	
Payments to old-age reserve account	425	
Payments to railroad retirement account	138	
Total deductions		1,113
Estimated net expenditures		6,432

A similar computation in which payments on account of the soldiers' bonus were also deducted gives $7,200,000,000 net expenditures for fiscal 1937, while a computation on substantially the same basis for fiscal 1936 gives $6,700,000,000. An average of the three years is very close to $6,750,000,000, and this figure is only a little less than the average of 1937 and 1938. Accordingly, $6,750,000,000 is accepted as the present scale of net federal expenditures that customs and internal revenues must equal if the budget is to be balanced and to stay balanced.

The third question involved in the subject of this paper is, what will the revenues be? Presumably by "revenues" is meant the revenues now provided by law and not revenues that might be raised through measures increasing taxes. The existing revenue system is too well known to require description but it may be recalled that it is a far different system from that existing in 1929 as a result of taxes added or strengthened in 1930, 1932 and every year thereafter.

To bring the definition of revenues in harmony with the expenditures definition some eliminations must be made. Items to be excluded are: repayments to the government of loans made by the R. F. C. and other agencies; social security payroll taxes under Title VIII (for old-age benefits); and receipts from the states for deposit in the unemployment trust fund. With these eliminations the problem may be stated as follows: given a net annual expenditure of $6,750,000,000, will existing revenue laws, operating unchanged during the next few years, yield an average of that amount, plus, of course, enough to pay interest on any deficits incurred?

After the deductions previously mentioned have been made, the revenue produced by the tax system in 1937 was nearly $4,900,000,000 and is officially estimated to be about $5,800,-000,000 in 1938. That the system is extremely productive is evidenced by the fact that if the $5,800,000,000 is realized, the general tax revenues will be the highest in federal history, the previous record being $5,700,000,000 in 1920. Including the social security and railroad retirement taxes the yield will, of course, be substantially more than that record. The expected $5,800,000,000 from general taxes is nearly twice as much as the net federal expenditures of 1930. Yet, despite its expected record volume the 1938 revenue will be nearly $1,000,-000,000 less than the average $6,750,000,000 scale of net expenditures (from taxes and loans) for the past three years.

The hope of balancing the present scale of expenditures rests, therefore, on the possibility that improved business conditions will increase the revenue by about $1,000,000,000. That this may occur is by no means inconceivable. The federal revenue system is very sensitive to business fluctuations. The variations in its revenues are much greater than those of the national income. Although there are some very stable revenue sources, income, estate and gift taxes, which are notably variable in yield, are the major elements in the federal system; they are expected to produce 55 per cent of the $5,800,000,000 total for 1938.

The variations in the probable yields of the tax system are indicated in tax estimates appearing in the Twentieth Century Fund publication, *Facing the Tax Problem*.[4] For a year of deep depression such as 1933 it is there estimated that the system will produce not more than $3,100,000,000; for a year of moderate prosperity such as 1924 about $4,900,000,000; and for a year of great prosperity such as 1928 about $8,200,000,000.

The estimate of $8,200,000,000 for a year such as 1928 must be used with some degree of caution since it includes $1,300,-000,000 of tax on capital gains. The capital gains of 1928

[4] Carl Shoup, Roy Blough, and Mabel Newcomer, *Facing the Tax Problem* (New York, 1937), chap. 8.

may recur rarely, if ever. Furthermore, it seems highly unlikely that if the tax rates now imposed had been in effect in 1928 the volume of realized capital gains would have been as large as it was. Finally, any continued period of high income would not show continued high capital gains, since prices of property and stocks would become adjusted to the new levels. A later publication of the Twentieth Century Fund accepts $7,000,000,000 to $7,500,000,000 as the probable yield of the present tax system at a national income level of 1928.[5]

Thus, it appears that in a period of high incomes, such as 1928, the revenue system would yield a surplus of approximately $750,000,000 over the present scale of net expenditures. At the 1924 level of business the deficit would be nearly $2,-000,000,000, and at the 1933 level over $3,500,000,000, despite the fact that even for that year the estimated revenues would have more than balanced the net expenditures of the pre-depression years.

The question may be asked, at what level of national income will the revenue system balance the present scale of expenditures? This question cannot be answered with any satisfactory degree of accuracy because the yield of the revenue system is affected by many factors besides the volume of the national income. The distribution of that income is of great importance because of progressive income tax rates. The extent to which income is earned through corporations is significant since special taxes are imposed on them. The rates of interest used in capitalizing future income into present capital values are important, for estate and gift taxes are applied to these values. The expenditure of the income is important since some articles, notably liquor, tobacco, automobiles and imported goods, contribute largely to federal taxes while most other articles are not taxed. Only if the patterns of distribution, expenditure, etc. are the same at all times when national income is at any specific level—a situation that probably does not exist—can satisfactory calculations of tax yields at different income levels be made on the basis of past years. Another problem is choosing between national income produced and national income paid out, since the ratios between them vary.

[5] P. W. Stewart, R. S. Tucker, and Carolyn Stetson, *The National Debt and Government Credit* (New York, 1937), p. 145.

Part of the tax falls on producers and part on income recipients. Figures of income produced are used here.[6]

Only by working from figures for the bases of the different taxes can satisfactory estimates be made. However, if it be assumed that future income distribution and other patterns will be the same as those of the past, a rough interpolation of tax yield figures can be made on the basis of national income. From estimates previously mentioned, and examination of other data, it is estimated that when the national income is approximately $75,000,000,000 the present tax system will yield $6,750,000,000. The national income produced for the calendar year 1936 is estimated by the Department of Commerce at $63,800,000,000 while the tentative estimate for 1936 is $70,000,000,000. The income for 1928 was approximately $80,000,000,000. Thus, if the accepted estimates are correct —and their tentative and approximate nature cannot be too strongly emphasized—the revenues will balance the $6,750,000,000 expenditures, in case national income rises another $5,000,000,000, or to halfway between the 1937 and the 1928 levels.

It was pointed out earlier that to balance and to keep balanced does not mean to balance occasionally. What probability is there that the average national income for the next five or ten years will equal or exceed $75,000,000,000? This question is highly debatable and to answer it would be foolhardy. The experience of the past fifteen years, however, is at least interesting. The average national income for the fifteen years, 1923 to 1937 inclusive, was about $65,000,000,000. The first seven years were years of high income with an average of slightly under $77,000,000,000. The average for the last eight years was $55,000,000,000. If the next few years are like 1923 to 1929 the revenue system should at least balance the $6,750,000,000 expenditure level. If the next few years are like the average of 1923 to 1937, revenues will probably be deficient by more than $1,000,000,000 annually. If the next few years are like the average of 1930 to 1937, revenues will probably be deficient by substantially more than $2,000,000,000

[6] Income calculations are based on Simon Kuznets, *National Income, 1919-1935*, National Bureau of Economic Research, Bulletin 66, September 27, 1937, p. 2, and on Department of Commerce estimates for 1936 and 1937.

annually. Only if the next few years are better than the average of 1923 to 1929 is there likely to be much surplus, above the $6,750,000,000 scale, to apply toward debt retirement.

In the previous discussion the point of view accepted has been that investments in reserve accounts, such as the civil service retirement and disability fund, and the old-age and railroad retirement reserve accounts, are as much a part of expenditure as are cost payments. Investments in the old-age and railroad retirement reserve accounts are financed by special payroll taxes and have been excluded along with those taxes as trust funds in order to avoid a varying figure for the present scale of expenditures. Some writers have suggested that economically the investments in the reserve accounts are not true expenditures. If this point of view be accepted the budget is not far from balanced economically at the present time. If the social security and railroad retirement payroll taxes are included in revenue the estimated tax revenues for fiscal 1938 amount to $6,400,000,000,[7] or almost exactly the estimated net expenditures for the year.[8] As the yield of social security payroll taxes under the existing act will increase rapidly, due to increasing rates, their inclusion in the total revenue should bring it to the $6,750,000,000 level in the near future at the present national income level.

Any budget balance achieved by counting the payroll taxes and not counting investments in the old-age reserve account, however, can be only temporary since benefit payments would have to be counted as expenditures and would increase rapidly within a few years, thus raising the scale of expenditures increasingly above the $6,750,000,000 level. The maximum excess of estimated taxes over estimated benefits is about $1,300,000,000 [9] or somewhat over the amount needed in addi-

[7] Relatively minor adjustments need to be made in expenditures for disbursements from the railroad retirement account, and net investment in the civil service retirement and disability fund, but the effect of these is unimportant.

[8] The effects of receipts from states for investment in the Unemployment Trust Fund are not considered to be in the same class as the payroll taxes for old-age benefits, since the excess of receipts over withdrawals will rapidly decrease and may be replaced by an excess of withdrawals especially in some years.

