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PUBLIC AFFAIRS PAMPHLETS

HOW CAN WE PAY FOR THE WAR?

BY MAXWELL S. STEWART

Why are our taxes too little and too late?

How much dare we borrow without inflation?

What kind of taxes are best in wartime?

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HOW CAN WE PAY FOR THE WAR?

By MAXWELL S. STEWART

Jim Hogan sat back in his chair, lit his pipe, and began to read his evening paper.

"You know, Mary," he said, "we are going to have a tough time paying our taxes next year. The paper says they're going to take 5 per cent out of our pay envelopes each week as a Victory Tax in addition to an awfully stiff income tax. And that is on top of the 10 per cent they are now deducting from my pay for war bonds. Thirty-three bucks a week is more than I have ever earned in my life, but with all these taxes and deductions we are not going to be much better off than we were during the depression."

"But we'll get along somehow, Jim. We always have. We've got to do our share to win this war."

"Yeah, I suppose so. I don't understand this talk about the corporation tax, the sales tax, and excess profits taxes. They don't concern me anyway. I don't see why the government just

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doesn't borrow the money it needs. We've got lots of rich men who ought to be willing to lend what they've got. All I know is that it is tough to get along on $33 a week."

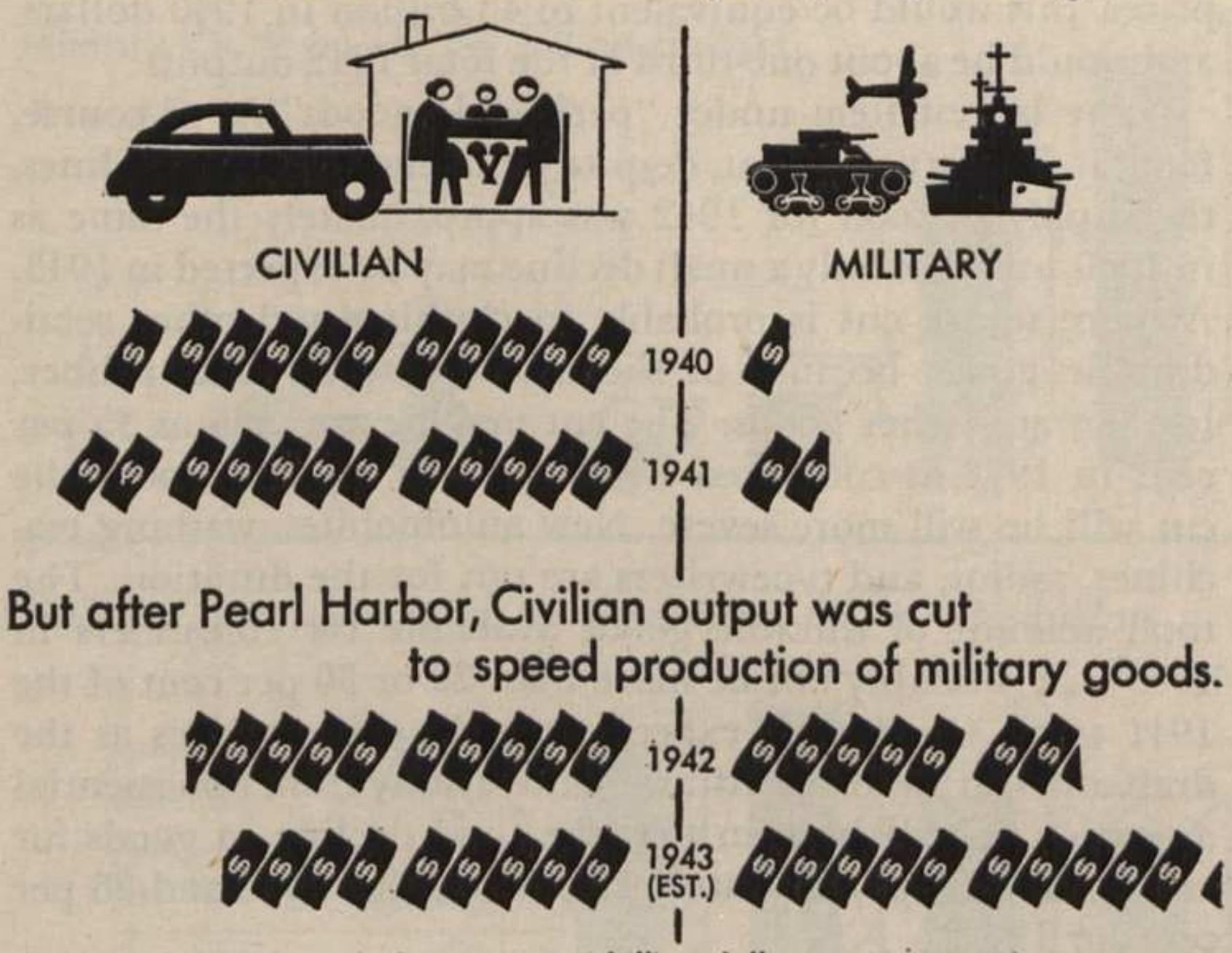
Jim is right about a lot of things. It is going to be tough to live on $33 a week in 1943. But Jim's dead wrong on one thing. It is going to make a lot of difference to him what kind of taxes are levied to pay for the war. And it is going to make a lot of difference to the country, too. He is wrong, too, about paying for the war through borrowing. It could be done; but he would be one of the first to suffer.

Our financial policies are much more important than Jim realizes. To win this war we've got to have planes, tanks, and guns before we can hope for success. But the cost of that success—in the suffering of our people, in damage to our way of life, and in the undermining of morale—can be held down by a wise and courageous financial policy. Or it can be vastly increased by stupidity and timidity. The whole future of our country may depend, to a large extent, on the way in which we pay for the war.

PLOWSHARES INTO SWORDS

WITH minor exceptions, there are just two ways of providing the supplies needed for war. One is to increase the total output of the country through a fuller use of our resources. The other is to cut down on what Jim, you, and I use in order that labor and materials may be shifted to military uses. During 1940 and 1941 most of our military needs were met through increased production. Except for automobiles, there was little decline in civilian output. After Pearl Harbor, however, the shift from civilian to military use was greatly speeded up. By the summer of 1942 the country had reached the point where we couldn't continue to increase our output. From then on to the end of the war an increase in war supplies could be achieved only by cutting down the output of goods for everyday use.

This does not mean that Jim's living standard, or yours, must drop as much as war production increases. Some decline, to be sure, has already taken place. But a large part of the increased military production will come at the expense of fewer



public buildings, swimming pools, new houses, and usual repairs. We have enough goods in stores and warehouses to meet Jim's needs and yours for a while. So far the pinch has been felt mostly in such things as new automobiles and refrigerators, which are not immediately essential for health or well-being. Despite apparent shortages in meat and canned goods, we have been eating as well as at any time in our history, and we have been well supplied with clothing and other necessities.

How We Are Really Paying for the War

The chart on page 5 shows how we are actually meeting the costs of the war. It shows our total production in 1940 and 1941, and our estimated production for 1942 and 1943; and how this production is divided to meet civilian and military needs.

You will note that about half of our total output will go for military purposes in 1943. In 1942 military expenditures

were approximately 50 billion dollars. Allowing for higher prices, this would be equivalent to 43 billion in 1940 dollars, and would be about one-third of the total 1942 output.

The largest item under "perishable goods" is, of course, food. It will be noted that, despite stringencies in certain lines, the supply of food for 1942 was approximately the same as in 1940, and that only a small decline may be expected in 1943. A more severe cut is probable in clothing and other semi-durable goods because of shortages in wool, silk, rubber, leather, and other goods. The cut may be as much as 35 per cent in 1943 as compared with 1941. In durable goods the cut will be still more severe. New automobiles, washing machines, radios, and typewriters are out for the duration. The total amount of durable goods available for consumers in 1943 will probably not be more than 20 or 30 per cent of the 1941 total. Consumers expect some drop in services as the draft and war industries draw workers away from nonessential activities. It will be seen that the total decline in goods for civilian use is approximately 18 per cent for 1942 and 26 per cent for 1943.

