Volume Title: Fiscal Planning for Total War

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Volume Publisher: NBER

Volume ISBN: 0-870-14117-1

Volume URL: http://www.nber.org/books/crum42-1

Publication Date: 1942

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Chapter URL: http://www.nber.org/chapters/c4921

Chapter pages in book: (p. 102 - 126)

CHAPTER 5

Direct Controls

IN ANALYZING the fiscal methods of 'buying' defense we emphasized the need of curtailing civilian purchase of nonmilitary goods, as well as of goods that compete directly with military production. We now discuss, first, the inadequacies of the price system in emergencies and of fiscal methods as the sole means of achieving the double goal of an effective diversion of resources to the war program and preventing inflation. Fiscal methods must be supplemented by direct compulsion. Second, we analyze the main types and techniques of direct control, observing the limitations on any system, and the interrelations between their use and wartime financial policies. This chapter is not intended to be a treatise on direct controls as such; it is confined rather to the implications of their use for governmental fiscal policies today.

1 WEAKNESSES OF THE PRICE SYSTEM IN EMERGENCIES

The efficacy of any fiscal policy that may be pursued by the government depends in considerable degree upon the effective functioning of the price system. Even in ordinary times we have found it desirable to supplement or modify the price system in certain sectors of our economy, such as public utilities, coal, oil, and agriculture. In wartime, such sectors are multiplied. At the close of the first World War, the experience of every large participating country had convinced students of the subject that earlier and more extensive direct economic controls by government would be necessary in the next war. The striking extent to which the British have gone in this direction in this war is evidence of an intensified conviction on this point.

What are some of the principal limitations upon the price system as an instrument for the reallocation of productive resources in a war? First, large military orders often create artificial scarcities by inducing a rush of inventory accumulation on the part of business enterprises and of hoarding by individuals, thereby accentuating the real shortages which arise from military buying or other causes. Even very high bids by the government are not sufficient to obtain control of supplies. In the long run, this condition might correct itself, but wars are fought in the short run. Priorities and rationing at consumer and other levels are means to combat this difficulty.

Second, although price advances based upon accurate forecasts of demand and supply conditions may serve to curtail non-military consumption to a certain extent, they cannot always be relied upon to do this with sufficient effectiveness. The curtailment may take place too slowly. A varying part of the civilian demand for many goods of great military importance is relatively unresponsive to advances in price. The chromium, nickel, and cadmium used in alloy steels, for example, are needed in such relatively small quantities for civilian purposes that little reduction would occur in this use of them even with sizable price rises, particularly in the short run.

Third, the expansion in general civilian consumption stimulated by rising employment and payrolls may compete successfully with the military demand for various materials on a price and profits basis. The growth of labor incomes may cause such increases in consumer demand and in the profits of consumer goods industries as to lead the latter to attempt both an increase in their output with existing facilities and an expansion of their productive capacity, thereby adding further to the competition with military demand for goods and labor. On the other hand, unnecessary or unnecessarily sharp price advances in some lines, created by the temporary artificial scarcities cited above, though subject to correction in the long run, may cause needless curtailment of civilian consumption.

Fourth, when rising and high prices do not constitute the most effective stimulus for the provision of the needed supplies, government may have to resort to outright compulsion. This is clearly true in the case of personnel for the armed forces: nearly all the major countries of the world have found it more effective to draft men for the army and navy than to try to attract them by high wages. Patriotism is a sharp spur for business men and workers; but, although the profit motive too is in general a similarly sharp spur, it may raise some serious obstacles through its bearing on certain business decisions. Business men have a natural reluctance to risk losing their regular markets by a temporary diversion of their facilities to military purposes. Also they are afraid to expand their plants to fill military orders because they dread the excess capacity they will have on their hands when the war ends. Even when the government is ready to provide the funds for expansion, as is ours, this fear of the postwar effects of the augmented plant capacity upon the industry's price structure may retard needed expansion. Moreover, private enterprises are naturally averse to making their designs, patents, processes, etc. available to potential competitors with idle productive capacity. But some duplications of plant and personnel which are desirable under normal conditions to give the public the benefits of effective competition and of flexibility in the responses to its changing demands may constitute wasteful uses of scarce resources in wartime. The British government is forcing numerous temporary consolidations of enterprises, particularly in the distributive trades, with the object of releasing productive resources for the war industries.

Fifth, the effectiveness of high and rising prices as a stimulus to output is sometimes lacking in the short run because of physical limitations upon factory capacity, shipping facilities, raw materials, or other needed factors. This has been the situation since early 1941 for numerous drugs, most metals, and nearly the whole machine tool industry. Free bidding during an emergency can bring about wild and possibly contagious price increases, with consequent enlargement of governmental costs, without eliciting enough additional supplies. Such cases invite price fixing coupled with rationing.