[9] Paul Douglas, *Social Security in the United States* (New York, 1936), p. 167.

tion to estimated 1938 general tax revenues to balance a $6,-750,000,000 scale of expenditure. After that point is reached benefits would increase and eventually exceed payroll taxes.

One factor that has not been considered thus far in this discussion is the possible effect of the federal taxes themselves on revenue yields. Can the federal government expect to continue to collect the present or a larger volume of revenue, or are the weight of taxes and the tax structure actually destroying the tax yields for the future?

In one sense the undistributed profits tax has this effect since it tends to result in collection in the present of personal income taxes that otherwise would be collected in future years. This results from pressure on corporations to pay dividends in the year in which earned instead of accumulating earnings and distributing them in later years.

The criticisms, however, go much beyond this. Many taxes have been condemned on the ground that they destroy industry. Just now the principal criticisms are brought against the capital gains, undistributed profits, and even the payroll taxes. On the other hand is heard the contention that the present level of national income has been reached because of a large federal spending program, financed by borrowing, and that with the end of the federal borrowing from the public the national income will sink back again to lower levels. These hypotheses and criticisms, although immensely important, are difficult to appraise, and little convincing quantitative evidence either proving or disproving them appears to have been developed. Certainly they contain elements of possible danger to the national economy, but certainly also the current business recession with its numerous and complicated possible causes is not convincing evidence that the taxes are resulting in a decrease in the taxable base. In any case, for the present purpose, the effects of the taxes, whatever they may be, would be reflected in the amount of national income and need not disturb the previous estimates, although they affect the possibilities of attaining and maintaining a sufficiently large national income to achieve a balance.

In a somewhat different category is the effect of the social security payroll taxes on general tax yields. The payroll taxes

will logically reduce the amount yielded by the other taxes, but the amount of the effect is probably not calculable.

Returning to the question put by the subject: "Will revenues be adequate to balance the present scale of expenditures and to keep it balanced?", it may be said in summary that if the estimates made above are reasonably accurate—and their frailties must be emphasized—the next few years will need to be years of national income substantially above that of 1937 and similar to the average of the prosperous years from 1923 to 1929, if the revenues are to balance and to keep balanced net expenditures at a $6,750,000,000 level. On the probability of that occurring no opinion is expressed.

Remarks by the Chairman

PRESIDENT MITCHELL: The discussion of the four interesting papers to which we have listened will be opened under the ten-minute rule, by Dr. James Harvey Rogers, Professor of Political Economy in Yale University.

DISCUSSION: THE FUTURE OF THE FEDERAL BUDGET

JAMES HARVEY ROGERS
Sterling Professor of Political Economy, Yale University

WHEN I was asked to speak at this session of the Academy's annual meeting and to tell this group of budget experts what was the matter with each of their papers, I protested vigorously. Certainly I am not in a position to talk primarily about budgets. However, I agreed to come this afternoon on the condition that I might say something on the general subject of budgets in the present situation, and particularly on " Government Spending and Inflation ".

Inflation in the United States may be regarded as composed of two distinct parts which are frequently confused:

(1) The increase in the reserve of our banks, upon which all our credit structure rests.

(2) The utilization of *excess* reserves for inflationary purposes.

The first part represents *potential* inflation only; the second represents *actual* inflation. With this division of the subject in mind, and with emphasis on the *actual* inflationary influence, government spending may be divided into three distinct categories: (a) pure inflationary spending; (b) non-inflationary spending; and (c) deflationary spending—that is, deflationary on net balance, as I shall attempt to describe below. These three categories of government spending it will be my purpose to describe as carefully as I can.

Pure inflationary spending is perhaps best exemplified by the activities of the W. P. A. Through its operations, government funds were turned over to ready spenders who otherwise would have had nothing to spend. Moreover, a large portion of the funds thus handed to ready spenders was raised by purely inflationary financial devices. Let me be explicit. These new funds, at least in major part, were borrowed from our banks through the sale to them of government securities. Thus the investments of the banks were increased and deposits

expanded by an almost equal amount. These new deposits in turn were used in paying the relief workers who thus came into funds which they used speedily in purchasing consumers' goods. Thus, literally out of thin air, were created new funds; these new funds were turned over to ready spenders; and these ready spenders spent them. This is what I call pure inflation. Note carefully, that these new funds thus raised and handled did not—as in the case of business spending—give rise to any additional production of goods or services; and consequently the resulting increase in spending was for *existing* supplies and the *current production* of goods *unincreased by the placing of the new funds in the hands of spenders.* Hence the effect of such spending is apt to be largely on prices rather than on production.

Non-inflationary government spending is of an entirely different character. The most familiar example is that of a country whose budget is in balance. Currently it is collecting funds, currently it is spending them. If its budget is in balance, it is taking from spenders the same amount that it is turning over to spenders. Consequently no effect on prices, and neither inflation nor deflation, is occasioned by the government spending.

I can now describe what I mean by *deflationary government spending.* Certainly no spending is of itself deflationary. However, on balance, government spending, as now, may frequently be deflationary. What I mean is this. While our government is during this fiscal year running a deficit of $695,000,000, its expenditures *on balance* are actually deflationary. The reason is as follows: at the same time that our government is turning over to spenders $695,000,000 more than it is taking in simultaneously in the form of taxes (and of loans by investors), it is actually taking in an even larger sum than this big deficit in the form of payments under our Social Security Act and in certain other minor ways. Moreover, the great bulk of these payments is taken in from very ready spenders. Hence the net deflationary influence is measured by approximately the difference between these social security contributions and the net budget deficit. This difference is now estimated for the fiscal year 1937-38 at approximately $370,000,000.

Some of you will ask however: What about business spending? Is this not much more than enough to make up the small deficit in government spending? The answer is: It has been—until the past few months. Since last June, however, there has been a rapid falling-off of capital flotations—the chief source of sustained buying of producers' goods—and since March a marked, though less rapid, decline in bank loans and investments. Not only is the deficit in government spending no longer being made up by business spending, but the deficit in one is being aggravated by that in the other.

What then is to be done about it? If I were determining the policy, I should patch up the economic system where it seems to be breaking down. To eliminate the shortage in business spending (there is still no substantial shortage in consumer spending) I should try to rebuild the capital market. To accomplish this, I should operate along three different lines.

1. I should remove all unnecessary expensive and time-consuming restrictions on the flotation of securities. This does not mean that we should return to pre-depression policies and the resulting abuses. Certainly few thoughtful citizens desire that. It is of great importance however that it be made easier, less expensive, and less risky for our investment houses to begin again to operate effectively.

2. I should try to give investors a greater incentive to save and to invest. This could be accomplished by allowing them to keep a larger portion of their capital gains. In my opinion, the consistent saver and investor is one of the most worthy and commendable persons in our society. On his activities depends nothing less than the continued growth of our national wealth and income. I should like to see his importance to the economic system recognized by giving him greater income tax concessions on capital gains than on other income.

3. I should try to give business a greater incentive to expand. One device for accomplishing this would be, at least in depression, to reduce substantially the undistributed earnings taxes on all funds actually used for plant or equipment during the current year. In addition unnecessary restrictions on various types of business resulting from hasty legislation during the past few years could be removed. These and other devices all directed to the end of making it *easier*, less *risky*, and more *profitable*, to *float*, to *own*, and to *issue* new securities would do much to reëstablish our capital market. In my opinion

it is no less than a *calamity* for the United States, the richest country in the world, and the one where savings are most abundant, and industry most productive, to be forced to run along for years without a thoroughly effective capital market through which the savings of its people can be turned quickly and without friction into current economic welfare and into continued growth of national wealth.

Funds coming through the capital market, however, are always slow in producing their effects, and in the present case where it is necessary first to rebuild the capital markets themselves, they are apt to be even slower. Under the circumstances therefore, and temporarily, I should resort again to government spending. This time, however, I should certainly not do it on a W. P. A. basis, but on a P. W. A. basis. The slump started and is developing most rapidly in the capital goods industries. Hence, I should see to it that the impact of the new spending be upon such industries. In other words, what is needed is a temporary public works program; and after our recent experience in this field there is no reason for repeating the errors of the past few years.

A public works program *par excellence* is a big armament program. In its prosecution not only would the greatest purchases be made from the heavy industries which are suffering most in the current slump, but also the resulting output would have the additional advantage of not competing with that of any private business. Furthermore, in the present state of the world, it seems to me that such a program would soon be regarded by peace-loving people as just as constructive as the one already in operation in Great Britain. For the great democracies which, with associated countries, continue to control 80 to 85 per cent of the economic system of the world to remain pacifist long enough to make it possible for them to be forced into war by a small group of irresponsible militarists, temporarily in power in countries which control not more than 20 per cent of the world's resources, seems to me an absurd policy. A vigorous and speedy rearmament program on the part of the United States would in my opinion do more to blast this fantastic situation and assure peace than anything else that could be added to the program already under way in Great Britain.