The chart shows us just how the increase from three billion dollars for military supplies in 1940 to 61 billion (1940 dollars) in 1943 is to be obtained. Out of a total increase of 58 billion, approximately 30 billion will come from increased production. Of the remainder, 13 billion will come from cutting down consumer goods, 12 billion from eliminating new building and construction, including machinery, and two and a half billion from a reduction in nonmilitary expenditures by the federal government.

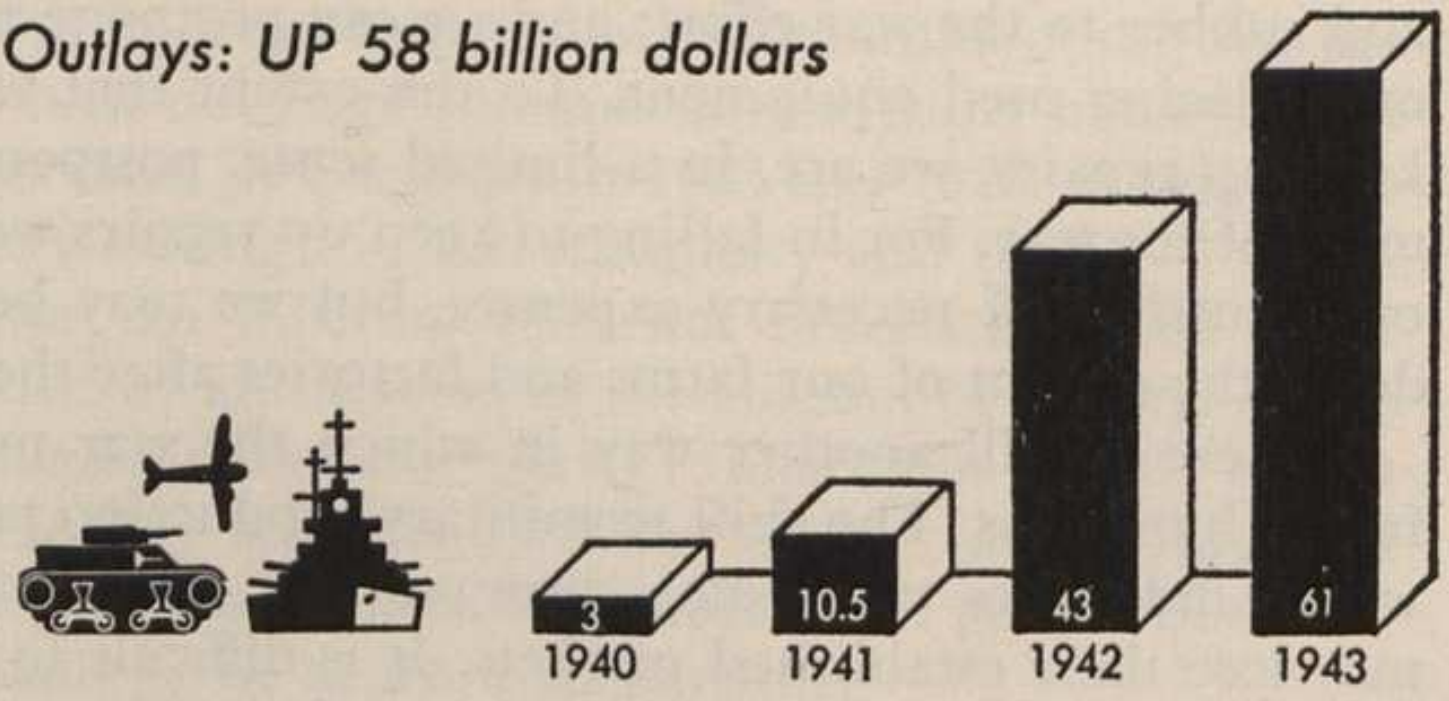
The Burden Cannot Be Shifted to Future Generations

There is, then, no mystery about how we shall pay for the war in terms of resources. Obviously, we must pay for it almost entirely from current output. You may have heard people talk of making our children pay for the struggle. This is impossible. It is true that they may be burdened by debt as a result of heavy borrowing. But it is we of this generation who must turn out the goods and draw in our belts to provide planes, tanks, and guns for our fighters. To a limited extent we can, it is true, draw on past production. We can use up

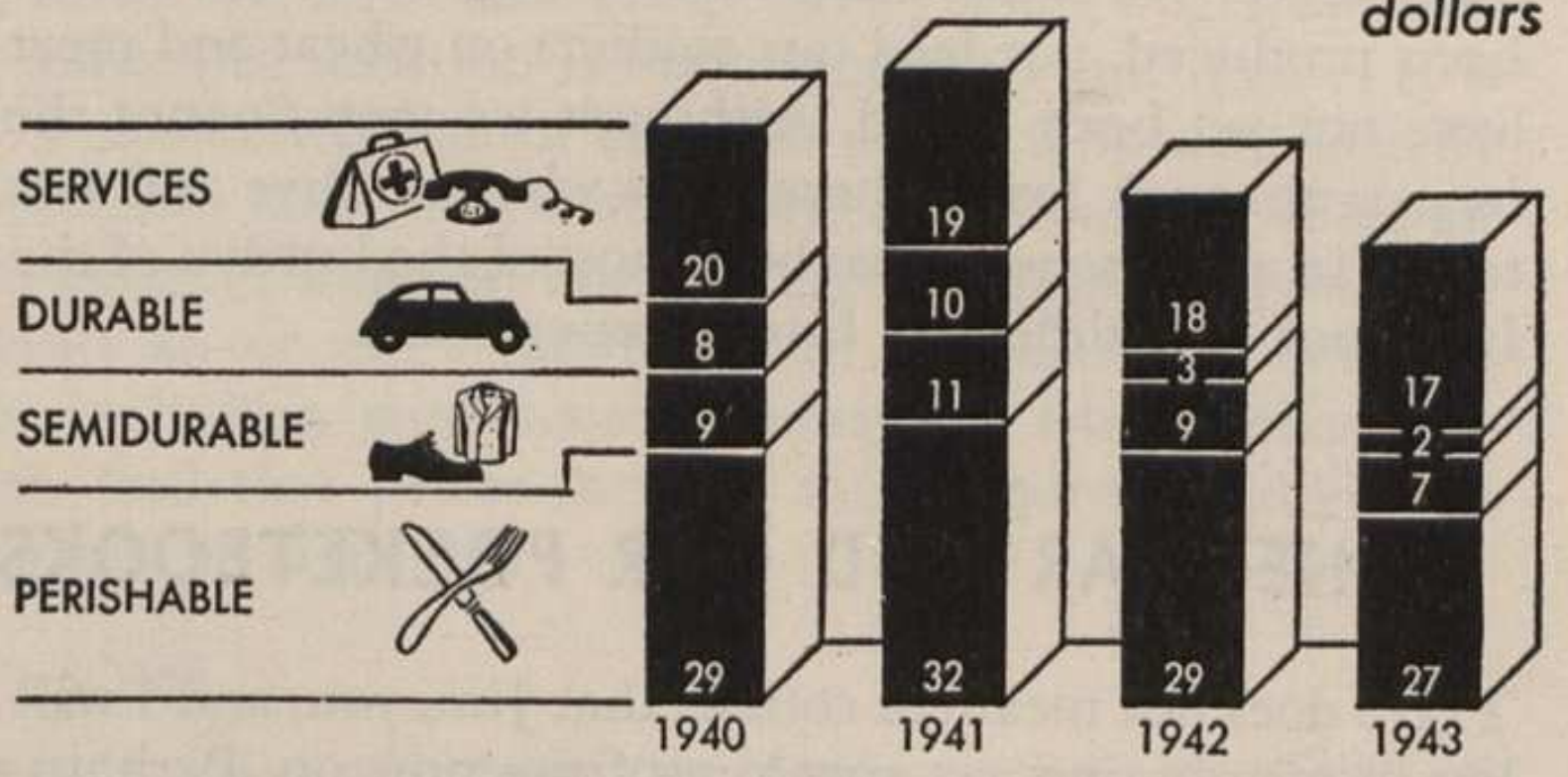
WHAT WILL HAPPEN TO OUR PRODUCTION (1940-43)