Sixth, widespread dissatisfaction with the unmodified results of the price system in the allocation of rewards and sacrifices is common during a national emergency. President Roosevelt reflected a strong popular sentiment when he said that nobody should be allowed to get rich out of the defense program. When thousands of young men are being called upon to interrupt their careers and to jeopardize their lives by serving in the army or navy, it is a natural and nearly universal human reaction to resent the often whimsical effects of wide price movements in enriching some classes and individuals and forcing radical curtailment of consumption upon others. When, as in Europe today, common necessities such as food and clothing are in short supply, the gross inequalities in their consumption that the price system, if uncontrolled, would bring about are likely to prove intolerable. In England the rationing of foodstuffs and the taxing away by the government of 80 per cent of all increases in business profits above the prewar level, though undertaken for other reasons as well, reflect these sentiments.

2 INDISCRIMINATE AND TARDY EFFECTS OF FISCAL CONTROLS

These deficiencies of the price system in a war are paralleled by the limitations of fiscal measures as the sole instruments of control, for such measures operate chiefly through prices. In addition, fiscal measures are difficult to apply with a sufficient degree of precision and discrimination, and are often exceedingly slow in their working. For example, the consumption of specific goods, such as aluminum or steel, may not be reduced when civilian spending in general is reduced by heavy increases in income taxes or the extensive application of sales taxes. Some taxpayers will get the money to pay the extra taxes by reducing their consumption of goods in abundant supply rather than by cutting down on durable goods made of materials needed for armaments. On the other hand, selective excises on automobiles, for instance, high enough to ensure a substantial curtailment of total civilian purchasing, would be hard on some people because they would apply inflexibly to both necessitous and luxury demand. One man's job may depend upon the purchase of an automobile, whereas such a purchase may be a sheer luxury to another. Worst of all, the latter is more likely to be able to overcome the inhibiting influence of the tax. Furthermore, even the ablest specialists do not know enough about the responsiveness of the demand for different goods to changes in their prices to fix specific excises with any hope of achieving precise reductions in their consumption.

So far as additional revenue is sought by raising the rates or extending the coverage of the existing income tax with its present method of collection, much of the corresponding curtailment in private spending will be deferred until shortly before or after the payments are actually due and some of it as long as a year or more. Corporations commonly accumulate funds as their tax liabilities accrue, but most individuals do so only in the year following, when the taxes are due. Even when paid, the restrictive effects of increases in taxes may be offset, as we have noted, because current liquid savings and accumulated funds are used.

3 NEED FOR DIRECT CONTROLS

Considerations such as these indicate that much more prompt, efficacious, and discriminating limitations on civilian spending may be accomplished by direct governmental prescription—priorities, allocations, and rationing—than by purely fiscal measures. Administrative decrees may be timed with considerable precision, altered from time to time, and formulated discriminatingly to lead producers and dealers to confine their sales of strategic goods to enterprises possessing duly approved allocation or priority permits.

Direct controls may also be used to reduce greatly the money costs of the war, and to lessen the dangers of inflation. To the extent that the government conscripts soldiers at $50 a month instead of bidding for them in the labor market, and limits the prices it pays for steel, shells, chemicals, and other goods to levels below those which would otherwise prevail, the Treasury's need for funds is reduced. By fixing maximum prices for a wide array of goods, the government prevents speculative and contagious price increases in civilian goods as well. Rationing can powerfully support price controls by reducing effective demand for rationed goods.

Direct controls may be classified roughly into three broad groups. The first includes all methods which apply direct action to channel and stimulate the flow of materials into military production and apply direct compulsion to restrict or prohibit the consumption of scarce materials for uses deemed non-essential in the war. The chief methods, known collectively as the *priorities system,* are priorities, allocations, and rationing. The second broad group includes all devices which operate directly upon the price mechanism, such as fixing the prices of commodities and services, wage and interest rates, rents, real estate, and other capital values. The third group includes restrictions on bank credit and the flotation of new corporate securities, in order that non-essential uses of credit and capital may be prevented from competing with the war program.

The Priorities System

Merely placing orders for the enormous quantities of the many and diverse products required for war will not ensure their production promptly or in the necessary sequence. Not only must civilian demands be prevented from delaying the production of military goods and from using up essential materials, but the competition of the various military demands with one another must be so handled as to prevent the less important from holding back or disorganizing the production of the more important. Some orders must be given precedence; manufacturers of military goods must be enabled to obtain the materials and equipment they require; and the production of some civilian goods and the use of certain materials in products for civilian consumption must be curtailed or even stopped.