Remarks by the Chairman

President Mitchell: That completes our formal program. We now have half an hour for discussion from the floor, under the five-minute rule, which I am in duty bound to enforce strictly.[1]

[1] Space limitations make it impossible to print in these Proceedings the interesting discussion by several members who spoke from the floor under the five-minute rule.—Ed.

PART III

EXPENDITURES OF THE FEDERAL GOVERNMENT

INTRODUCTION *

S. PARKER GILBERT, *Presiding*
Of J. P. Morgan & Co.
(Member of the Treasury War Loan Staff, and
Assistant Secretary and Under Secretary of the Treasury, 1918-1923)

A WISE MAN once said that everything sooner or later comes down to a question of finance. This truth has been impressing itself more and more upon us during the past year, as one thing after another comes home to roost. And so we have dedicated this Annual Session of the Academy to a study of the finances of the Federal Government.

In order to clarify discussion we have deliberately chosen to speak in terms of controlling expenditures rather than of "balancing the budget", which has become such a slogan and is used so blindly that it often confuses thought. Of course, the budget ought to be in balance, income against outgo, with a sufficient margin each year to allow for the sinking fund and other statutory debt retirements. That is the first rule of sound public finance. But the budget of a country like ours cannot be considered in a vacuum apart from the life of the country itself. In a great war, for example, where national existence is at stake, no one questions the expenditures necessary for the winning of the war, and the resulting deficit has to be financed. So also, in a great national emergency, as in the last depression, the national credit has to be used for the time being to fill the gaps in private spending and private credit. When the

* Introductory Address of the Presiding Officer at the Third Session of the Fifty-seventh Annual Meeting.

emergency is over, the first and most significant stage of budgetary recovery is the end of deficit financing, when cash income and cash outgo are brought into balance. That stage we now appear to have reached, after seven successive years of deficits.

The national credit, if it is to be kept good for the time when the country most needs it, must not be abused. It is the most precious of all national resources, and the best protection against national emergencies. But it is sensitive and can be impaired if, for example, it appears that expenditures are getting out of control or are being made on a scale or for purposes which shock the public conscience. Constant vigilance must, therefore, be maintained to make sure that expenditures are brought back within the available revenues at the earliest possible moment after the emergency has passed.

This was done after the Great War when expenditures were brought down from nearly seven billion dollars in the fiscal year 1919-1920 (which to the Treasury represented the first full year after the peak of war expenditures) to about four billion dollars (including statutory debt retirements) in the fiscal year 1921-1922. Federal expenditures were, in fact, held down to around this level for the next five or six years, due largely to the work done by the Bureau of the Budget under the inspiration of its first Director, General Dawes, and to the effective coöperation of the Executive and the Congress, who actively competed with each other to reduce expenditures to the lowest possible level.

Unfortunately the same results were not accomplished after the depression, and it is this situation which has been giving rise to concern. Leaving out of account statutory debt retirements and the large special payments for the soldiers' bonus, federal expenditures in the last two fiscal years, 1936 and 1937, averaged about seven billion dollars a year, with 1937 expenditures rising to a total of nearly seven and one half billions. In other words, expenditures have grown to nearly twice their pre-depression level, and have been showing signs of getting out of control. The net federal debt, including guaranteed debt, has increased from about sixteen billion dollars in 1930 to about thirty-nine billions in 1937. Expenditures which were started to meet emergencies have been fastening themselves

on the country as fixed charges. Vested interests have been created which are growing more and more insatiable in their demands. And the size of the federal establishment itself has passed all records. The "appetite has grown by what it fed on", and unless checked these constantly mounting expenditures threaten to devour the country's substance.

This fiscal year has seen a reversal of some of the most threatening tendencies, and more progress, I think, is being made than most of us realize. The Secretary of the Treasury has long been exercising the influence of his great office toward bringing federal expenditures under control, and with the support of the President he has been able to check many new demands for expenditure, and to obtain important reductions in other fields. This is no easy task, with habits of spending as deeply ingrained as they are. It is in fact a continuing task of the first magnitude, and the Treasury's determination to bring expenditures under control offers real grounds for encouragement, not only in itself but also because it is matched, I believe, by a growing determination in Congress and still more among the people of the country to put an end to extravagance and reckless expenditure. This determination is growing as the burden of taxation is increasingly felt and it is realized that the Government has nothing to spend except what it gets from the pockets of the people, that all expenditures sooner or later have to be paid out of taxes, and that inflation would represent the cruelest possible form of taxation, imposing its burdens on those least able to bear them in the form of increased costs of living.

The most significant thing thus far this fiscal year is that Treasury cash income and cash outgo are coming substantially into balance, after taking into account the receipts from social security taxes, which, whatever the demerits of the law, do represent cash receipts to the Treasury. This means, if continued, the end of deficit financing, and thus the disappearance of the only real threat of inflation to which the country has been exposed. The fear of inflation, paradoxically enough, is itself deflationary, and if that fear can be eliminated by firm Treasury control of the budget and at least a balance of cash income and outgo, the result will be to provide a new basis of confidence for that revival of private business activities which is necessary in order to take the place of the artificial stimulation which has been for so many years provided by abnormal Government spending.

For the same reasons, and to avoid deflation, it seems to me time that the Federal Reserve System, and the Treasury itself, should take note of the cessation of deficit financing and relax the series of deliberately deflationary measures which were put into effect in 1936 and early 1937, and which are still operating (though the reason for them has ceased) to deflate not merely the country's banks and business activity but also agricultural prices and general employment. In other words, we want neither inflation nor deflation, both of which are harmful to the welfare of the country and to be avoided.

The Administration, I believe, should also bring to an end at the earliest possible moment the uncertainty as to the value of the dollar, by renouncing the present power to make further changes and confirming the value fixed in January 1934, which, if deficit financing has ceased, should be able to stand the further test of time. This year, for example, the structure of business and prices has been repeatedly disturbed by the continuing uncertainty about the value of the dollar, first from fear that the gold price would be reduced and recently from fear that it might be increased. The resulting fluctuations in commodity prices and in the attitude of businessmen of all kinds toward inventories, purchases, and commitments for new business have been depressing and deflationary, and are responsible in considerable part for the present business recession. The great community of industry and commerce has been badly whipsawed in the face of this fundamental uncertainty, which should be promptly removed, so that they may again be able to plan for the future.

The progress thus far made in balancing the cash budget must not be allowed to obscure the vital importance of more effective control and further curtailment of expenditures. Even now, on the basis of the Treasury's latest estimates, the Federal Government will be spending this fiscal year at the rate of around seven billion dollars. This is far too heavy a burden for the people to bear. It is gradually lowering the general standard of living, and as the Government takes to itself in taxes more and more of the country's annual produc-

tion, less and less, whether they realize it or not, is left for the people as a whole. The first principle, therefore, is that no additional taxation should be levied, and that further progress should be made by curtailing expenditures rather than by new taxes. The opportunities for curtailment have barely been touched. The task which remains can be accomplished, but it requires in the first place constant Executive pressure through the Treasury and the Bureau of the Budget to bring down to reasonable figures the expenditures of the Executive Departments and the spending agencies. It requires a willingness in Washington, and a determination in the states and municipalities, to return to our best traditions of local self-government and local self-reliance. It requires self-denial on the part of those vested interests in spending which have grown so great in recent years. Above all, it requires the active interest and support of the great body of the people for the efforts which the Treasury and the Executive make in the direction of real economy. There are still vastly more taxpayers, direct and indirect, than there are beneficiaries of Government payments; and if the taxpayers will only assert themselves, the Treasury's pressure to reduce expenditures will be immeasurably more effective.

The national credit depends not merely on the control of expenditures, but also on the taxing power and the state of the revenues. Here the outstanding fact is that the country is already too heavily taxed, that present taxes are sapping its vitality and impairing the sources of revenue. Taxes should in fact be reduced. And a wise revision of the laws, which moderated the present extremes and showed regard for the trend of the country's business, would by revitalizing agriculture, industry and employment put the revenues on a much healthier basis and yield at least as good returns. At present it is fair to say that we have probably the worst tax system of any civilized country. This is not the fault so much of any one political party or administration, though it must be admitted that the last five revenue laws, passed one each year for five years, have contributed some of the worst pieces to the crazy quilt.

