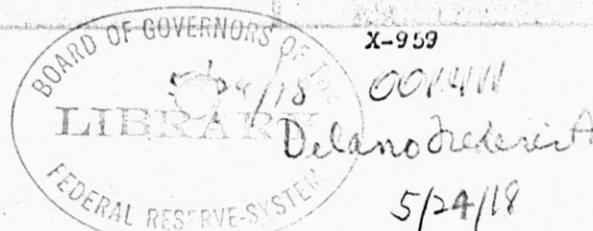


FINANCING THE WAR.



Considering the size of our country and the wide distribution of our population; considering also the distance from actual military operations, it is not surprising that it has taken a year for the public to appreciate the seriousness of the war that is now being waged, and to form some adequate conception of what it is all about; but thanks to the operations of the draft law, and to the three campaigns of education in connection with the sale of Government bonds, there can be no doubt in any one's mind today that the citizens are solidly behind the Congress and The President in supporting any measures that may be deemed necessary to the successful prosecution of the war.

The subject of financing the war is not a simple one to deal with; it does not lend itself readily to popular oratory, so because it is dry, and because it is complex, it is largely left to the specialists. On the other hand the effects of bad financing are so serious that it is highly desirable that the subject be better understood; and for that reason it will be my endeavor to state as briefly as I can, and in as simple phraseology as I can command, the principles involved and the probable results of various measures already adopted or in contemplation.

WHAT THE GOVERNMENT NEEDS IN PROSECUTING THE WAR.

To begin with, as will be readily conceded, war is essentially wasteful, and therefore, to counteract the evil effects of the war, there must be great economy.

When a nation goes to war, the Government as the representative of all the citizens must take many men out of productive employments and use them as soldiers. It must take other men and women from their various occupations or avocations and employ them in making munitions and equip-

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ment, or building ships, docks, and all sundry things which are required; and finally the transportation system of the country must be taxed to the utmost to collect, distribute and forward the men, the munitions, and the equipment.

In other words, the Nation requires, using a phrase which is already hackneyed, "goods and services". It must obtain the services of the men and women, those who fight and those who serve in other capacities. But in order to obtain this service or these materials, the Government must accumulate money, because that is the common denominator to which goods and services may be reduced, or the terms in which their value may be expressed. Hence, it is for this reason that the first act of a nation at war is to pass laws authorizing its fiscal or Treasury officials to raise money by taxation or by borrowing/^{or}both. It is clear that the greatest financial errors ever made in attacking such problems have usually been due to a failure on the part of a nation's leaders to appreciate the seriousness or magnitude of the matter. Thus at the beginning of our Civil War, President Lincoln called for seventy-five thousand volunteer soldiers for three months service, and the financial plans then made were based upon the theory that the number of soldiers that would be required would not be very large, and that the duration of the war would be short.

Even with the limited perspective we have of the present contest in Europe, which began less than four years ago, it is apparent to us already that all of the European nations greatly underestimated the magnitude of the struggle, and if we have been more forchanded in this country, it may be attributed in great part to the fact that the immense scale of European operations has become apparent to us and we have thus been saved from making some of the mistakes that were made by the nations of Europe. However, it is

explained, it is certainly a fact and an interesting one, too, that the expenditures by our Nation the first year of the war have been actually less than estimated, because the ability of the country to provide goods and services has actually lagged behind the appropriations made by Congress and the estimates of the fiscal officers of the Government.

RAISING MONEY.

There are two ways, and perhaps only two ways, in which the government of a nation can secure funds from its people. It must do it either by taxation, which may take any one of many forms, or it must do it by borrowing from the people and issuing its bonds or "promises to pay" in exchange. Furthermore, when the necessities of a Government are as great as they are with us in the present crisis, every effort to obtain funds must be employed. On the other hand, irrespective of how funds are raised, the ultimate source is the savings of the people, existent or potential. If the existent savings of a wealthy nation like the United States could be tapped to any large extent, there would be little difficulty in financing even so great a war as this; but the difficulty is that people's savings are non-existent in the form of currency or coin, but are represented by investments in Government and municipal improvements; in colleges, schools, churches; in homes, factories, railways and steamships; or as the phrase usually goes, in "bricks and mortar". A large percentage of these investments may be termed productive. that is, investments of such a nature that they yield a return in the form of interest or profit, and even those permanent expenditures which do not yield monetary returns, may be rightly claimed to yield a compensation in the form of greater comforts or enduring satisfaction in some form.

Starting with the assumption that we can finance the war only from people's savings, either already existent (and not appropriated to other uses)

or prospective, we may go on to consider and discuss the best method of diverting those savings to the coffers of the Government. To that end let us first consider the subject of taxation.

TAXATION.