One means of achieving these ends, first used during World War I, is the priorities system. Although the allocation of scarce materials, tools, and industrial equipment, and the prohibition of certain uses of them, have become a part of that system, it was originally devised as "a method by which one body of officials would sit in judgment to determine the sequence in which materials should be manufactured and orders filled".[1]

a) *Preference Ratings*

Both during World War I and in our recent defense program the priorities system was at first confined to grading orders or contracts by means of preference ratings (also called priority ratings) which would indicate their relative importance or urgency. These ratings were conceived of as serving two purposes: on the one hand they were intended to aid producers by requiring suppliers to give preferential treatment to orders for such materials or equipment as were needed for the execution of a contract with a rating; on the other hand they were expected to help each producer plan his own production by requiring him to execute his contracts in the order of their indicated urgency.

Preference ratings were at first assigned solely to war contracts or orders that were either regarded as of special urgency or with respect to which the producers applied for priority aid in obtaining essential materials and supplies. Such aid was most commonly given in the form of an individual preference rating certificate issued to a manufacturer and constituting a notice to a specified supplier that the manufacturer's order for specified materials was to be given preferential treatment. When, however, a manufacturer is engaged wholly or almost wholly in essential war work, a blanket rating gives him the right to acquire specified materials quickly, without getting a separate certificate for each order. Similarly, if several manufacturers are all engaged in making the same kind of product and are having difficulties in obtaining materials, a blanket rating may be issued to all, and thereby the numerous individual certificates which would be required to cover each contract and each supplier are obviated.

Preference ratings are usually applied to finished products, such as tanks, airplanes, ships, guns, and, by successive extensions to subcontractors and suppliers, reach down to the raw materials in an effort to channel their flow through to the final products.

b) *Allocation of Materials*

As the books of producers become crowded with war orders, there is an increasing tendency to apply for priority aid; preference rating certificates assume unwieldy proportions and create new problems. What has been termed the 'priority scramble for raw materials' tends to develop, and the immediately available supply proves insufficient to meet all demands of equal priority. Some better system of controlling and allocating supplies then becomes necessary, as it does whenever shortages exist or seem imminent in any vital material or equipment. Such a system is that known as industry-wide mandatory priority control and allocation, by which the government prevents the use of the controlled scarce products in any manner not specifically authorized or directed by the priorities administration. Instead of taking physical possession of, and paying for, the entire output of the industry, then reselling it to various buyers, the government specifies to whom and in what quantities the producer will be permitted to sell it.

While preference ratings bring about some subordination of civilian to military demands, non-defense industries are more directly and specifically affected by industry-wide control and allocation of materials. Under it the quantities of the controlled materials which may be used for non-military purposes are definitely limited. Civilian needs may be allotted specified amounts of a material in the order of their importance; or the maximum quantity that may be used by a particular industry or in the manufacture of a particular product may be set; or use for non-military purposes may be entirely forbidden.

An actual shortage of raw materials cannot, of course, be made up for by allocation. But by wise allocation the most effective use of the supply can be ensured, the 'priority scramble' minimized, and better planning of the military program as a whole and of the operations of individual manufacturers achieved. Unlike preference ratings, which apply to finished products and exert their influence downward through the manufacturing process, allocations usually exert control over the scarce materials and direct their flow upward to the final product.

A priorities system, like other forms of direct control, inevitably leads to more and more stringent and extensive action. As preference ratings become inadequate, the use of materials and of industrial tools and equipment and their allocation have to be specifically limited. And as war production increases in volume and urgency, transportation facilities, fuel, electric power, and even the labor supply must be subjected to priority control in one form or another. The next step is to stop the manufacture of customary products by direct order or other forms of duress, as has already been done with automobiles and numerous other products. Similarly, as acute shortages of civilian goods develop, resort must be had to consumer rationing if gross inequities in the distribution of the supplies are to be avoided and inflationary competitive bidding prevented. And to prevent stocks of scarce goods from being exhausted before a rationing scheme can be worked out and put into effect, it may be necessary to impose a temporary ban on their sale, as was done with new automobiles and tires.