Our present taxes are oppressive and destructive, and in combination with the complicated and frequently very high taxes imposed by states and municipalities on the same taxpayers, often come close to the point of confiscation. Instead of aiming to collect fair taxes on the multitudes of transactions and the great volume of business profits which would normally occur in a great country like ours, the tax laws prevent transactions and dry up business profits and business initiative. They have greatly impaired both individual and corporate savings, so that there no longer exists an adequate fund of savings to finance improvements and new enterprise. Frequently, they aim largely to punish, or to accomplish other ulterior objectives, but whatever satisfaction this may give, we are learning that it does not produce revenue.

In addition to being unscientific, our tax system is hypocritical, un-democratic, and un-American. This may be due in part to general indifference and unwillingness to face facts, and to a strange preference for emotional methods of taxation. The result, however, is that we have a tax system which puts impossible burdens on struggling new businesses and new developments, and on the man who has his way to make in the world, thus threatening the chief mainsprings of individual and corporate activity which over our history have accounted so largely for the growth of the country and the great improvement in the general standard of living.

Present taxes actually favor established interests and accumulated wealth. The so-called undistributed profits tax, one of the most wicked taxes ever devised, falls heaviest on small and growing businesses and on those which are struggling and burdened with debt. To the great established business concerns it is relatively more bearable, but it affects them arbitrarily and unevenly, and they too suffer from the general damage to the country's business. The tax produces little or no revenue, it paralyzes the capital goods industries, and it greatly exaggerates extremes of boom and depression. It prevents business of all kinds from building up reserves of economic and financial strength against future emergencies, and forces it under severe penalties to dissipate its resources. And while the Government pursues monopolies through the Trade Commission and the Department of Justice, through this tax it actually promotes monopoly by confirming already established interests and discouraging and perhaps preventing the

growth of competitors. After a little more than a year of operation, the undistributed profits tax has proved itself not merely a complete failure but a destroyer of constructive business and employment. Its immediate repeal is one of the most helpful steps that could be taken.

The individual is affected in much the same way by the present income tax system, federal, state and local. The extremes of the income tax are arbitrary and capricious in their operation from year to year, are so high as to deaden if not destroy individual initiative and enterprise, and they are known to be relatively unproductive. While there exists a full-fledged system of tax-exempt securities which provide a refuge from these taxes for accumulated wealth, no such relief is open for the individual who has to make his way in the world and who must pay taxes to such a point that it is becoming steadily more difficult for him ever to get ahead or to accumulate enough savings to provide for his wife and family after his death.

The taxation of people of relatively small incomes is equally hypocritical and perhaps more burdensome. In fact their taxes are high but many of them are hidden taxes, levied apparently on the principle that it is best for people not to know they are paying them. These taxes fall hardest on those least able to bear them, because they appear largely in higher costs for articles of necessity, and frequently become multiplied several times in the process of manufacture and distribution of goods. And in addition there are the so-called social security contributions, which I think must frankly be regarded as taxes on employment. Under the law as it stands, the cash receipts from these taxes, which are estimated for this year at about a billion dollars, go into the general fund of the Treasury and are used to meet current expenditures. The special public debt obligations which are simultaneously created will in turn have to be met out of new taxes when they have to be paid. The burden, which gradually becomes much heavier, falls hardest on millions of people of small incomes, who do not understand how the law operates and whose very jobs may be threatened by the inevitable tendency of a heavy payroll tax to reduce employment.

Altogether, it is high time that we became aroused to the iniquity and the dangers of our present tax system, which if continued threatens not merely the revenues but the progress of the country. It is encouraging that both Houses of Congress and their committees have already begun to make an exhaustive reëxamination of our tax laws, and that the Treasury under the leadership of the Secretary is working to the same end. Nothing would accomplish more toward the revival of business confidence and of business activity than the repeal of the undistributed profits tax, the reduction of the social security taxes and the revision of the law on a pay-as-you-go basis, and the moderation of those extreme rates of taxation which in themselves are unproductive and which are working so insidiously to discourage individual initiative and the future development of free enterprise.

Business recovery and sustained business activity are themselves, in large measure, the key to the state of the Government's finances, because of the extent to which they directly affect both revenues and expenditures. Recovery means less unemployment and therefore less demand on the budget for relief and other emergency expenditures. It also provides greater revenues for the Treasury and therefore the best chance for avoiding deficit financing and bringing about better-ordered national finance.

For the time being there is no doubt that we are experiencing a business recession of unusual suddenness and some magnitude. It lies largely in the hands of the political authorities, and the public opinion of the country as expressed through them, to determine whether it shall develop into a severe depression or terminate in a new and sounder recovery. Many factors are favorable. The dollar, for example, is not now overvalued and is not vulnerable, as it was in the last depression, to great foreign withdrawals. This year we have had the best crops for many years, and these, it seems to me, are still to be regarded as a blessing and not as a " national calamity ". Generally speaking, the material for recovery exists.

On the other hand business is still struggling under many handicaps and uncertainties which it is within the power of the Government to relieve. Apart from those which we have already discussed, there are still deadlocks in the great building and public utility industries, due mainly to Government competition, interference and hostility. These are unnatural and

unnecessary and could be broken with good will on both sides. The railroad industry, another great sector of the country's business, and the most regulated of all, is suffering from the pressure of increased costs and taxes, and the threat of declining traffic. Everywhere costs of production have been mounting, in part because of Government policies, and we need in all quarters a better realization of the resulting threat to business profits and business activity.

Above all we need to return to the " old-time religion ", of working and saving and living within our income, and abandon the dream that the Government is all-wise and all-powerful enough to plan or control all agriculture, business and industry. We have learned by experience that the general standard of living cannot be raised by policies of scarcity and destruction of wealth, and we must get back to that American ideal of honest work and free enterprise, through which the country has prospered and grown great. American enterprise, after all, is the primary source of employment, of production, and of the revenues on which the Government itself depends, and if not badgered to death by the Government it can and will go ahead under its own power under conditions of economic freedom. For this no great program of legislation or of new Governmental measures is necessary. The problem is rather to profit by the lessons which we have learned, to remove the handicaps which now prevail and release into new activity the pent-up forces of the nation.

REMARKS BY THE CHAIRMAN

MR. S. PARKER GILBERT: It is the great tradition of representative government that the "power of the purse" resides in the elected representatives of the people. This principle is firmly embodied in our Constitution. Originating in England as a check on the power of the King, "the power of the purse" has frequently become obscured, as Congressmen and Senators have regarded themselves as suppliants for their own constituents. Sometimes in recent years it seems to have been forgotten, and converted into "blank checks" given to the Executive. However much this may have been justified in times of great emergency, it is encouraging now to find many signs that the Congress is reasserting its prerogatives, and it is fitting that our first speaker this evening should himself be a member of the Congress and a leading exponent of its great traditions. Of a family long distinguished in American history, he has for years devoted himself in study and in practice to the problems of government and of public finance, and as Governor of Virginia he reorganized the finances of the Commonwealth and placed them on such a basis that they have withstood without strain the troubles of the depression years. Now in the U. S. Senate, member of its Finance Committee and of the Joint Committee on Organization of the Government, he can speak with authority on these questions. Friend and colleague of the Honorable Carter Glass, whom all Americans delight to honor, I have the honor to introduce the junior senator from Virginia, the Honorable Harry F. Byrd.

EXPENDITURES OF THE FEDERAL GOVERNMENT

HON. HARRY F. BYRD
United States Senator from Virginia

YOU have invited me to speak on the expenditures of the federal government, a subject that has interested me more than ever before because of my investigation as Chairman of the Senate Select Committee to Investigate Federal Agencies for Purposes of Government Reorganization. It is a big subject because the federal government has spent in seven years the incredible sum of 47 billions of dollars; and it is a vital subject because the prosperity of each American citizen depends on the preservation of the credit of the nation. We have added 22 billions to the public debt, and we are still adding day by day and hour by hour, and it is inevitable that the national credit will be impaired unless we retrench.

In the limited time assigned to me, it is difficult to cover the vast and complicated problem; hence, for the sake of brevity, I shall eliminate most of the fractions and speak in billions, as the government spends in billions.

Anyone in Washington today who discusses public finance in terms of less than a billion is regarded as a piker. Yet to spend a billion dollars in a year requires the disbursement of about $2,000 every minute of every day and night, including Sundays.

Today at Washington a public man is a liberal in proportion to how liberal he is with other people's money. Those of us in the Senate and House of Representatives who speak from time to time against gigantic waste and extravagance, that has exceeded any expenditure in the world's history, are berated as tories and reactionaries, as hard men, completely indifferent to human suffering. Yet, not a man in Congress today who has spoken and voted for economy and efficiency would hesitate to vote the sums necessary to protect any American against hunger and cold, and I believe would support sound and logical expenditures, within the ability of the people to pay, to improve the conditions of those who do not now enjoy a decent standard of living.