As already stated, taxation may take many forms; for example, we may have direct taxes against the individual, such as the income tax or the real estate tax; or we may have an indirect tax in the form of taxes on purchases or upon merchandising, manufacturing, or other enterprises, whether corporate or not, which, while direct in one sense, are in their final incidence indirect upon the individual.

The extent to which taxes may be applied, of course, varies greatly with the conditions under which the taxes are levied, but it is generally recognized that in war, a loyal people will sustain its Government, and will cheerfully bear a far more heavy burden of taxation than in ordinary times. There is naturally a wide diversity of opinion as to how taxes should be levied, as to the inequality of taxation, etc.; and while it is at best a subject upon which it is exceedingly difficult to secure a complete agreement, it is safe to say that the people will, in such times as these, accept the decision of The President and the Congress.

While it is out of the question to attempt to cover the whole field of taxation in a few brief paragraphs, it is at least proper to set down some principles which are to be generally agreed upon by the experts.

First: It is very desirable that the taxes shall be so applied that they will cause people to economize, for, as already stated, the only source of funds is savings and the only one way to neutralize the wastefulness of war is by the most rigid economy.

Second: Direct taxes, such as the income tax in the United States,

or the real estate tax, used in most of our cities, have a distinct merit because they can not be evaded, and the individual knows exactly what he is paying.

Third: Indirect taxation, which may take any one of several forms, is highly desirable in some respects, though objectionable in others. In so far as it operates as a tax on consumption, such for example as a tax on tobacco and spirits, or on articles of food and luxury, it is very valuable both because it is easily collectible, and because by adding to the cost of the article it tends to reduce its use, and therefore results in economies.

Indirect taxes are popular with the legislators, because the tax is included in the price of the article, and is paid by the public without grumbling, and in so far as this form of taxation does not fall upon the bare necessities of life it is desirable. (*)

Other forms of indirect taxation are more open to criticism, for example, taxes against corporations, known as taxes at the source. These taxes, such as excess profits taxes and the like, yield large revenue and in so far as they are a check on excess profits, are desirable. At the same time, they are in the end largely paid for by the consumer without his knowledge, for the reason that every individual pays taxes on everything he buys because taxes are necessarily included in the cost of production and sale and hence must be included in every payment whether it be for rent, for the butcher's bill, the merchant's bill, or anything else.

(*) Taxes on the consumption of necessities of life are objectionable but even fuel, meat, bread, sugar, etc., should be taxed if used in more than necessary quantities - Just how such taxes can be applied and not be evaded is a matter worthy of some study. -

Taxes at the source when applied against public service or public utility corporations (e.g., gas, electric, telephone, telegraph, or transportation) which are under contract or law required to furnish service at a fixed cost can not be thrown upon the consumer, except (and that is an important consideration) in the form of diminished quantity or quality of service, and must therefore come in part if not wholly out of the profits or dividends of the owners. This sort of taxation is unequal and undesirable chiefly because it results ultimately, if not at once, in the impairment of the service which the public desires.

THE LIMITATIONS ON TAXATION.

It may be asked with a good deal of force, to what limit may a nation go in fixing its taxes? That is indeed a difficult question to answer, and one in which experience and education are the only safe guides. It was not many years ago that a national tax of two billion dollars seemed very high in the United States, whereas we can now look at national taxes which will yield possibly twice this figure, with considerable equanimity. It may be said about taxation, as about many other things, that "one does not know what one can do until he tries". It is probable that if the public were thoroughly informed as to the advantages of the "pay as you go" policy, and appreciated the comparative results from raising funds by taxation and raising them by issuance of bonds, it would submit with cheerfulness to a more severe form of taxation than any yet suggested, but much education is needed to bring our people to the proper frame of mind.

The individual, whether in private life or in the conduct of his business, must not feel that taxes are so severe that he can no longer endure them, or that his business is to be ruined. He must be convinced that the winning of the war and the future safety of the nation depends on sound war finance, and that that involves heavy taxes, because "we must pay as we go".

It is an undeniable fact that all forms of taxes are unpopular, that almost every individual who pays taxes has a deep rooted conviction that some other individual has managed to evade his share, or is paying less than he should. At the same time, the payment of taxes, whether national, State or municipal tends to bring home to the citizens the importance of an efficient and good government and contributes to good government by imposing upon the citizenry the necessity of watching public expenditures.

SECURING FUNDS BY BORROWING.

The only other alternative for raising money to pay for the war is by borrowing it from the citizens through the issuance of Government bonds.