(1940 DOLLARS)

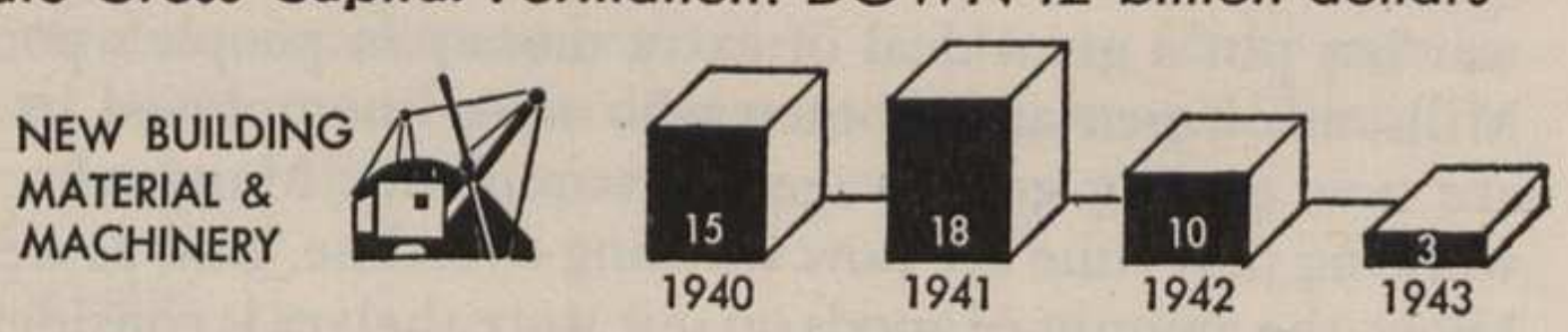
Military Outlays: UP 58 billion dollars



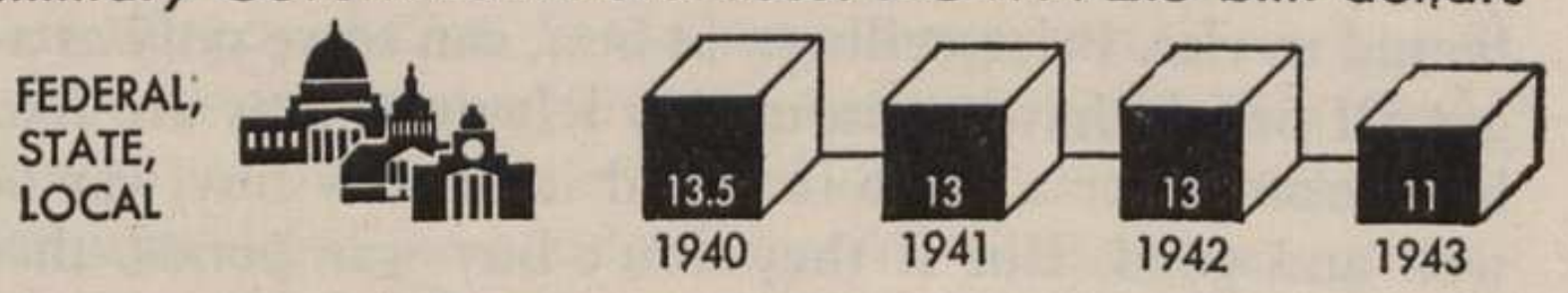
Civilian Consumer Goods and Services: DOWN 13 billion dollars



Private Gross Capital Formation: DOWN 12 billion dollars



Nonmilitary Government Purchases: DOWN 2.5 bill. dollars



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existing stocks of goods; we can contribute scrap iron, copper, and rubber to the war effort; and we can postpone repairing or replacing used equipment. To the extent that we fail to keep up repairs, we are, in a limited sense, postponing payment of the war. For in failing to keep up repairs we are not only putting off necessary expenses, but we may be cutting down the output of our farms and factories after the war.

There is still another way in which the war may cause future hardships. The shift to military production may cause whole industries to become disorganized; many companies may lose their established markets. It is difficult to measure this cost in money terms, but it is none the less important.

We cannot, however, borrow from the future in any other sense. We cannot make tanks from steel that has not yet been produced, nor feed our soldiers on wheat and meat that have not yet been raised. Although we may *finance* the war in part through loans, those of us who are alive and working today, in a *real* sense, must bear most of the burden of the war. It cannot be saddled on future generations.

THE WAR AND OUR POCKETBOOKS

THIS does not mean, of course, that Jim, you, and I will have less money in our pay envelopes from now on. Perhaps some of us will. But many of us will have more, through longer hours and overtime work. Taking the country as a whole, the war has put a great deal of extra money in people's pockets. Millions of men and women who were unemployed in 1939 are now getting good wages in war plants. Many who were working part time are now working overtime. But, as we well know, the amount of goods on our store shelves is considerably less today than before we entered the war. Unless the extra money is drained off in taxes or some other way, prices are bound to rise. Price ceilings, at best, can serve only as a stopgap. If people have extra money left over, they are likely to look around for a place to spend it. If they buy war bonds, well and good. But if they don't buy war bonds, they are bound to bid up prices of unregulated scarce articles. It is this process that leads to inflation.

Checking Inflation

When we speak of inflation, we often think of starting the presses to turn out huge amounts of new paper money. That is what was done in Germany in 1922 and 1923. We did it in this country during the Revolutionary and the Civil Wars.

However, an inflation does not necessarily need to be accompanied by an increase in the amount of money. To be sure, it usually is. But the mark of inflation is *a rapid rise in prices.* This may result from either an increased amount of money in people's pockets or a shortage of goods. Both factors are likely to be at work in wartime.

Governments are tempted to create money because that is probably the easiest way of financing a war. The public is lulled into a feeling of false prosperity by rising wages, salaries, and profits. But inflation is both dangerous and unfair. It is really a concealed form of taxation which falls most heavily on those least able to bear the burden. It does not affect all groups equally. Some groups find that their incomes increase as rapidly as, or more rapidly than, the rise in prices. But others, including most wage earners and white collar employees, find that prices increase much more rapidly than their wages or salaries.

HURTS SOME

Hardest hit are those whose incomes are rigidly fixed in terms of dollars. These include teachers, government employees, professional men and women, many clerks and white collar workers, insurance agents, and employees of the public utilities. Widows and retired persons living on pensions are in a particularly difficult spot.

AIDS OTHERS

But although inflation imposes a heavy burden on wage earners and salaried employees, it actually benefits some groups in the population. In the last war a great deal was heard about profiteering, and a profiteer was regarded as a wicked, unpatriotic person. But as a matter of fact, an uncontrolled inflation would put most manufacturers, wholesalers, and retailers in a position where they could not help making large unearned profits. As prices rise, they would find that they

could sell their wares at a higher price level than that which prevailed when they bought their supplies. This would naturally make for high profits and would give the business and stock-owning groups a larger share of the national income than they would get in normal times unless these earnings were absorbed by additional taxes. Speculators would be in an even more fortunate spot. Since they are in closer touch with business trends than most persons, they would be in a position to profit from the spiraling prices. Their profits would be at the expense of the average consumer, who is desperately trying to span the widening gap between his income and the ever-mounting cost of living.