It is easier to spend than to save. It is easier for a public official to respond to the pressure and propaganda of organized minorities than to attempt to merit the approbation of the inarticulate citizens who favor economy but do not take the trouble to express themselves either by voice or ballot. When the protection of public money against extravagant expenditure ceases to be a virtue, and a representative is mainly judged and rewarded by the magnitude of the appropriations he obtains for his district or state, economy and efficiency—most difficult at the best—become that much harder to accomplish.

Public spending grows by what it feeds on. The independent struggle of the individual to make a living for himself often weakens before the temptation to go on government relief. Of course there are thousands of cases for which public relief is necessary, but it is certain that money from the government in different forms, and I include in this observation the business man who seeks to borrow government money at lower interest rates than he could obtain elsewhere, establishes a powerful paid army to fight any retrenchment that may stop or reduce the payment to them of money collected from the taxpayers. Once federal employees believe they have a vested right to their jobs, once new departments and bureaus are established and allotted public funds and extended public privileges, including the free use of the mails for propaganda to prevent the loss of their jobs, once emergency spending is continued beyond the emergency, the stream of expenditures becomes an overwhelming flood which only heroic measures can keep from engulfing the nation.

I am only a business man. I do not believe in destructive economy, as my public record will prove. I favor adequate support for the functions of government. I readily agree that the activities of government must expand in times of emergency and that in normal times the aid of the government can properly and wisely be used to improve the condition of all the people. But I do say that a mandate for progress and welfare without a mandate for solvency is a mandate impossible of fulfillment and most likely a mandate for disaster.

A program to spend billions in the effort to increase social justice is limited, within reason, by the ability of the nation to pay and still maintain our system of government. It is quite true that human values may be conserved and promoted by better health, better housing and better living, and that these are much more important than property values; yet, social security built upon debt is a house built upon the sands. True liberalism requires the government to keep its resources unimpaired, to prevent distress and to coöperate with the localities in providing for the poor in emergencies, because it is the poor who suffer the most when business is bad and unemployment increases. Other emergencies will come, and we must not exhaust our resources to the extent that we cannot meet the responsibilities of the next one.

In speaking tonight I shall talk very frankly of the serious significance of huge government spending. I speak as a friendly critic. I am a member of the political party, many of whose leaders actually claim credit for the expenditures of the last four years. The Republican party, likewise, cannot deny its share of responsibility. Five billions of our present debt was created under Mr. Hoover; and a majority of Republicans in the Senate and the House voted for most of the appropriations that made possible our present spending program and created the new indebtedness of the last four years. It is only fair also to recall that many business men and other citizens urged spending as a panacea for the depression. The slogan, "prime the pump and spend ourselves back to prosperity", became exceedingly popular, and the Congress was urged to enact bigger and greater appropriations.

I shall not consume time in generalities and in the exposition of accepted economic principles. We know that the budget must be balanced soon or disaster must inevitably come. We know that excessive taxation is a barrier to future progress and destructive of present prosperity. But there is yet time to save this perilous situation. The credit of the government is still sound, but will not remain sound if we continue to spend on the present extravagant and enormous basis.

I am not an alarmist. I am conscious of the great financial resources of America. However, in six years the increases in the federal debt have been more than four times the total wealth of my own state of Virginia, a wealth that Virginians have been accumulating by frugality and industry for more than three hundred years. Virginia is an average state in wealth and population, so that our new debt represents the total value of all the property of every character owned by citizens of four sovereign states of average wealth and population. We cannot safely dissipate so much of our resources.

This enormous debt today becomes more disturbing as we face the prospect of new debts caused by continuing deficits. The time has come to begin to retire this debt created in the emergency of the depression, as we did after the World War; yet spending is not being reduced and the federal income is dwindling.

President Roosevelt admirably and eloquently expressed the supreme importance of maintaining sound fiscal policies when he said on October 19, 1932:

> We all know that our own family credit depends in large part on the stability of the credit of the United States. The credit of the family depends chiefly on whether that family is living within its income, and so it is with the nation. If in some crisis it lives beyond its income for a year or two, it can usually borrow temporarily on reasonable terms. But if, like a spendthrift, it throws discretion to the winds, is willing to make no sacrifice at all in spending, extends its taxation to the limit of the people's power to pay, and continues to pile up deficits, it is on the road to bankruptcy.

The President was right! The credit of the United States is the foundation upon which our system of credits must rest. Destroy faith in the credit of the nation and our whole system of credits will collapse. The federal government has no power to create wealth. It can print those counters we call money, but real wealth is created by the application of human industry to the national resources. Real wealth is mostly the wealth that comes either from the surface of the earth or from the riches beneath the earth. New wealth is not the result of new theories of finance or banking or ingenious legislation. Ladies and gentlemen, it is a dangerous thing to spend wealth faster than new wealth is captured from God's eternal granary; and yet, this is what we have done in prodigal fashion. For six years consecutively expenditures by the federal government alone have greatly exceeded each year the combined gross value

of all agricultural products and all the products of mines, even after inflating the farm income by government payments. This has never occurred before in the history of America except in the two years of 1918 and 1919 when we did more than our part to finance the most expensive war in history.

The justification assigned for vast public spending has been the need of overcoming conditions created by the depression that Mr. Roosevelt inherited when he came into office in 1933. I was in the Senate during those trying days. I give full credit to the President and the Congress for the many brave and necessary things that were then done to relieve distress and restore confidence.

Five years have passed and our recovery justified the President in saying in Wyoming on September 24, last: "The greater part of the emergency is over." We cannot continue indefinitely emergency remedies.

In 1930 the gross debt of the federal government was 16 billions. It had been reduced from the World War peak of 26 billions by the payment of about a billion each year during the twenties. On November sixth the direct gross debt of the federal government was the startling and stupendous sum of $37,019,677,682.77. In addition, our government has guaranteed in full the obligations of 25 wholly owned government corporations and partially guaranteed the obligations of 10 semi-government corporations. This contingent liability is approximately 5 billions, and all this makes the total direct and contingent obligations today approximately 42 billions. It is true that this gross debt is subject to such credits as may come from recoverable assets and the ultimate liquidation of the 35 corporations whose obligations have been guaranteed by the government in whole or in part. However, an examination of these numerous guaranteed government corporations discloses a ramification of their liabilities and assets that confuses the most experienced economic experts. Years will pass before the recoverable value can be appraised and the actual credit on the present 42 billion gross liability of our government be determined.

I feel completely safe in saying that the credits and recoverable assets shown in the government reports have been grossly overestimated. Take, for example, the Reconstruction Finance Corporation. The government purchased $500,000 of stock and about $4,000,000,000 of notes of this corporation. The stock and the notes are carried on the government reports at face value, leaving the impression that the total assets represent sound values and will ultimately be recovered into the treasury to reduce the public debt. This conclusion is accepted by the public by reason of the confidence in the soundness and efficiency of the chairman, Mr. Jesse Jones.

However, the Brookings Institution, employed by the Senate committee on reorganization, recently disclosed that two and a half billions of the assets of the R. F. C. were diverted for relief expenditures and to pay the regular expenses of other agencies and for other expenditures, none of which is recoverable. So today the stock of the R. F. C. is valueless and the notes are not worth more than fifty cents on the dollar in recoverable assets. Yet only recently the Corporation issued a financial statement showing and claiming a surplus of 150 millions as of December 31, last.

Why was this devious and misleading method adopted by the officials responsible for recording appropriations? An inquiry from me to a high budget official brought the response that the only reason he could assign was the desire to avoid huge totals in the regular appropriation bills. Mr. Jesse Jones, the able chairman of the R. F. C., is not responsible for this confusing statement. I happen to know that he has been endeavoring to have the balance sheet, as issued by the United States Treasury Department, corrected in order that it may reflect the facts. But even Jesse Jones, as able a business man as he is, cannot collect from Harry Hopkins money already spent for relief. Either two and a half billions should be appropriated to maintain the integrity of the R. F. C. assets or legislation should be passed to write down the securities to true value.

The financial reports of the government should be an example of clear and candid statements such as the government requires by law from private business; and it punishes by imprisonment any business man who violates this proper law. The complexity of the contingent liability of the government and the difficulties of liquidation cannot be discussed in the limited time of my address, yet we should realize that the

losses in guaranteed obligations—and such losses are certain to be large—must be met some day as a government expense and either added to the direct debt or paid by current taxes. The federal government has endorsed with full recourse the notes of these numerous corporations and, like any other endorser, must pay if the maker of the obligation fails to pay.

The Twentieth Century Fund, an independent fact-finding agency, says that our total government debts—federal, state and local—of 56 billions, are "the largest that any nation has ever had." This competent authority calls this debt a great potential peril and recommends that in the next fiscal year a billion at least be paid out of current federal revenue for debt retirement.