Borrowing money from the public is the usual way of financing a war. One obvious reason for it is that the machinery for borrowing is simpler and can be put into operation more speedily and easily than the machinery for taxation. As soon as a nation determines upon this course there is comparatively little room for differences of opinion, and it is only among the experts and the economists that the evil effects of borrowing are appreciated. However, it should be obvious to any one that the source of supply, whether the funds be borrowed or whether they be taken by taxation, is the same, to wit, the savings of individuals. In one case these savings are contributed by the individual to the Government once and for all, in the other case they are loaned to the Government with the promise of repayment. It is the common understanding that in one case we make the present generation pay for the war, whereas in the other case we think we are putting the burden upon the future generation; but this statement, in the opinion of many economists, contains a fallacy which should be carefully studied and analyzed. The economists who believe this statement to be fallacious maintain that there is no way in which the cost of a war can be deferred; that the reason the war must be paid for at the time and not by

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posterity can perhaps be best explained by pointing out the essential fact that what the Government requires is, as we have already said, "goods and services"; that the services of the soldiers and the services of the men and women behind the lines, to make the munitions, clothing, etc., and to supply transportation by land and sea, must be paid for when supplied.

The conception that a government could make posterity pay for present day expenditures seems to have become fixed in the public mind from the analogy of every day corporate finance. Thus when a railway, or a mining or manufacturing corporation, or a merchandise undertaking raises capital it borrows from the public today with the expectation of paying the money back from the accruing profits. In such^a case, if the enterprise is successfully administered, the public has contributed to it and so has borne the burden as well as enjoyed whatever profits the undertaking may have yielded. In that case the funds originally contributed are not spent for goods and services, which are thereupon consumed and wasted, but are spent in creating and developing an organization which will produce goods or services for sale to the public, and which will from the profits from future sales repay the investors. On the other hand, when a nation borrows money from its people the money is at once spent for munitions of war, for food, clothing, blankets and a multitude of other things which add nothing to the wealth of the nation, and which are soon consumed.

The further fact which seems constantly to be lost sight of is that the same people from whom the money is borrowed by the nation, must be taxed to pay the interest and repay the principal; for the money has been spent for the conduct of the war and not to create new or added earning capacity.

Because the truth of this statement may not be readily conceded, let me see if I can make it more plain. Let us suppose that we were a nation of a million people, each with an annual income of ten thousand dollars.

If the Government should call upon us to subscribe to the Liberty Loan bonds and we each subscribed the same amount, say one thousand dollars, the Government would receive a round billion of dollars and we or our heirs would receive forty million annually as interest upon our investment. But who would pay back the principal at maturity? Why we, the same people from whom the Government borrowed the money. In other words, we are the Government. (*) We are lending the money to ourselves and paying ourselves the interest and eventually repaying the principal to ourselves at maturity. But, you ask, "what if some of us do not subscribe to the bonds? Some might do twice their share and some might do nothing". In that event, what would happen would be that the man who did not subscribe would still have to contribute in payment of taxes for the repayment of the money. Thus, he would be required to pay taxes to meet the interest on his assumed share of one thousand dollars worth of bonds, even if he had not subscribed to the bonds.

In the case assumed, each man has contributed ten per cent of his income, or one thousand dollars and has to pay in taxes each year enough to pay himself the forty dollars of interest due him, plus enough more to pay the bonds at maturity. If the bonds run for twenty-five years that would be, say, forty dollars a year more as a sinking fund, or, say eighty dollars total. If he does not subscribe and another man takes his share, he receives no income from Government bonds owned by him, but finds himself taxed for his share of the interest and sinking fund payments.

(*) Lincoln expressed it in undying words: "A Government of the People, by the People, for the People".

INFLATION.

The essential difference between raising money from the public by taxation and raising it by the issuance of bonds, is the resulting inflation. Inflation is a word that is much used, but not always understood. In its simpler and most readily comprehended meaning it is that form of inflation of the currency which was common in our Civil War, when the Government, instead of printing its promises to pay in the form of investment bonds, printed them in the form of currency notes. Under that method of inflation a government wishing to buy a million dollars worth of produce, or to pay a million dollars in wages, would simply print a million dollars of its own "promises to pay", and these promises to pay in the form of currency would thereafter pass from hand to hand as money. The extent to which this sort of inflation may go without wrecking the financial structure of a nation depends entirely upon the wealth of the nation, and the confidence which the public or other nations have in its ability to keep its promises. The usual symptoms of such methods of inflation are the disappearance of metallic money and the general advance in the prices of commodities. In this terrific war, most of the European nations have resorted to this or similar methods of inflation, and because the operations of various governments have been united through banking transactions and by reason of interdependence and close international relationship, even those nations entirely unconnected with the war have felt the effects of inflation. As a result, there has been in effect in the last three and one-half years, a world inflation the like of which has never before occurred. To illustrate: Prior to our entry into the war, when the European nations were buying heavily in the United States, they paid largely in gold for what they bought, and as a result about a billion dollars in gold coin came to this country in the

period of two and one-half years. The reason the European nations were able to send us their gold was that they printed paper money for their own use, releasing gold for us. But that gold inflation in this country is one explanation of the general advance in prices of all commodities, although undoubtedly it is not the only explanation; for it must be freely admitted that prices have been effected, first by scarcity, occasioned by increased demand from Europe for many articles produced by us; second by reason of the fact that increases in taxes and wages of labor have entered into the cost of production and sale of all articles, and account for a share of the increased prices of commodities. (*)