The priorities system, as we see, is not a static plan which is put into effect and never altered. On the contrary, it is a system which unfolds and evolves steadily, in accordance with the successive stages of an emergency. In the early phases of the present emergency, such as the eighteen months prior to Pearl Harbor, when the military demand for scarce resources was not especially great in relation to supply, preference ratings were the predominant and reasonably effective device used to channel materials into military production in an orderly sequence. By early 1942 the situation had become radically different. It was clear that we must meet a substantial proportion of the needs of the other twenty-six United Nations as well as our own military and civilian requirements. Demand upon our resources became virtually unbounded, but we had to keep it within the limits of our physical capacity to produce. This balance is being achieved by a steadily widening use of mandatory allocations under which our supplies are apportioned among the competing demands largely in accordance with strategic considerations.

Price Control

The priorities system not only dominates production of both military and civilian goods; it also affects commodity prices. By restricting and controlling the use of basic industrial raw materials which are under industry-wide control and allocation, thereby limiting or preventing competitive bidding for them, it assists in preventing their prices from rising. By curtailing and even entirely shutting off the manufacture of numerous consumer goods, however, it creates inflationary pressures which can be successfully combatted solely by a program which includes an effective scheme of price control. In the case of consumer goods in which acute shortages are created, price control could probably not be made effective unless accompanied by a system of rationing. For without rationing there would still be competitive bidding of one form or another for the scarce supplies, and bootlegging and other forms of evasion of price control would appear. These evasions are also possible under rationing, but in much less degree. Because of the restrictive influence the production of military products necessarily exercises upon the supply of many consumer goods at the same time that consumers' money incomes are being generally increased by the expenditures associated with the war, general price control, supplemented and reinforced by fiscal measures designed to draw off or immobilize excess consumer purchasing power, becomes necessary if inflationary price rises are to be avoided.

In the present conflict, far more than in the preceding, the significance of price control has been fully and widely appreciated. All major belligerents have assigned price control a principal role in their economic organizations. In most countries, these control systems were put in operation upon or shortly after the outbreak of hostilities. Some countries, especially those whose military efforts were furthest advanced in September 1939, have used price control as a means of more perfect preparation for war as well as for its more effective prosecution.

Price control has been recognized as a necessary supplement to the priorities system,[2] as helpful in promoting the war and keeping down the money cost. But its chief value is in preventing or at least retarding the price increases associated with the transition from a peace to a war economy. When war comes, the established peacetime pattern of demand becomes obsolete; the demand element of the price structure is violently and suddenly rearranged. The types, amounts, and proportions of goods desired by the people as a whole under war conditions are radically different from those wanted in normal times. This change in the national will is reflected in government spending. But government spending, in and of itself, cannot supply the nation with its newly desired instruments of war. A redirection of productive energies must follow a redirection of national spending. Toward this end, the configuration of the price structure begins to change. Prices of wanted goods rise relatively to prices of unwanted. Forces are unleashed which tend to remedy both short supply and redundance. Time is too short for the price system to make needed adjustments and too much is at stake. Price control can prevent increases that are unnecessary or potentially greater than necessary, thereby contributing the positive advantages already enumerated elsewhere. On the other hand, it can permit an increase held desirable as an incentive to production, or for any other reason. In short, it can retain those aspects of the free price system which are useful in wartime and at the same time remedy some of its defects.

It obviously has numerous advantages in war industries. So far as price rises are prevented or minimized, the over-all money cost of war is reduced. The government does not have to collect so many dollars during the course of the war and carries a smaller indebtedness into a postwar period of lower price levels and money incomes. Price control helps also to minimize business hoarding, manipulation, and speculation, as well as civilian accumulation of essential materials.

So far as a stabilized cost of living is achieved, an important source of pressure for wage increases is removed. A rise in the cost of living is a frequent and persuasive argument for advancing wage rates. But if wage rates are progressively advanced, the consequent cost changes may, like some increases in commodity costs, operate to discourage or diminish essential production, and the consequent increase in money income accentuates the fiscal task of mopping up excess spending power. Moreover, a stabilized cost of living, by preventing a decline in real wage and disputes based upon it, removes at least one source of labor trouble.

a) *Methods*

Effective price control requires the regulation of prices and of supply and demand. It is direct when it takes the form of authoritatively established selling prices; it then becomes synonymous with price fixing. When it is formal, official price schedules are imposed upon the markets; when informal, representatives of the industries concerned agree with price control officials upon prices to be charged and impose upon themselves the enforcement procedure known as 'price discipline'. Informal price fixing is widely used because, among other reasons, the conference negotiations which are at its heart afford an excellent opportunity to enlist the civilian cooperation essential to successful wartime price control in a democracy.