We are now entering the eighth consecutive year in which our government spends much more than its revenue. In our previous history, the longest period of substantial successive deficits was two years. In the three war years, after deducting loans to Allies, our government spent for normal and war expenses only a little more than it has spent in 1935, '36 and '37—25 billions against 24 billions.

Now let us see what the tax burden means in terms of each American family. Let us bring to roost these prolific tax chickens. In 1913 the per capita income was $350. In 1936 it was $469, an increase of 34 per cent. Total government expenditures equaled $30 per capita in 1913 and $134 per capita in 1936, an increase of 347 per cent. On a per capita basis, government expenditures in 1913 represented 8 per cent of the national income. In 1936 these expenditures represented 28 per cent of the national income. Public debt equaled $59 per capita in 1913 and $430 per capita in 1936. Today about one third of every person's income would be required to meet government expenditures, if we paid as we spend. These figures, of course, refer to total government cost. Many of the states, cities and counties have yielded to the contagion of extravagance. The children of Uncle Sam have followed his bad example. In 1936 the deficits of all governments in America were 7 billions, nearly 5 billions of which were created by the federal government.

Should we not hearken even to the few voices crying in the wilderness? When we cite these terrifying figures someone always cries, "What, would you deny relief to human suffering?" No, we would not let anyone starve in this country, but the disturbing thing is that the increase in the regular expenses of our federal government is enormous in addition to the expenditures for recovery and relief.

During the prosperous years of the twenties our government spent about three billion dollars each year and paid a billion a year to retire the World War debt.

To get the debt back to what it was seven years ago we must pay one billion each for twenty-two continuous years. Not even with uninterrupted prosperity for a whole generation could the people and the business of the country sustain the terrific burden necessary to run the government on this basis and make this debt retirement. To do so would require nearly a thirty per cent increase in our 1938 annual tax collections, and remember that this year our tax collections are estimated to be the largest in our history and only approached by one single year—in 1920—when war profits were subjected to high tax rates.

I want to introduce to you the mysteries of the two budget system. *I declare that our expenses are now being leveled off on the seven billion basis because of the gradual transfer of emergency expenditures to the regular budget.* In 1934 the federal government adopted the two budget system; one for emergency and the other for regular expenses. We have two budgets but we have only one treasury. In 1934 the regular budget presented to the Congress by the President was two billions, seven hundred millions. *In 1938 the regular budget is five billions, four hundred millions—an increase of one hundred per cent in four years.*

A reduction is shown in the statement of recovery and relief expenditures because many of the items of emergency expenditures have been made permanent by transfer to the regular budget. An example is the appropriation for the C. C. C. camps, which was first in the emergency budget and is now included in the regular expenses. But there has been no reduction in our total expenditures, and excluding the non-recurring soldiers' bonus, we will spend as much or more in 1938 than we spent in 1937, or in any previous depression year. This year, to date, we have actually spent more than in the same period of last year.

At best it is most difficult to comprehend the expenditure of billions, but the confusion has been greatly increased by this strange device of keeping two budgets. When the administration announces a reduction in spending for recovery and relief, at once we begin to feel better and to think that finally we can look forward to a real reduction, but later we find the regular budget has been increased, and the total is as much or more. We have juggled expenditures back and forth from one budget to the other, but the taxpayers pay the bill for both budgets. The two-budget system has merely aggravated the general confusion.

It is disturbing to see the astounding and progressive increases in the regular expenses after eliminating all items in the emergency budget. The following table of regular budget expenditures comes from official government auditors and does not include recovery and relief expenditures:

Regular Expenditures

1934	$2,700,000,000
1935	3,200,000,000
1936	3,300,000,000
1937	4,400,000,000
1938	5,400,000,000

When we add expenditures for recovery and relief, for public works, for the huge slum clearance program begun at the last session, for additional T. V. A.'s, for the cost of the new farm program and other costly projects, either already recommended or under consideration, it is conservative to say that we have reached the level of a seven billion annual expenditure without debt retirement—in fact considerable restraint must be exerted to hold it to this huge figure. This year we shall spend more.

Only a major surgical operation to reduce expenditures will enable us to carry the burden of sustaining this annual cost and commence to retire our emergency debt.

The difficulties of ascertaining the true expenditures are made greater by the policy of the government in deducting from expenditures an excess of loans collected over loans made. In this manner the combined expenditures in 1937 were reduced in total by two hundred forty-three millions. Of course the excess collected of capital loans should be applied to a reduction of the public debt.

In the budget of 1938 two hundred thirty millions of social security taxes are used for regular expenses. The effect of this will be to reduce the deficit by the use of a tax, *collected and paid* for the specific purpose of providing old-age security.

One may imagine the denunciation a corporation would receive from the government if it indulged in such improper financing and used for current expenses an income dedicated to a trust fund for the security of the aged.

Nothing Congress has done has contributed more to extravagance, and done more to destroy the budget system, than the practice of making lump sum appropriations. About fifteen billions of such appropriations have been made in the past four years as compared to one and one-half billion of lump sum appropriations in all the previous history of our country. From these lump sum recovery and relief appropriations, equivalent as they are to blank checks, great sums have been diverted for expenditure by the regular departments, thus expanding the activities of these departments. Over three billions of lump sum appropriations, made for recovery and relief, were allocated for expenditures by regular departments in 1934, 1935 and 1936.

I know something personally of the waste involved in lump sum appropriations. An allocation from a lump sum appropriation was made for the construction of homes in Virginia to be rented to mountain people, costing complete including land and all other costs about $8,000 per home. I had no opportunity to vote on this appropriation for my own state. A competent builder offered to reproduce one of the homes for $900, yet my requests to stop this waste near my own home were unavailing. I introduced a bill to cancel the appropriation, but the department is working under pressure to expend all the fund before Congress meets. In the same manner the Resettlement Administration has built about fifteen thousand homes throughout the country, some costing more than $16,000 per home unit, for rental to the low income group. In some instances the General Accounting Office estimated the overhead expense to be forty per cent.

The huge deficits that have been added to the public debt are not due to failures of the revenue. Taxes have been increased so that in 1938 we anticipate the highest income in the history of our country.

If we were maintaining a balanced budget, even the painful exaction of enormous taxation from our people might be justified as a patriotic imposition to meet a period of national economic peril expected to be temporary; but we are paying the taxes without balancing the budget. Our people are paying these painful taxes without relief from the conditions that cause the pain. The patient who suffers acute physical pain should be relieved by morphine, but the cause of the pain must be removed or the continuous administration of morphine will make the remedy worse than the disease.

Why disguise our condition? A true diagnosis must precede an effective remedy, and a true diagnosis requires a frank and fearless recognition of our economic predicament.

What is our situation today? We work under the load of the most stupendous debt any nation has ever carried. Our taxes are reaching the point of diminishing returns and today are a decided factor in the high cost of living. Remember that more than half of the taxes collected by the federal government come from invisible taxation paid by the housewife, the laborer and every one who eats or buys necessities. Last year forty-three citizens had incomes of over one million and the aggregate of these incomes was seventy-three millions. If we confiscated all of the incomes of these millionaires, the money obtained would operate the national government for only about three days. The rich must bear a just share, yet these figures prove the futility of confiscating property to sustain our great expenditures.

Let us not be deceived, the people as a whole will pay most of this vast debt and carry this heavy national expenditure.

We have suspended the terms of statutory debt requirement that provide for annual contributions to the sinking fund in ratio to the public debt. We have assumed the responsibility at heavy cost to maintain an artificial price of gold throughout the world. We are buying and burying in the ground in a costly mausoleum at Fort Knox the same gold that was dug out of the ground under the impression that it was usable precious metal.

The federal government is now paying on its obligations a low interest rate because money is cheap. Our guest tonight, Secretary Morgenthau, has admirably managed the issuance of obligations at the lowest possible interest rates. But when the obligations become due—and fifteen billions are due in the next five years—we face a likely increase in existing rates. The obligations given by the government to the Social Security Trust Funds bear by law 3 per cent interest—an increase of one-half per cent over the average rate now paid. An increase in interest rates will remain for a long time as a potential new burden on the treasury. An increase of one per cent means $400,000,000 annually more to be paid by taxation.

We are told that a balanced budget is on the way. I cannot credit this prophecy. On the contrary, I predict that on July 1, 1938 the estimated deficit of eight hundred ninety-five millions will be at least twice that sum. Without reduced spending the outlook for 1939 is equally gloomy because the business recession, as predicted even by government officials for 1938 and already felt by business men, will be reflected in revenue receipts for the 1939 fiscal year.