It is doubtful if we in our country could have avoided inflation, no matter how hard we had stuck to the plan of higher taxation or the "pay as you go" policy, but we may as well frankly admit that while our financial policy has been conservative, the great increase in our currency issues has contributed to the general inflation. True, we have not issued currency or Government promises to pay in the form of circulating notes, but we have issued bonds, and we have permitted - and indeed could not have forbidden -

(*) The extent to which inflation has accounted for the general rise in prices is of course debatable. Those who dispute it, point to the rapid advance in wages since 1914, due to the increased demand for labor and the withdrawal of many soldiers from industry. The increased demand or diminished supply of many commodities is also pointed to. As against these arguments we have the increased index number of more than two hundred commodities, the increased deposits and loans and discounts of our banks, the increase in the volume of currency per capita and the increase in the national debts of all the great nations.

the use of these bonds as collateral for bank credit. Thus while the Government has not paid for "goods and services" with its own circulating notes, it has issued its promises to pay in the form of bonds and it has permitted these bonds to be hypothecated for currency; and thus, through our banking system, has created a machinery under which the owner of Government bonds might secure bank credit with which he might pay by check or in currency for what he bought. We have thus far in this country been able to hold down the issuance of currency by maintaining a high gold reserve against it, and there is no national currency that is on a stronger basis; but to deny that the issuance of Government bonds to raise funds to pay for goods and services result in inflation, would exhibit an unwillingness to look the facts in the face.

How raising of funds to pay for all but permanent improvements results in inflation might well be illustrated by the analogy of corporate finance familiar to most people. If a railway corporation or a manufacturing concern were to issue its bonds or notes to pay for wages or fuel, it would at once be recognized as doing a reckless thing, the common rule with all honestly managed corporations being that money raised by sale of bonds, notes or added capital can only be spent for permanent betterments, or for those forms of expenditures which increase the earning capacity of the corporation.

THE GOOD AND EVIL EFFECTS OF INFLATION.

While the effects of inflation are manifestly bad, it would be unfair not to admit that inflation has some good effects. In so far as it increases the prices of commodities generally, it results in compulsory economiss, and in this sense operates as a sort of tax on consumption. Hence, if it be true, as we have contended, that economy is necessary in

war times, it might be urged that a heavy consumption tax was a most desirable method of bringing about enforced economies. A just answer to that suggestion seems to be that such a form of consumption tax falls with great severity upon the citizens in general, because it adds to the cost of the necessities of life, upon the wage earner it falls heavily - unless and until he is able to get his wages advanced in proportion to the amount of the inflation - and upon those dependent on moderate fixed incomes or fixed salaries it is an unduly heavy burden. It affects, of course, all corporations or individuals engaged in manufacturing and other industrial enterprises, but it may in many cases be passed on to the consumer in the shape of increased prices. With those corporations who, by reason of contract or law, are required to accept a fixed compensation, it is very burdensome. Perhaps the most serious indictment against the results of inflation is the fact that it dislocates all the delicate inter-relations between wages, compensation, payment for services, prices of commodities, etc., and although brought about by the operations of the Government itself, its effect is to raise prices against the Government, thereby increasing the necessity for still further taxation or borrowing. In other words, it establishes what may be termed a vicious cycle, in that it first raises prices, and by so doing creates the necessity of raising more money, and so still further raises prices again.

CONCLUSIONS.

Our conclusion must therefore be:

First: That the Government needs rigid economy of all its citizens to win the war; that it requires it not only because it needs money to

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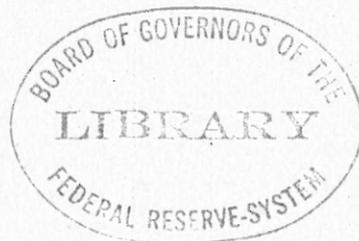
command and pay for goods and services, but because every self denial will release some goods or some service which the Government can use to good advantage.

Second: It is clear that taxation is not only the best way for citizens to support their Government, but taxes intelligently applied will do much to produce the very savings of which we have been speaking.

Lastly: Taxation and the resultant savings are the only ways to mitigate the perils and pitfalls of inflation.

F. A. DELANO.

May 24, 1918.

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