Price fixing ostensibly accomplishes the purpose of price control but its effectiveness may often be more apparent than real. Divergences between the real and the fixed price are more likely when the fixed price is supported by indirect price control. The disadvantages of price fixing, when used alone, lie in enforcement. The fixed price is usually not the same as, and is presumably below, the price which would be established by a free market. Price control authorities must be prepared to cope with the myriad devices of price evasion, with bootleg or 'black' markets, and with all the potentialities inherent in the alteration of the commodity for which the price is fixed as well as in the modification of the trade practices that ordinarily surround it. When evasions threaten to undermine respect for the law, the price control authority can resort to price and commodity 'policing'. At best difficult and expensive, especially in a democracy, it should be avoided if possible.

Price fixing may be total or partial.[3] Total price fixing usually implies the selection of a general standard. Here, average or maximum prices in effect at a given date or within a given period become either the fixed prices or the bases for the determination of fixed prices. Partial price fixing, on the other hand, by its very nature calls for individual price standards, in the choice of which judgment must be exercised. The appropriate price is that just high enough to supply sufficient incentive for production. Further, differential prices for different producers and for different units of supply, and 'price parity' must also be considered.[4]

To supplement and support price fixing, or conceivably even to take its place, prices may be indirectly controlled through manipulation of the supply or demand factors, or both, underlying the market. Manipulation of demand for consumer goods includes all forms of moral suasion, restriction of consumer credit, and rationing. These devices are valuable supplements to wartime fiscal policy in that they rapidly and certainly reduce civilian competition for materials and resources needed in the war program. They promote the war effort by conserving resources and by facilitating price control. By reducing consumer demand they relieve the pressure set up in consumer goods markets by an abundance of free purchasing power and divert that purchasing power to idle balances, purchase of government bonds, or other uses. Consumer rationing is of particular effectiveness in another direction: consistently and rigorously applied in all markets where prices are under upward pressure because of an abundance of purchasing power or of the repercussions of priority and allocation systems upon underlying industries, it can remove many of the enforcement hazards inherent in price fixing. If money alone cannot command goods, the temptations to and the likelihood of price evasion will be appreciably lessened.

Manipulation of supply includes the purchase and sale of commodities by the price control agency or a governmental agency cooperating with it, requisitioning stores and inventories, payment of subsidies, encouragement of salvage, stimulation of invention, search for new sources of supply, encouragement of full capacity operation, conversion of plant facilities, additions to plant and equipment, resort to imports, and control of exports.

The goals of price control can be achieved through price fixing or indirect measures, or through both. Price fixing by itself, however, has certain serious disadvantages. Indirect price control, on the other hand, while reasonably effective in the early stages of a war program, cannot be expected to meet later requirements fully unless supplemented by price fixing.

b) *Wage Control*

Stability of wage rates is an enormously important factor in the effectiveness of price control. The reasons are simple and familiar. Continuously advancing wage rates will in time raise costs and, consequently, bring pressure on prices and cause them also to advance. While the cost of advancing wage rates is in truth often absorbed by declining overhead costs and increased efficiency, these factors cannot be counted upon as permanent sources of savings, especially in the increasing number of industries and plants that have attained capacity output. A very large proportion of the working population also is engaged in activities, notably the services and commerce, in which gains due to technological progress or increased efficiency are limited or nonexistent and in which, therefore, advancing wage rates are translated swiftly and almost proportionately into higher costs and prices. Whatever effects an advance in wage rates may have on costs and prices, it tends to swell labor income and, in time of shrinking supplies of goods and services, acts as a positive force in bidding up prices and, hence, in raising the general price level. Since labor income accounts for more than 70 per cent of national income and is anyhow expanding by reason of fuller employment and overtime, there can be little doubt that pushing up wage rates still further augments this major share of the national income and adds to the potency of this inflationary force.

The reality of this simple sequence of events has been recognized in all warring countries. It accounts for the variety of measures governments have taken to limit income and to throw restrictions around its expenditure. Income has been cut by resort to forced savings, by drastic income taxes, by outright wage control, or by some combination of these measures.

In the United States wage rates started to go up at the beginning of the war in 1939, and have advanced at an accelerated rate since the beginning of 1941. During the first half of 1942 they continued to rise and the leading trade unions pressed for further increases. The combination of advancing wage rates and expanding employment has greatly increased aggregate payrolls and labor income. With the current expansion of war production and the shrinkage of goods available for civilian use, the continued rise of wages and employment is bound to exert a cumulative upward effect on prices and render difficult, if not impossible, effective price control.