My reasons for predicting a much larger 1938 deficit are, first, the revenue will not reach the estimates; and, second, the President has allowed only one hundred and eighty millions in his estimate for deficiency and new appropriations in the next eight months while our deficiency and new appropriations in 1937 were nearly a billion dollars.

The excessively high receipts estimated to be received from the undistributed profits tax will never materialize. This new tax system has failed as a revenue producer and has been a decided barrier to business recovery, for this law taxes a corporation an additional 27 per cent for spending current revenue to build new plants and provide new employment. When a main problem of America is unemployment, it is a strange theory to penalize by extra taxation a business enterprise desiring to expand and employ more people. Capital must go to work to carry the present burden of unemployment, but no enterprise can expand and pay a high additional tax penalty for doing so.

As I conclude, I anticipate some may say, "Well, what would you do about it?" The only constructive thing to do is to stop writing checks. Talk neither pays debts nor reduces expenses. We have talked economy, but nothing has been done about it. As one who has devoted months of study to

government spending, assisted by competent experts, I declare advisedly that we have the most costly and wasteful bureaucracy at Washington in the history of the United States of America. We have created in four years over fifty new agencies and many more bureaus and subdivisions. We have more than doubled in four years the federal employees in the city of Washington and the last report shows we are still adding new employees.

Hundreds of millions can be saved in administrative and overhead expenses and simplifying the duplications of government agencies. Other hundreds of millions can be saved by eliminating waste and extravagance from necessary activities and by abolishing altogether the less essential activities. We should and can at once go on a pay-as-you-go basis—not by new taxes, but by retrenchment.

You must remember that public economy like private economy is neither spectacular nor attractive. It is a steady, hard, uninteresting grind. The home band does not often turn out to greet a returning economizer. We talk a lot about it and do little. But under our present perilous situation the longer we defer economy the greater and more terrible the penalty we will pay.

Remarks by the Chairman

Mr. S. Parker Gilbert: The historic rôle of the Secretary of the Treasury is to protect the public credit at home and abroad, to finance the Government's needs, to supervise the public revenues, and generally to act as guardian of the finances of the nation. Called to these high responsibilities in the autumn of 1933, and serving through these years of unusual stress and strain, the present Secretary has risen to the high traditions of his office, and it is due largely to his honest and inquiring mind and careful judgment that we have avoided many of the pitfalls which beset us. In difficult times he has successfully discharged the heavy task of financing the Government's requirements, and has been giving his best efforts to reëstablishing effective control over Government expenditures. Now, under his leadership, plans are under consideration for revision of the revenues which will be of great importance to the future of the country. We are greatly honored by his presence with us tonight, and I now present to you the Secretary of the Treasury, the Honorable Henry Morgenthau, Jr., of New York.

FEDERAL SPENDING AND THE FEDERAL BUDGET

HON. HENRY MORGENTHAU, JR.
Secretary of the Treasury

I welcome the opportunity to discuss before the members and guests of the Academy of Political Science the subject of federal spending and its relation to the balancing of the federal budget.

Nineteen years ago tomorrow we signed the Armistice ending the World War. That war was enormously costly in human values, and it was enormously costly in material values. In the two years between the middle of 1917 and the middle of 1919, the federal government sustained a net deficit of twenty-two billion dollars.

During the past four years this country has been engaged in another war. This time our enemy was a great economic disaster. In this war we fought with jobs and with dollars to save farmers from losing their farms; to save home owners from losing their homes; to give not only bread but work to the unemployed; to increase the security of jobs, property values and business profits; and to bring order out of chaos in our economic system.

This war, like that other war, required a many-sided campaign under intelligent and courageous leadership—a leadership that was magnificently supplied by President Roosevelt.

Finally, this war, like that other war, required a large spending program. This program, plus the special needs arising out of the great drought and the prepayment of the soldiers' bonus, necessitated net outlays during the four years ended June 30, 1937, of some fourteen billion dollars in excess of our receipts.

Of course, it is easily possible to criticize some of the detailed uses of the relief funds. Let us concede that there was some waste. In any expenditure program of such magnitude this is inevitable. But, contrasted with the human and material values at stake, such wastes as may have occurred shrink into insignificance.

We deliberately used an unbalanced federal budget during the past four years to meet a great emergency. That policy has succeeded. The emergency that we faced in 1933 no longer exists.

I am fully aware that many of our problems remain unsolved. I am aware that there still remains a considerable volume of unemployment; that the speculative markets have recently been under severe pressure; and that our business indexes have recently shown a declining tendency. I am further aware that some persons contend that another great spending program is desirable to ward off the risk of another business depression.

I claim no prophetic insight into the future. But, after giving serious and careful consideration to all of these and other factors, I have reached the firm conviction that the domestic problems which face us today are essentially different from those which faced us four years ago. Many measures are required for their solution. One of these measures, but only one, in the present juncture is a determined movement toward a balanced budget.

Early in 1933, after three years of progressive deterioration, our whole economic mechanism was demoralized. Under these conditions, there was no agency outside of the federal government with the resources and the courage to bring about a business revival.

Today the situation is greatly changed. We are now nearing the end of one of the most active years in the business history of this country. On the whole, this high level of activity has been of a healthy character—not of the character that usually marks an unhealthy boom and precedes a serious depression. The present situation is not characterized by the existence of huge inventories, high interest rates, over-extended credit positions, or great surpluses of housing and capital equipment. We have not reached the stage of full employment of our productive resources. On the contrary, from all these standpoints, conditions are favorable for a continued increase in the level of business activity.

This stands in contrast to the unhealthy excesses of 1929. It stands in even sharper contrast to the banking collapse, the bread lines, the bankruptcies and the general demoralization of 1933.

Despite the substantial increase in the public debt during the past four years, the credit of the federal government has remained absolutely unimpaired. Not once during even the darkest days of the depression did the treasury experience the slightest difficulty in borrowing all the funds that were required. Moreover, the rates of interest on our borrowings have been lower, for comparable securities, than at any other time in the history of the country.

But the underlying conditions that made deliberate deficit spending the wisest kind of policy during the depression have been altered during the progress of recovery. Thus, when we borrowed during the depression to finance our deficit spending, a large part of the funds was obtained through an expansion of bank credit. To this extent, our spending did not absorb capital funds that might otherwise have gone into private industry, nor did it absorb by taxation funds that might otherwise have gone into private consumption. Even to the extent that our bonds and notes were purchased by non-banking investors, the effect was largely to put to work capital funds that would otherwise have remained idle.

Our industrial recovery of the last year, however, has created large new demands for private capital. Our commercial banks have been again utilizing their credit resources for the financing of private industry. During the present calendar year, the insured commercial banks of the country have substantially reduced their holdings of government securities in order to meet actual and prospective demands for commercial credit. The obligations that they sold, plus an amount equal to the securities newly marketed by the treasury, were purchased by investors. Any deficit spending under conditions of active demand for private capital would have to be financed in large part by capital funds that would otherwise be available for business purposes.

The basic need today is to foster the full application of the driving force of private capital. We want to see capital go into the productive channels of private industry. We want to see private business expand. We believe that much of the remaining unemployment will disappear as private capital funds are increasingly employed in productive enterprises. We believe that one of the most important ways of achieving

these ends at this time is to continue progress toward a balance of the federal budget.

I turn now to the immediate practical aspects of budget balancing for the coming fiscal year. What are the controlling figures?

Our total receipts for this year were estimated in the President's budget summation of October 19 at about six billion six hundred and fifty millions, and our total net expenditures at about seven billion three hundred and forty-five millions, leaving an estimated net deficit of six hundred and ninety-five millions.

To attain an ordinary balancing of the budget next year—that is, a balance after full provision for accruing liabilities for old-age benefit payments, but exclusive of debt retirement—it would be necessary to accomplish a net improvement of about seven hundred million dollars in our budgetary position, as last estimated. To be prudent, we should not count on an increase in revenues next year from the existing tax structure. Nor should we impose additional taxation. Instead, we should plan to bring next year's expenditures within this year's income.

But where can cuts totaling seven hundred millions be made? After a careful study of the whole problem, I have come to the following conclusions. On the one hand, while everything possible is being done and will be done to keep a tight rein on the regular operating expenses of the federal government, including the national defense and interest on the public debt, I do not believe that we can find large savings in this field. Further, our expenditures under the Social Security Act will increase next year.

On the other hand, by focusing attention on the several classes of expenditures that have been mainly responsible for our past deficits—namely public highways, public works, unemployment relief and agriculture—it is apparent that great savings can be made.

Let me give you an idea of the possibilities for savings in these fields.