Inflation Does Not Lessen Sacrifices

Since an inflation slows down the war effort by increasing costs and is injurious to the majority of the population, you may ask why sane men ever embark upon a course of action that brings it about. The answer is that inflation is rarely chosen as a deliberate policy. Rather it is the result of ignorance, drift, and group political pressures. Every group tries to saddle the taxes on someone else, and because people naturally dislike high taxes, Congress always hesitates to tax sufficiently. Borrowing appears easier because it seems to postpone the day of reckoning. It seems easier to borrow from banks than from individuals because no one needs to cut down his spending. Yet actually inflation does not and cannot cut down the need for sacrifices. The sacrifices must be borne if the Army and the Navy are to get the supplies they need to win the war. Inflation cannot create supplies that are not there. It merely distributes the sacrifices unfairly and creates additional burdens, both for the present and the future.

HOW WE CAN FIGHT INFLATION

THE government has two very different kinds of weapons available for the struggle against inflation. They are: (1) Direct government control, such as is achieved through rationing, priorities, and price ceilings; and (2) taxation and other financial measures.

No government relies exclusively on either one of these in wartime. But in a democracy the financial measures are fully as important as the more direct government controls. The two must be carried on together.

Price Control

The purpose of price control is to prevent or at least retard the price increases that naturally develop as a result of the shift from peacetime to wartime production. When war comes, the kind of goods that the country as a whole requires is very different from the kind needed in time of peace. Without price control, there would be tremendous changes in the prices of articles needed for the war. Price control can prevent increases that are unnecessary or that may become greater than necessary, and yet at the same time permit a rise in price where an advance is necessary to increase production. Effective price control is of great importance in the total war effort. It saves money for the government by holding down the cost of munitions and supplies. This means that taxes do not need to be as high as would otherwise be necessary and that we shall not have to carry such a large debt into the postwar period. The holding down of the cost of living is important, too, because it cuts down labor's demands for higher wages and thus reduces the number of labor disputes.

Ceilings Not Enough

We should not, however, think of price control as being limited to the establishing of price ceilings. Price ceilings merely set the top price at which an article may be sold. They are not so strict as a system of price fixing in which the price of each article is definitely set. But experience in other countries has shown that any kind of price fixing is difficult to enforce, particularly under wartime conditions. There are many ways in which fixed prices can be evaded. It is almost impossible, for example, to prevent changes in the quality of the articles sold. Bootleg or "black" markets spring up, which are most difficult to control. In order to prevent such evasions from undermining respect for the law, the price control authorities may be forced to call in thousands of persons to help enforce the law. This is difficult and expensive, especially in

a democracy, and should be avoided if at all possible.

Such drastic action may not be necessary if the price ceilings are supported by other means of price control. There are many ways by which this may be done. The government may, for example, restrict the demand for goods by rationing. It may cut down buying by limiting consumer credit. Or it may persuade people to cut down voluntarily on the use of vital materials. Or it may control the supply of goods by paying subsidies, converting plants, controlling foreign trade, taking over all supplies, or by many other methods. A government in wartime may find it desirable to make use of many of these different methods of price control in addition to price ceilings. A broad program is much more likely to be successful than a narrow one that relies merely on one or two types of control.

Weakness of Direct Controls

In some respects direct controls—priorities, price ceilings, and rationing—are better than financial measures for checking inflation. They can be applied more quickly and more accurately. They may be more effective. But they present serious disadvantages. Most of the direct controls are difficult and costly to administer. In order to make them work, the government has to interfere more and more with private business and the habits of life of the average citizen. This leads to the kind of annoyance, damage to private interests, and denial of individual freedom that a democratic people is reluctant to accept. Moreover, serious political obstacles often stand in the way of the kind of controls that are needed. A representative government naturally hesitates to take action that may be injurious to important groups of voters, even though such action is necessary for the welfare of the country as a whole.

Financial Measures

Largely because of the difficulty of enforcing sufficiently strict measures of direct control, no nation ever succeeded, before the present conflict, in carrying on a major war without some inflation. Some rise in prices is almost inescapable because of the increased demand for certain kinds of goods, making it necessary to turn to more expensive sources of supply. Labor costs also are bound to rise because of the scarcity of

skilled workers. But no matter how much money the government spends for the war, a serious inflation could not occur if the increase in government spending was offset by a corresponding reduction in spending by individuals and private business.

There are four ways in which the government's financial policy can be shaped to support direct controls in the struggle against inflation:

1. By imposing high taxes on goods that compete directly with the war program, the government can make them so expensive as to discourage their production.

2. By increasing all kinds of taxes, the government can cut down on all kinds of private spending, including investments.

3. By borrowing a part of people's remaining income, including money that would usually be invested or used for repairs or replacement of buildings or machinery, the government may further cut down on private and business spending and even dig into past accumulations of wealth.

4. By cutting down its own spending for roads, bridges, buildings, and other nonessential purposes, the government may release men and materials for war.

The Basis of Wartime Fiscal Policy

In the last war most countries bungled their financial policies because they did not understand what they were up against. Most officials viewed the financial task as merely one of raising funds. Very little thought was given to the effect of new taxes as they were levied. Consequently, a number of ridiculous blunders were made. It never seems to have occurred to anyone, for example, that if theaters and moving picture houses are to be allowed to operate at all, they might as well play to full houses instead of half-empty ones. Nor was any thought given to what use people might make of their money if they were discouraged from attending the movies because of high prices.

Actually, control over such matters as taxation and borrowing is an important weapon in the hands of the government. By using this weapon skilfully the government can discourage people from buying things they don't need, thereby

saving men, machines, and materials, and speeding up the entire war effort.

When you pay your taxes or buy a war bond, you think you are giving the government money to buy bullets, tanks, or airplanes. As a matter of fact, that is not why paying taxes and buying bonds are important. If you didn't pay your taxes or buy a bond, the government would go right ahead and buy all the planes and tanks the country could produce. But it would have to pay for these, to a larger extent, by *new* money obtained by borrowing from banks. And in spending the money that you didn't use for bonds, you would be competing with the government for labor and supplies. Your chief contribution in paying your taxes or buying the bond lies in the fact that you are thereby cutting down your spending. Thus, the curtailment of spending, rather than the mere raising of funds, must be the goal of our financial policy in wartime.

WARTIME INCOME AND SPENDING

BEFORE we can say just what methods should be used for cutting down spending, it is important that we see how the war has affected the income and spending of the chief groups within our population. This is particularly important as a guide to tax policy. For if we know what groups are likely to receive the greatest share of the increased income resulting from the war, we shall be greatly helped in deciding on a wise policy of war taxation.

Income

A considerable shift is expected in the total amount of income going to each of the three broad income groups—those having incomes below $1,750, between $1,750 and $10,000, and above $10,000. It is expected that the number of families in the lowest group—Jim's group—will decline by approximately 7,000,000. As a result, the total income of this group will probably be about six or seven billion dollars less in 1943 than it was in 1941. But the total income of the middle group will jump about 29 billion dollars, and that of the relatively

small numbers of persons in the top group some five and a half billion.

Spending

Changes in the income of the various groups do not, however, tell the whole story. We must also take into account how much of its income each group spends. For in framing a wartime tax policy, it is necessary for the government to drain off all excess funds that might be used to bid up prices. In peacetime our spending is closely related to our incomes. But in wartime the amount we spend is cut down by taxes, rationing, and the shortage of all kinds of goods. In the chart on page 5 we saw that our total production for 1943 will be 128 billion dollars but that only 53 billion (1940) dollars' worth of goods and services will be available for American consumers. Our spending, therefore, must be limited to this amount.