The threat of consequences of this sort has not passed unnoticed. Many forms of regulation have been suggested, ranging from substantial withholding taxes on wages to ceilings on all wage rates. In the price control bill, approved January 30, 1942, Congress refers to the problem by declaring that "it shall be the policy of those departments and agencies of the Government dealing with wages . . . , within the limits of their authority and jurisdiction, to work toward a stabilization of prices, fair and equitable wages, and cost of production".

Failure of Congress to go beyond this broad statement of intent has been due to a deep and persistent conflict between price and wage policies. It has been assumed that the two are independent and that prices can be controlled in the face of rapidly rising and unregulated wage rates. The first labor board, the National Defense Mediation Board, failed to adopt a general wage policy and may be said, in its adjudication of specific cases, to have encouraged demands for higher wage rates during 1941. Its successor, the National War Labor Board, though apparently concerned over the inflationary effects of rising wages, has been unable to impose effective curbs on increases. If wage increases are to be restrained and prices stabilized, the adoption of principles to guide it in dealing with current and future demands for wage increases would seem to be one of the Board's most urgent duties. If it is unable to reach an agreement on wage policy, the country must be prepared either to face a continuation of the wage movements of 1941 or to look to Congress to give more specific instructions to the governmental labor agencies than it has so far.

Control of Credit and the Capital Markets

In the credit and capital markets the free play of competitive forces under ordinary competitive rules might succeed in diverting a large fraction of private savings to non-defense uses, in unduly raising the interest costs of the government's emergency borrowing, and in permitting a dangerous expansion of bank credit.

A wartime policy of credit control must aim, therefore, to prevent such diversion of savings, yet interfere as little as possible with governmental borrowing operations and the free flow of credit to industries engaged in military production. In other words, non-essential credits must be restricted and the extension of credit for essential purposes facilitated.

The principal types of credit with which we are concerned in this section are commercial bank credit for ordinary purposes, installment credit for the purchase of consumer durable goods, long term capital for new plant additions, working capital, home building, etc., and speculative credit for the purchase of capital assets.

Direct control of credit may be either quantitative or qualitative. Under ordinary peacetime conditions, quantitative methods are usual. For example, the Federal Reserve Board, in past years, has attempted to influence credit conditions mainly by methods designed to increase or decrease the reserves available to member banks.

Although reasonably effective in times of peace, such quantitative methods alone suffer from serious defects during a war. The general tendency of a reduction in excess reserves is to check an expansion of bank credit by raising interest rates. This method of over-all credit limitation has the unfortunate effect of raising the interest cost of governmental borrowing and increasing the difficulty the government has in selling its bonds, owing to the depressing influence of rising interest rates on the market value of outstanding issues. Furthermore, a general tightening of credit makes it more difficult for private industry to get credit for military production.

On the whole, the evidence seems to indicate that more harm than good is likely to come from an extensive use of quantitative credit controls in wartime. What is clearly called for is a qualitative control of credit or a direct limitation of particular credits deemed non-essential for the war program.

Fortunately, from the administrative standpoint, the problem is not nearly so difficult as it might seem. So far as the priorities system is effective in curtailing the flow of materials and equipment to non-defense uses, credit is automatically limited for these areas. The generalization may be made that direct credit control will be necessary only in areas where other methods of direct control do not reach or prove inadequate. In fact, direct control will usually be unnecessary for all the types of credit listed above, except speculative credit for the purchase of capital assets and installment credit for the purchase of consumer goods.

For example, the Reserve Board, on September 1, 1941, imposed restrictions upon the extension of credit by banks and others for the purpose of financing any one of twenty kinds of consumer durable goods. At the time, the priorities system was just beginning to restrict the output of such items as are largely competitive with military production. Credit control in this area, therefore, seemed a useful device to check both an undesirable expansion of credit and the production of non-essential goods. Since then, however, production of most of these items has been either curtailed severely or stopped completely. Consequently, the occasion for regulating this type of credit has been greatly lessened.

During the first World War a Capital Issues Committee was established in the United States to control the sale of securities for the purpose of raising new capital. Under a somewhat inadequate priorities system, it performed a useful function in checking non-military capital outlays, particularly in state and municipal bond issues for construction purposes. In 1941 the Securities and Exchange Commission took a step in this direction by requiring that all prospectuses filed with it contain a statement indicating whether the proceeds were to be used in ways serving national defense. More stringent steps of this kind may be taken in the future, but there is little evidence yet of any need for them. War Production Board control over materials and equipment is now so complete that very little construction or expansion is possible in enterprises not related to the war.