First, take the item of highway expenditures. Prior to the depression, the federal grants to the states for public highway construction generally ran under one hundred million dollars annually. This year the total federal outlays for highways inclusive of emergency expenditures, are estimated at two hundred fifty-three millions; and in addition, the existing highway programs call for new appropriations totaling more than four hundred million dollars for the next two years. I believe it is now time to return to the average annual level of highway expenditures that existed prior to the depression, especially because during the past few years many other millions of dollars have been spent for highways out of relief appropriations.

Second, there is the field of public works, other than highways, on which we are spending five hundred seventy-three millions this year. This is a greater sum than the total that was spent for this purpose during the entire five-year period between 1926 and 1930, inclusive. Next year, despite the fact that there will be available from appropriations and allocations already made for this purpose more than six hundred millions, I believe that we can and should move definitely toward a lower level of public works outlays.

Third, I sincerely hope that employment conditions will make possible a further substantial reduction in our outlays for unemployment relief and the C. C. C. camps. During the present fiscal year, by reason of more active private business, these expenditures are already being reduced by more than seven hundred fifty millions below last year's.

I turn next to our expenditures on behalf of agriculture. The total of this year's expenditures, exclusive of public highways, for the regular activities of the department, the soil conservation program, rural electrification, resettlement, commodity loans, and lower interest rates for federal land bank borrowers, exceeds nine hundred million dollars. Despite the magnitude of this sum, you are all aware that possible further measures involving large additional expenditures are now being discussed.

I am strongly in favor of a long-range program to maintain the independence and the purchasing power of the farmer. Such a program must take into consideration the farmer's opportunities in the foreign markets as well as in those at home; and no agricultural program can long endure which makes excessive demands upon the federal treasury, or is unfair to consumers. The farmer himself does not want subsidies, but

rather such fair prices and such balanced production of crops as will make subsidies unnecessary for his decent economic status.

Balancing the budget is as much in the interest of farmers as in the interest of other parts of our population; and it requires the coöperation of the farmer as well as of other sections of the public.

Only with the solid backing of the public can we hope to achieve economies totaling seven hundred millions in the four fields that I have cited.

There may be some persons who would counsel a more drastic reduction of expenditures or a program of far heavier taxation in order to make certain a more substantial reduction in the public debt in the next fiscal year. There are serious objections to either of these courses.

I have already indicated that I believe it undesirable to increase taxation. There are equally compelling reasons why we should not reduce expenditures too suddenly and too drastically. I strongly favor a vigorous program for the progressive reduction of federal expenditures to the minimum demanded by the government's responsibilities.

Obviously, however, one reaches a point in reducing government expenditures at which no further reductions can be made, unless it is decided to cripple many essential governmental activities—in other words, unless it is decided to make drastic changes in national policy. For example, it would mean consideration of such things as weakening our national defense, and slowing up or abandoning flood control, soil erosion prevention, and relief for the aged and the unemployed. Such a course, I believe, would not have the approval of either the American people or their elected representatives in Congress.

Moreover, it would clearly be disastrous to many of the needy unemployed, and disruptive to many sections of private industry, if we were to cut government expenditures in the coming fiscal year by much more than the amount I have indicated.

We are definitely in a transition period between unbalanced and balanced federal budgets; but I firmly believe that there is just as much danger to our economy as a whole in moving too rapidly in this direction as there would be in not moving at all.

Relatively few persons realize the striking fact that the net improvement this year in the budgetary position of the federal government as estimated will amount to more than two billion dollars. In other words, the net deficit this year is estimated at less than seven hundred millions as compared with more than two billion seven hundred millions last year.

This net improvement of more than two billion dollars in a single year provides the best answer to those who, in most cases ignorant of the true facts, have publicly despaired of our ability to balance the federal budget.

True, much of this year's anticipated budgetary improvement comes from increased revenue, but we are supplementing this by also seeking reductions in expenditures.

In addition to these considerations, I should like to point out that, as a result of the Social Security Act and related state laws, it is estimated that the federal government next year will receive more than one billion dollars net for investment in government securities for the Unemployment Trust Fund and the Old-Age Reserve Account. Although this investment will not change the total amount of the public debt, it will with a balanced budget result in the transfer to these reserve accounts of more than a billion dollars of government obligations now held by private investors.

Even during the decade of the twenties, when the treasury was receiving large payments of interest and principal on war debts, and from the sale of surplus war materials, the maximum reduction made in any single year in the public debt held by private investors was about one billion three hundred millions. The rate at which it is safe to reduce the public debt in private hands depends upon the rate at which private funds flow into investment channels. It is unsafe to go too fast.

Although we are not contemplating any increase in the total tax burden, the character of our tax structure is being given earnest consideration.

The federal tax system affects everyone in the country. We in the treasury in studying tax problems have two objectives always before us: first, that the tax burden shall be distributed as fairly as possible, and second, that the collection of taxes shall be as little burdensome to the taxpayer as possible.

It is with these aims that, by direction of the President, we have been reviewing the whole tax structure in the last few months and are just now in the process of presenting to a committee of Congress the information we have collected. The study has not been directed toward raising additional revenue. Instead, we have sought to determine whether there are inequalities and injustices in the distribution of the tax burden and whether there are some taxes whose costs of collection and whose burdensome effect outweigh the revenue gain. In addition, we want to simplify collection and make the taxpayer's record-keeping less difficult.

We realize that our tax laws are too complicated; we want to make them less so. We realize that there are inequities; we want to eliminate as many of them as we can.

In making this study, we have invited the assistance and the advice of groups of taxpayers and of individuals. We want to hear the taxpayer's side of the story. We want all the facts we can get and we have obtained both facts and opinions.

Our tax revenues come largely from individual earnings and business profits. We do not wish to impose levies which tend to dry up the sources of tax revenue. The laws should be so written and administered that the taxpayer can continue to make a reasonable profit with a minimum of interference from his own federal government; provided that the taxpayer cooperates with his government in carrying out the purpose and the spirit of the tax laws. Of course, tax policy cannot properly be determined from exceptional cases. We must look at the whole picture. We base our decisions on extensive information and upon analysis of actual tax records.

The amount of our income-tax revenue is only about half our total internal revenue. Less than three million people out of our total population pay individual federal income taxes. We would be applying the principle of capacity to pay more justly if we were to reduce the number of consumer taxes and at the same time to increase the number of income tax payers. Taxpayers who are squarely confronted with their own tax burdens are bound to be keenly alive to the way the money is being spent by their government.

The budget now nearing completion is predicated on a definite estimate of receipts, based on the existing tax structure. It is a cardinal point of our policy that the tax system, as revised, must not yield a smaller return for 1939 than the present system would yield.

Let me repeat: We want to adjust inequalities and remedy defects in the tax laws. In doing this, we have sought the help of the taxpayer and have given him a sympathetic hearing. If we find that the operation of any particular tax is unfair, we stand ready to say so publicly.

My object this evening has been to present, as clearly and as frankly as I know how, a comprehensive picture of the federal expenditures and the budgetary outlook. I have tried to make plain the underlying economic reasons, as well as the humanitarian ones, for the past deficits; and I have tried to bring out clearly the considerations that now demand further definite steps toward a balanced federal budget. I have shown why, in my opinion, this balance should be sought by a reduction in expenditures without an increase in the total of the tax burden. But I have also shown that there is a limit to reductions; and that balancing of budgets needs the help of industry to keep up total tax receipts unless we are again to resort to deficit financing.

The principal aims of our budgetary policy have been, and I hope will continue to be, to promote a high level and healthy character of business activity, a maximum volume of employment at good wages in private industry, a reasonable return to capital and enterprise, fair treatment for our agricultural population, and adequate revenues to meet the services now demanded of the federal government.

The attainment of these ends rests very greatly on private initiative and on the coöperation of private enterprise. This is a necessary supplement to any efforts which the government can put forth. This administration is going to do everything possible to promote a continuation of recovery and to balance the budget through cutting expenditures. But I wish to emphasize that in no event will this administration allow anyone to starve, nor will it abandon its broad purpose to protect the weak, to give human security and to seek a wider distribution of our national income. We are confident that, with the full coöperation of the business world, our present difficulties will be overcome; and that the aims that I have set forth above, which are properly those of private business as well as those of the national government, will be achieved.

REMARKS BY THE CHAIRMAN

MR. S. PARKER GILBERT: Ladies and Gentlemen—In bringing this Annual Meeting of the Academy to a close, I should like to express, in your names and in the name of the Academy, the thanks of us all to the distinguished speakers who have contributed so much to the sessions held during the day by their interesting and illuminating papers on various phases of the general subject which we have been discussing tonight.

I should also like to express the thanks of us all to the distinguished speakers who have honored us by their presence tonight, and especially to the Secretary of the Treasury who has come from his heavy official responsibilities to give us this message concerning the government's budgetary and financial policy.