The three income groups will be affected quite differently by rationing and the shortage of goods. Ordinarily, more than two-thirds of the refrigerators, washing machines, radios, and new furniture would be bought by the $1,750 to $10,000 group. This group, and the group below it, will feel the wartime restrictions most. Since they will be unable to get the goods they want, they will spend more on other things and have more than usual left over for savings and taxes.

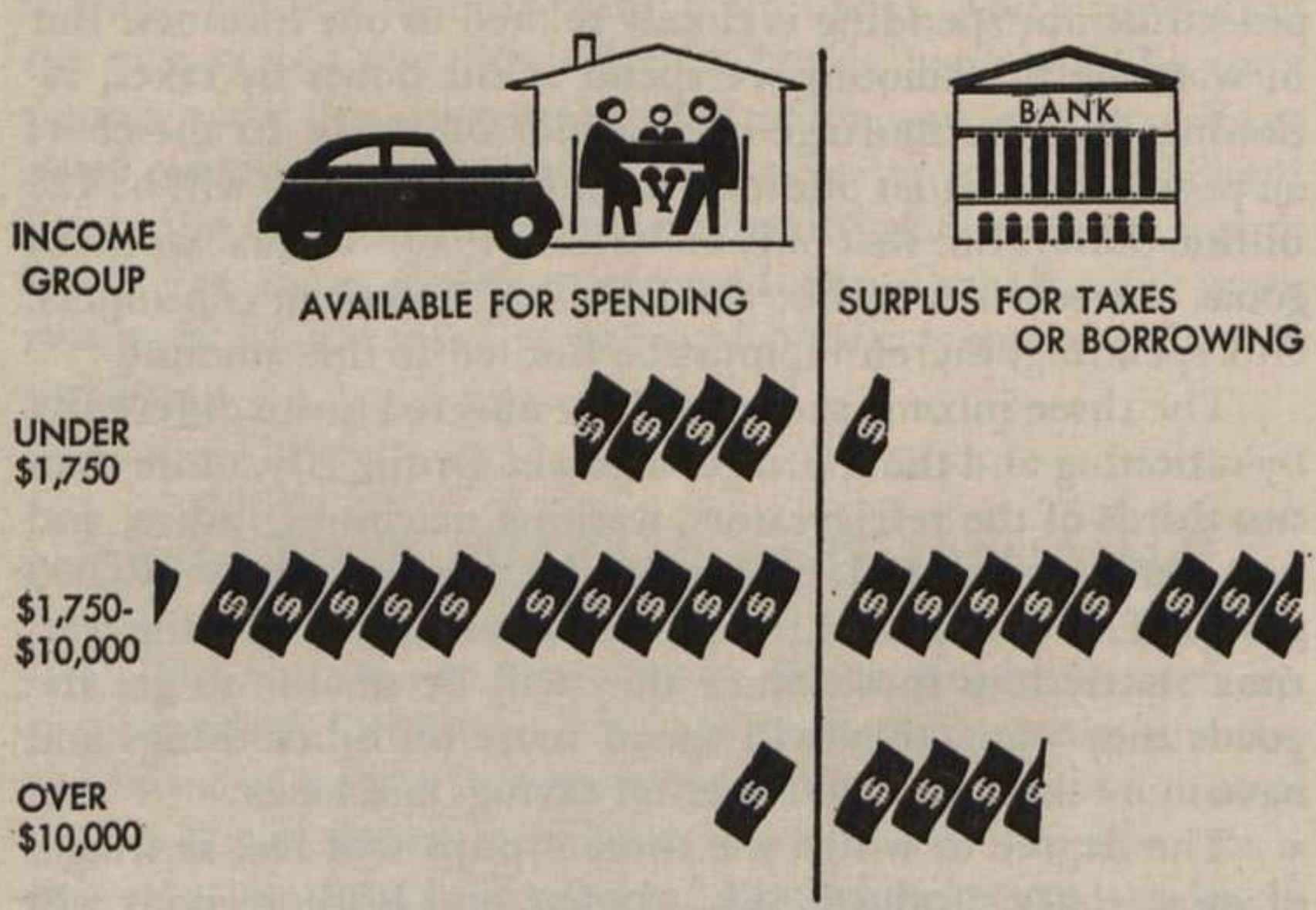
The degree to which the three groups will feel shortages of meat, dairy products, silk, woolen, and leather goods will depend on how effective our rationing system becomes. If the scarce goods are fairly rationed, the burden will be divided evenly. If, however, rationing is half-hearted, the poorer groups are bound to suffer. And if our price control system breaks down, families with low incomes may be forced to spend so much for food and clothing that they will have little left for other things.

Taking into account shortages and other changes brought about by the war, it is estimated that the 61 billion dollars' worth of goods available for consumers in 1943 will be divided among the three income groups as follows:

Under $1,750	$15,000,000,000
$1,750 to $10,000	42,000,000,000
Over $10,000	4,000,000,000

The Taxable Surplus

The figures above are important because they enable us to see, by comparison with the following chart, just how much each group has left over after buying the things that are available under wartime conditions. The group with incomes of less than $1,750 has roughly three billion dollars left; the



$1,750 to $10,000 group has 31 billion; and the group above $10,000 has about 14 billion, making a total of 48 billion for all three combined. These figures, rough as they are, furnish a useful guidepost for our wartime financial policies—both with regard to taxation and borrowing.

These figures are necessarily somewhat rough, but they show us several things rather clearly. They show us, for example, why we cannot hope to raise all of the vast sums necessary to pay for the war from persons with incomes of more than $10,000. It is evident that a very large amount will have to be raised, either through taxation or borrowing, from

persons in the other two income groups. An ideal wartime financial program would attempt to get, in one way or another, all of the excess purchasing power in the hands of each of these groups. In practice, such a program is probably impossible. Nevertheless, any program that is even reasonably successful must be designed to absorb a large part of the excess from each of the groups.

TAX OR BORROW?

FOR years economists have argued over the relative merits of taxation and borrowing as a means of paying for a war. Both are, of course, necessary, and both must play a part in any government's program for financing a war.

Borrowing is a fairly painless way of diverting huge sums that might otherwise be spent for luxuries. And borrowing does it more quickly than taxation. Furthermore, it is probably better for morale. Most persons feel much better about getting a nicely embossed bond in exchange for their money than a mere tax receipt. When they lend the money, they have made no sacrifice. They are as well off financially as they were before. When they pay their money out in taxes, they feel that it is gone forever.

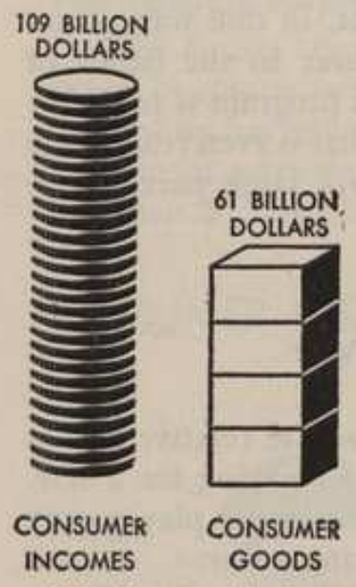
Advantages of Taxation

Taxation, however, is better than borrowing for cutting down unnecessary wartime spending. Taxes not only take a man's money—borrowing does that—but they make a man *feel* poorer. This makes him cut down his spending. When a man lends money to the government, he usually takes it out of his savings. This means that he has as much to spend as ever. But if he pays the same amount in taxes, he may still try to save for a rainy day. Because of this, a heavy tax program helps support rationing. A man who feels pinched by taxes is less likely to be tempted to buy goods that he doesn't need on a "black" market.