Possibly some additional control may seem desirable to regulate the raising of additional working capital by private business. Under the present corporate tax structure, in which interest is a deductible expense and high tax rates are applied to corporate incomes, the cost of such additional capital is almost negligible and the temptation to float such issues, even if they are not needed for immediate business purposes, is offered. Excess funds of this kind may constitute a potential inflationary threat because they may be invested in capital assets, such as real estate and common stocks. If held as idle cash balances or invested in government bonds, they cannot hamper the war program.

Under these conditions, the need for control seems to lie chiefly in the field of speculative credits extended to carry capital assets. As individuals accumulate savings because they cannot use the customary consumption and investment outlets, strong pressures arise for such funds to spill over into the capital markets and into speculative real estate purchases. Rising prices in these fields may stimulate the extension of bank credit for such purposes, create further inflationary pressure, and make more difficult the sale of government bonds.

During the first World War this country permitted a boom in farm real estate, financed in considerable degree by bank and mortgage credit. Inflationary forces during and immediately after the war were thereby accentuated. The disastrous deflation which followed left a legacy of widespread bankruptcy among farmers and banks for the next decade.

No such phenomenon has yet appeared in the United States, probably because ordinary civilian spending has not yet been curtailed sufficiently for large excess funds to accumulate in the hands of the public. In totalitarian Germany, on the other hand, the control of the stock markets has been one of the most difficult tasks with which Nazi officials have had to cope. Despite drastic taxation and forced government loans, savings have continued to accumulate rapidly and have spilled over into the purchase of securities. German officials have expressed considerable concern over the inflationary implications of the advance of approximately 60 per cent in Berlin stock market averages since autumn 1939 and have tried various measures to check it, but without complete success. A similar though less striking phenomenon has appeared in England. Since the low point reached with the collapse of France, the London stock market average has shown a moderately but steadily rising trend; meanwhile stock market averages in the United States have shown more weakness than strength.

Although this situation presents a problem which is broader than mere credit control, regulation of speculative credit is the first line of defense. The Federal Reserve Board already possesses broad powers to limit the use of credit in security markets, and both federal and state banking laws restrict the extension of credit for carrying real estate. If inflationary tendencies appear in either of or both these areas, more drastic restrictions may prove desirable.

Even if the credit factor were eliminated, the danger of stock market and real estate booms might still remain, because of the pressure exerted by rapidly accumulating cash savings. Such developments do not directly divert resources from the war effort, but they are inflationary and may have detrimental indirect effects. The chief reason is that advancing capital markets create an illusion of prosperity in the minds of the owners of capital assets and tend to heighten the pressure for consumption expenditures.

The checking of such developments by direct control is elusive and difficult, as is shown by the German experience. Some degree of control over urban real estate values may be achieved by establishing ceilings on rents, and over rural real estate values by preventing an advance in agricultural commodity prices, but control of a stock market boom by compulsion is not easy. On the whole, the best safeguard against booms of this sort is a wise fiscal policy which will not only mop up as much as possible of the excess purchasing power in the hands of individuals by taxation and the sale of government bonds, but will also check inflationary tendencies in the stock market by heavy taxation of corporate profits.

4 EFFECTIVENESS AND LIMITATIONS OF DIRECT CONTROLS

Theoretically, under a perfect system of direct controls a nation might wage a major war successfully and bother little about its fiscal policies. If the priorities system could divert all resources needed from civilian to military uses, if price controls could maintain proper levels of commodity prices, wages, and rents, and if credit control could prevent speculative excesses in the capital markets, a country might conceivably finance the cost of the war entirely through bank credit or printing-press money.

Even under such hypothetical conditions, the difficulties would be enormous. In the first place, tremendous inflationary pressures would arise from the excess purchasing power in the hands of individuals which would make administration progressively harder. In the second place, the psychological effects on the population would be very adverse because of uncertainty concerning the future. Finally, the postwar legacy of debt might easily prove unmanageable.

In the real world, of course, no such achievement would be possible, even for a totalitarian nation like Germany. While we may concede that a major war, which involves the diversion to military purposes of half the national product, could not be waged successfully without an effective system of direct controls, we must also realize that the limitations to the effectiveness of any such system are definite.

The first is the difficulty of administration, which is almost insuperable in any attempt to organize, in minute detail and quickly, a population of 130 million. Another difficulty arises from the progressively expanding necessity for direct controls. Direct controls imposed upon certain areas of production or consumption intensify the inflationary pressures in the areas which remain uncontrolled, forcing the system to widen step by step until it encompasses almost every phase of human activity. With each successive step administration becomes more onerous, and the stresses and strains in the economic structure increase.