Another big advantage for taxation as compared with borrowing is that taxes do not leave the government encumbered with a huge debt. Although the debt itself may do no

INFLATION AND ITS CONTROL

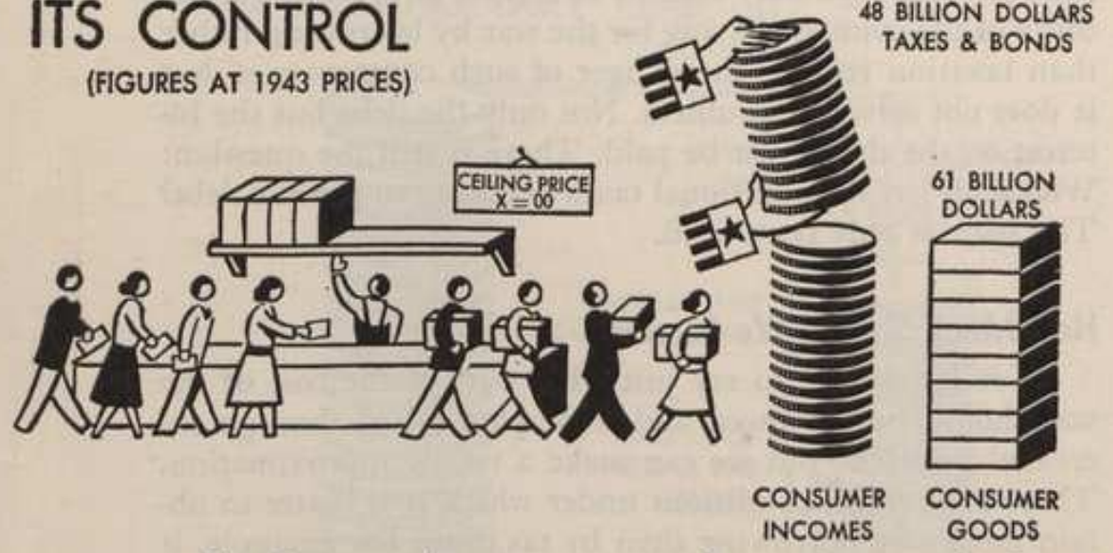
(FIGURES AT 1943 PRICES)



Wartime production creates high incomes but limits consumer goods



People are BOUND to bid up prices for scarce consumer goods if they have extra money left over... This leads to inflation.



The Government can control inflation by rationing and price ceilings

It can also control inflation by cutting off excess funds through taxes and bond sales

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immediate harm, it prolongs the problem long into the future. Taxation is clean-cut; it leaves no messes to be cleared up after the war. Something of the extent of the problem caused by wartime borrowing may be seen in recent budget estimates. It is expected that the debt of the federal government will reach 125 billion dollars by June 30, 1943. If the interest on this debt can be held to 2 per cent, a total of two and a half billion dollars will be required yearly merely to pay interest. This is twice as much as the government received from the income tax on individuals in any year between 1917 and 1941.

Too heavy taxation does, however, carry certain dangers. If taxes on wartime business profits were 100 per cent, for example, businessmen would have no incentive for increasing their efficiency or cutting down waste. Similarly, if all increases in individual incomes during the war were taxed away, a man would have nothing to gain by working harder than usual. This danger is much less if the man or the business is left part of the increased income, but high tax rates may still cut efficiency.

High taxes may also injure civilian morale. As we have said, people don't mind lending money to the government because they know they will get it back. But heavy taxes cause grumbling, even though they may be necessary. People particularly resent a *sudden* rise in taxes. They will accept a doubling or tripling of taxes if it is done gradually. But they dislike to have it come all at once.

Then, too, there is likely to be a dispute over who shall bear the burden of increased taxes. Since the wealthy and the moderately well-to-do have more left over than poorer families after paying for necessities, it is clear that they should be expected to bear the heaviest burden of war taxation. But it is natural that they should resist a disproportionate increase in taxes and seek to place more of the burden on the more

numerous families with low incomes. The fight over who shall pay the taxes may become so serious as to endanger the unity of the country. Paying for the war by borrowing rather than taxation reduces the danger of such controversies, but it does not solve the problem. Not only the debt but the interest on the debt must be paid. There is still the question: Who shall pay the additional taxes necessary to pay the debt? The issue is only postponed.

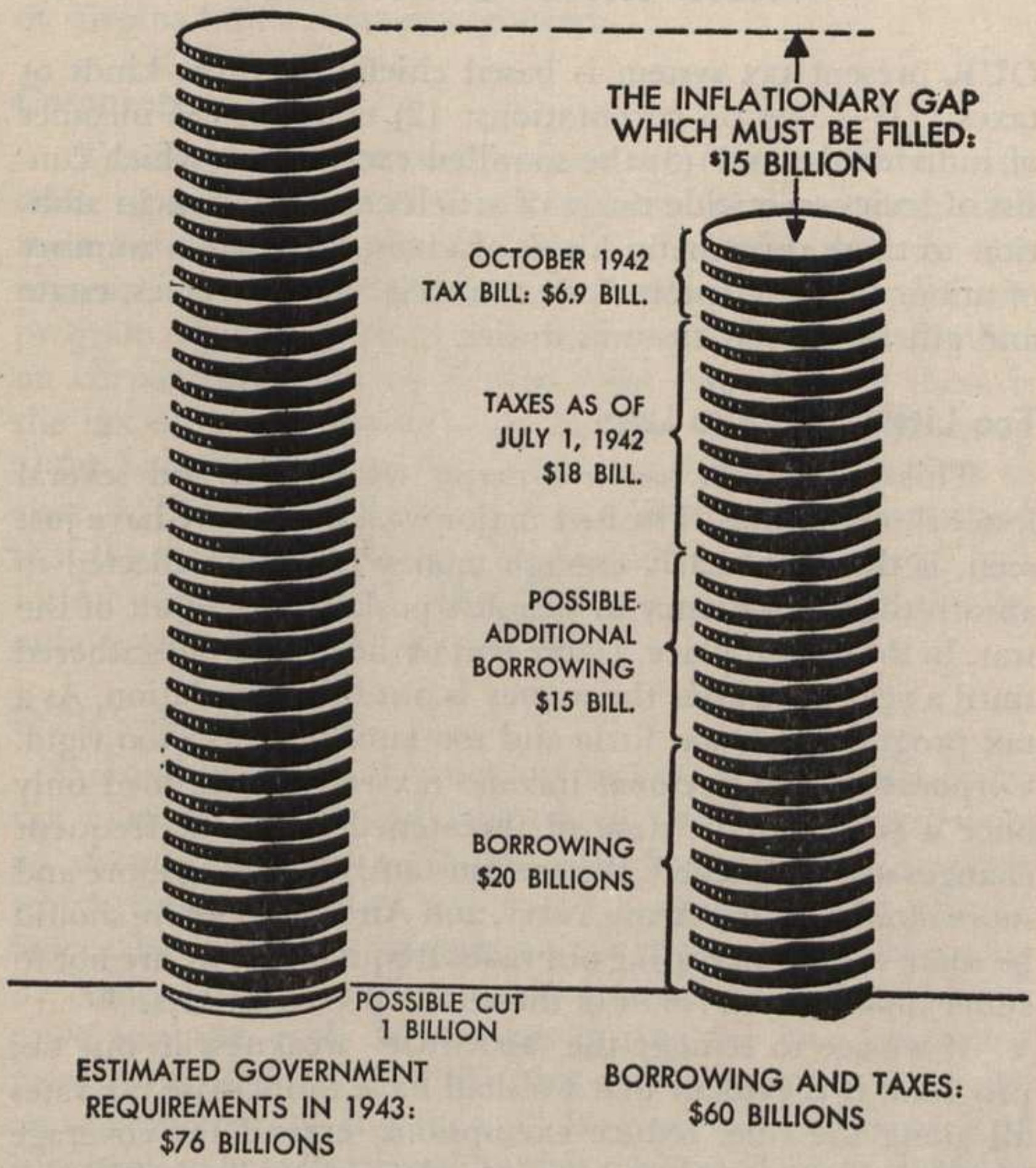
How Much Should We Borrow?

It is impossible to say just what part of the cost of the war should be borrowed and what part raised through increased taxation. But we can make a rough approximation. There are certain conditions under which it is better to obtain money by borrowing than by taxation. For example, it would probably be unwise to levy such heavy taxes on people that they could no longer pay their life insurance premiums. And people should be allowed to save some money to repair their houses, replace their automobiles, and meet the special needs of the postwar period. Taking these and other special factors into consideration, we can justify borrowing to the extent of 20 billion dollars yearly during the war. Even more than this could probably be raised through the sale of war bonds without contributing to inflation.

How Much in Taxes?

It is estimated that the government must raise at least 76 billion dollars in the fiscal year 1943 to meet its military and nonmilitary requirements. At most, the nonmilitary expenditures might be cut by a billion beyond the cuts already listed in the budget. We have seen that 20 billion could be borrowed without causing inflation. This leaves some 55 billion unprovided for. Possibly 15 billion of this might be borrowed without disastrous consequences. This leaves 40 billion—at the very least—that must be raised in taxes. The figure may be as high as 45 billion. It is estimated that the taxes on the statute books on July 1, 1942, will yield 18 billion in 1943. Thus, at the very least the government should raise an additional 22 billion in taxes during 1943.

THE INFLATIONARY GAP



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The Treasury estimates that the tax bill passed by Congress in October, 1942, will yield only about $6,900,000,000. This is more than 15 billion dollars short of the 22 billion needed. This 15 billion is often called the "inflationary gap." Spending must be further curtailed by this amount if we are to avoid an additional rise in prices and if inflation is to be brought under control.

WHAT KIND OF TAXES?

OUR present tax system is based chiefly on three kinds of taxes: (1) Taxes on corporations; (2) taxes on the incomes of individuals; and (3) the so-called excise taxes which consist of levies on a wide range of articles and services. In addition to these three main kinds of taxes, there are a number of minor taxes. These include the social security taxes, estate and gift taxes, and customs duties.

Too Little, and Too Late

This tax system has two major weaknesses and several lesser shortcomings. The first major weakness, as we have just seen, is that not nearly enough money is being collected to absorb the extra money in people's pockets as a result of the war. In the second place, a large part of the taxes is not gathered until a year or so after the money is put into circulation. As a tax program, it is too little and too late. It is also too rigid. Corporation and personal income tax reports are filed only once a year. But in time of threatened inflation, frequent changes may be needed. We are constantly spending more and more money for the Army, Navy, and Air Force. There should be some way of increasing our taxes frequently if we are not to suffer inflation as a result of these unexpected outlays.

If we are to remedy the "too little" weakness in our tax program, it is evident that we shall have to increase tax rates all along the line, reduce exemptions, extend the coverage of existing taxes, and perhaps introduce some altogether new kinds of taxes. The "too late" shortcoming can be overcome in part by providing that at least some of the taxes on income be collected as the income is earned, and by imposing new taxes which can be collected more promptly.

Our tax system has one other important defect. Different taxes naturally fall on different groups of people. We saw earlier—on page 14—just how much each of three main income groups had in surplus funds available for savings and taxes. Out of a total of 48 billion dollars, some 14 billion would pass into the hands of the group with incomes of more

than $10,000, about 31 billion to the $1,750-10,000 group, and about three billion to the under-$1,750 group. The existing taxes do not even approximate this pattern. The existence of surplus funds is largely ignored.

Corporation Taxes

Taxes on corporations produce more revenue than any other type of federal taxation. Congress has already increased these taxes considerably, and many economists believe that corporation taxes should play a major role in our wartime tax program. Quite a number of different taxes have been levied on corporations, but by far the most important of these is the tax on a corporation's net income. This tax was set up as far back as 1909 and has been strengthened from time to time. When the 1941 tax bill was passed, it was estimated that the corporation income tax would yield three and a half billion dollars in 1943. The 1942 tax bill increased this by only eight million dollars.

EXCESS PROFITS TAX

Second in importance among the corporation taxes is the tax on excess profits. This is distinctly a war tax. It represents an attempt to capture a large part of the unusual earnings which result from the war and rearmament. The present federal law permits a corporation to calculate its excess profits by comparing its wartime earnings, under a rather complicated formula, with its earnings during the four peacetime years from 1936 to 1939. To this extent it represents a tax on wartime profits. But the law also permits a corporation, if it prefers, to base its tax on the amount earned over and above 7 or 8 per cent of its total invested capital. Such earnings may or may not represent "war profits." Experience has shown, however, that most firms chose to base their tax on a comparison with prewar earnings rather than on their invested capital.

It is important that the corporation tax and the excess profits tax be considered together in considering increased taxes on corporations. Particularly important is the rate of tax which will apply on any additional profits that a corporation may earn. Suppose, for example, that a corporation has sufficient earnings so that it is taxed under the highest brackets

of both excess profits and the corporation income tax. However justified the high tax may be, it is clearly not wise to destroy all incentive to increase the corporation's earnings still further. Just what proportion of a corporation's added earnings may be safely taxed under wartime conditions is difficult to say. But something, clearly, should be left.

Personal Income Taxes

The tax on our personal incomes has one important advantage over most other forms of taxation. It can be adjusted in accordance with our ability to pay the tax. It is, therefore, probably the best way we have for distributing fairly the burden of paying for the war. There are, however, many things that must be taken into account in revising the income tax to meet wartime needs. We must consider, for example, the taxpayer's reaction to any proposed increase in his tax. Any new tax burden that is so severe as to compel very large sacrifices by taxpayers of a particular group may have a bad effect on morale and obstruct the war effort—especially if this group feels the sacrifices to be heavier than those of other groups. We must think particularly of such groups as wage workers, hired managers and executives, farmers, small businessmen, professional men, and investors. In general, most wage workers and farmers are in the lower and lower-middle income brackets. Most small businessmen are in the middle income bracket. Most investors are in the middle and upper brackets. Thus, if we can decide just how important it is to preserve the incentives of each of these groups, we shall have a rough guide which can be used in distributing the tax burden on the different income groups. In this connection, we must remember that the common people are likely to resent it if they feel that the wealthy or any other group is getting off too lightly.

PERSONAL EXEMPTION AND CREDIT FOR DEPENDENTS

The tax-free exemption allowed for heads of families or single persons has been sharply reduced in recent years. The reason for granting a personal exemption is fairly clear. Everyone needs some income to purchase the absolute necessities of life. The amount needed depends primarily on the

number of persons dependent on the head of the family. This amount should be kept free from taxation in order to make sure that everyone can get these necessities. The argument for such an exemption is especially strong in wartime because of the importance of maintaining public health and morale.

The idea behind the personal exemption and the credit for dependents would be more fully satisfied, however, if the deduction were limited to the normal tax and the first bracket of the surtax. The allowance may now be deducted from the entire surtax. Hence it is worth much more to a rich person than to a person with a low or moderate income. Under the 1942 Revenue Act a married man, with two children, earning from $1,900 to $3,900 would save $361 because of the exemptions. But a person whose income is so large that at least $1,900 is taxed in the top bracket would save a total of $1,672. Perhaps the simplest way of making the exemption the same for every taxpayer with similar family responsibilities would be to deduct, say, $75 from the tax of every single man, $150 from the tax of a married man, plus $40 for each child. A change of this sort would yield about $200,000,000 in additional revenue for the government without interfering with the purchase of necessities.