The second limitation is political. While the populations of most countries show an amazing willingness in wartime to bear sacrifices and to subordinate their individual interests to the common welfare, certain areas usually exist in which effective controls are politically very difficult. We need look no further than at the attempts to regulate agricultural prices and to control wage rates in the United States today.

Finally, certain areas, e.g., capital assets, are extremely difficult to reach by methods of direct control. Large amounts of excess purchasing power that are not absorbed by taxation or directed into the purchase of government bonds will inevitably spill over into the capital markets, unless transactions in the latter are virtually prohibited.

Credit control as such cannot be expected to prevent a general inflation in wartime. Even if the priorities system is entirely adequate, and is supplemented by direct control of credit wherever necessary, general inflation may still occur if taxation and borrowing policies are unwise.

5 INTERRELATION OF DIRECT CONTROLS AND FISCAL POLICIES

The principal conclusion is that no system of direct controls can function effectively in the absence of adequate taxation and sound borrowing policies. Direct controls and fiscal policies are mutually complementary, and a judicious combination of the two is essential for the successful prosecution of a major war.

Adequate fiscal policies, on the one hand, make a system of direct controls more effective by reducing the inflationary pressure of excess spending power and by checking civilian competition for essential resources. An efficient system of direct controls, on the other hand, has important influences on fiscal policy:

1) By restricting investment opportunities in most of the usual areas, it facilitates the government's task of channeling private savings into the purchase of government bonds.
2) It makes possible government borrowing from sources such as commercial banks, which, in the absence of direct controls, would be highly inflationary, but which, with such a system in operation, may not be.
3) With effective direct controls it may be possible, and en-

proper, for a government to raise a smaller propor- f its total financial needs from taxes and a larger rtion from loans.

n taxation policies, which would be desirable if di- ontrols were inadequate or ineffective, tend to be- unnecessary, even harmful, when a system of direct ols operates efficiently. An example, discussed in de- ı Chapter 9, can be seen in the proposal to impose excises on articles, such as consumer durable goods, roduction of which is directly competitive with the program.

NOTES

1 Bernard M. Baruch, *American Industry in the War* (Prentice-Hall, 1941), p. 47.

2 "The priorities system cannot work alone. It is the heart of industrial mobilization, but it needs the other organs. Above all, it must have the assistance of price control, conservation, the search for substitutes and commandeering.

Price control is necessary because the priorities system is actually a means of short circuiting the laws of supply and demand. Scarce commodities, instead of being distributed to those who can pay the highest price as under a free economy, are allocated to those needs that are most important to the armament effort as a whole. Such a violation of natural laws makes it absolutely necessary to supplement the priorities system with some control of prices." Bernard M. Baruch, Priorities: The Synchronizing Force, *Harvard Business Review*, Spring 1941, p. 267.

3 Total or over-all price fixing envisages control of all prices, while partial or selective price fixing requires the exercise of governmental authority only in the case of 'unruly' or 'key' prices. The interrelation of all prices makes any system of selective price control exceedingly difficult to administer effectively. Since the prices of other goods and services are affected by the control of some, the former are in fact 'controlled' but controlled remotely, ineffectively, and irrationally. Selective price control amounts therefore to rational control over some prices and irrational control over others. The more effective the price fixing is the more probable become these undesirable results. Unutilized purchasing power is diverted to the uncontrolled markets where prices rise more than they otherwise would. Inflation is thereby stimulated and relative prices are distorted more than they would be in consequence of war production alone. Moreover, if any of the uncontrolled prices are cost elements of the commodities for which the prices are fixed, price advances may compel a revision of the fixed prices themselves.

The strongest arguments against total price fixing rest upon the administrative difficulties it would involve. To control all prices, to police all prices, commodities, and services would require for a large country an enormous administrative staff, an unbelievable number of administrative decisions, and a range of administrative activity approaching total control of the economic system. The spectre of such problems has been decisive for most of those who have supported selective price control. Nevertheless, control systems that begin with a few prices may be forced to add so many that the distinction between total and partial price fixing tends to disappear, as it has in the adoption by the OPA of a 'ceiling' on prices in general and with few exceptions.

[4] To base minimum fixed prices of certain agricultural commodities on parity prices injects into the price control program an element of variability beyond the reach of the price administration. Parity prices are determined outside the price control agency, are themselves dependent upon other prices, and at the same time exercise significant influence over other prices, many of which enter into the cost of living. An upward price spiral might be started which could, under certain circumstances, menace a large part of the price control program. Whether these circumstances will appear depends in large degree upon the effectiveness of control over non-agricultural prices and upon the demand-supply relationships that determine actual agricultural market prices as opposed to agricultural parity prices.