CREDIT FOR EARNED INCOME

For some years the government has given a special credit of 10 per cent against the normal income tax for money earned by work as contrasted with income derived from property. The idea that the money received from hard work should not be taxed as heavily as money received from property rests upon sound logic. But the case becomes less clear in wartime when the risks which imperil property income are probably greater than the risks to the wage earner. A program of war taxation might, therefore, consider the temporary abandonment of the earned income credit, especially since this would greatly simplify the job of making out and checking returns.

CAPITAL GAINS AND LOSSES

Whether the profits gained when a man sells his stock, bonds, real estate, or other property at a higher price than he paid should be taxed like other income is a matter that

has long been in dispute. In time of war, when the chief purpose of additional taxation is to absorb spending power which might be used to bid up prices, the case for taxing such gains is particularly strong. In any event, it is clear that we can scarcely reverse our established policy of taxing such gains at this time.

JOINT RETURNS

Another issue on which there has been much dispute is whether a husband and wife shall be allowed to file separate returns or whether they shall be compelled to file a joint return. If both husband and wife have a good-sized income, they usually have to pay less in taxes if they file separate returns. This is true because, when their two incomes are added together in a joint return, they are likely to have to pay part of their tax in a higher surtax bracket than if each paid separately.

Some women's groups have opposed compulsory joint returns on the ground that it was an attack upon women's rights. Others have attacked the proposal as an invasion of state's rights since it would override state law in the states where husband and wife share property equally under the law. Actually, neither women's rights nor state's rights is involved. The only question worthy of debate is whether the individual or the family should be considered as the basis of income tax legislation. Why should a family in which both husband and wife have incomes pay less in taxes than a family in which only one contributed to the family's support? It is possible that the joint return might, in some instances, discourage a wife from taking a war job. But this difficulty could be overcome by allowing an additional earned income credit where both husband and wife are working.

TAX-EXEMPT SECURITIES

The recent steep increase in surtax rates has focused attention sharply on the possibilities of avoiding the payment of income taxes through the ownership of tax-exempt securities. State and local bonds and some federal issues are wholly exempt from taxation. Many other federal bonds are partly exempt. It is estimated that there were approximately 20 bil-

lion dollars' worth of tax-exempt state and local government securities outstanding on June 30, 1941. About $4,800,000,000 of this were held by federal, state, and local government trust and investment funds. The remainder was in private hands. The special needs for revenue in wartime led Secretary Morgenthau to propose, on March 3, 1942, immediate taxation of all income from present and future issues of tax-exempt securities. Congress has rejected this suggestion, and there has been some argument as to whether under the Constitution, the federal government can tax the income derived from state and local government bonds. But some solution of the problem must obviously be found if the burdens of the war are to be distributed fairly among all groups.

COLLECTION AT THE SOURCE

The income tax is particularly open to criticism as being "too late" as a weapon for combating inflation. Except for the so-called Victory Tax, it is not collected for many months after the taxpayer receives his income. Comparatively few taxpayers save up money to pay a tax that is not due until the following year. They pay their tax out of the next year's income. This raises no particular problems in ordinary years. But it is obviously unsuited to wartime conditions. A rise in the income tax rates on *this year's income* does not cut down *this year's spending*. Cutting down *next year's* spending will not check an inflation that is developing *this year*.

The Bureau of Internal Revenue could hardly be expected to handle the flood of returns if all of our millions of taxpayers were required to file monthly or even quarterly returns. But this would not hold true if, as a brake on inflation, the tax was collected, so far as possible, when the money is paid out. The number of firms and agencies paying out money, although large, is much smaller than the number of persons to whom it is paid. For years the social security taxes have been deducted from the worker's wages, and the new Victory Tax is to be collected in the same way. It should not be difficult to make arrangements so that the normal tax and the first bracket of the surtax should be similarly deducted. Dividends, being paid by corporations, could easily be made subject to a similar deduction. It would not be hard to arrange

with banks to withhold the tax on interest payments, and the interest on bonds might be taxed without great difficulty. There are, however, certain types of income, such as the interest on mortgages, unsecured loans, or loans secured by collateral, rent, and the money earned by shopkeepers or professional men, that would present real difficulty. The tax on these special types of income would probably still have to be computed in yearly tax reports.

Many people would still have to file yearly reports in any case in order to find out how large a surtax they had to pay, or to report incidental income not collected at the source. But the number of such returns would be much smaller than is now handled by the Treasury and could be kept down if arrangements could be made for allowing for dependents and personal exemptions before the tax is withheld. This could be done quite easily for wage and salaried workers. Such an allowance would not need to be made for those receiving dividends, interest, or royalties. Exemptions could be ignored for unearned income without much injustice.

One of the chief advantages of setting up arrangements for deducting the income tax from wages and salaries is that the tax rate could be changed quickly if conditions demand it. If it appeared that inflation was imminent because people were spending too much, increased taxes could be put into effect within a few days. They could even be raised several times a year if the situation was critical enough. Since Congress is not set up to act quickly, it might grant the President power to change the income tax rates, within certain limits, whenever necessary.

Indirect Taxes

We now turn to the third major kind of taxes—the indirect taxes, of which the so-called excise taxes are the most important. There are many such taxes. The ones with which we are most familiar are the levies on liquor, tobacco, and gasoline. The excise taxes vary greatly in value and desirability; but as a part of our wartime tax system they do serve to raise money quickly and they help to restrict spending. They also may be used to curtail the sale of the kinds of consumer goods that compete directly with the war program. In this

sense they may be used as a substitute for rationing. Let us suppose, for example, that instead of rationing bicycles the government had decided to cut down sales by imposing a heavy excise tax. The system would not be as fair as the present rationing system. It would not guarantee that only persons who needed bicycles would get them. But it would be far simpler to operate than a rationing system and might yield the government a fair amount of money. Such an arrangement might well be used where the production of a nonessential article has to be cut down, or for limiting spending on luxuries of all kinds. Excise taxes are, of course, bad where they fall on essential things, such as food or clothing, for they serve to keep the taxed articles from the poor but do not particularly discourage purchases by the well-to- do. If there was a shortage of milk, no one would propose, for example, that its distribution be limited by imposing a heavy tax on each quart sold.

The Sales Tax

The sales tax is often described as a "general excise tax" since it would apply to every article that one buys. Such a tax is often advocated as a direct means of absorbing consumer spending power. It appears to be a tax on spending rather than on saving, although its effect may in many cases be to reduce savings.

A federal tax on all retail sales would undoubtedly involve problems in administration. Less difficulty would be encountered if the tax was levied on sales by manufacturers. But a retail sales tax of the same rate will yield much more revenue than a tax at the manufacturer and would therefore be more effective in cutting down spending.

SALES TAX vs. INCOME TAX

As a weapon for absorbing consumer spending power, the sales tax is distinctly less satisfactory than the income tax. The income tax absorbs some of the total spending power and leaves the taxpayer free to spend the remainder of his money as he chooses. A part of every family's income is left free from tax so that the family may be sure of enough money to buy the essentials of life. The sales tax, as ordinarily ap-

plied, lacks these advantages. The sales tax is usually a flat tax. It is the same percentage on all sales. It rests as heavily on purchases that are necessary for bare subsistence as it does on luxury articles. Even persons whose income is less than is necessary for minimum needs for subsistence and health must pay the tax. Thus, the imposition of even a moderate sales tax might force many families below the level of consumption necessary to maintain health and morale in time of war. Because it falls proportionately more heavily on the groups with low incomes, the sales tax is particularly ill-suited for tapping the sources of excess spending power as we found them on page 14.

Ways have been suggested for removing many of the disadvantages of the sales tax. Food, and possibly clothing, might be exempted from the tax. This would, however, greatly cut down the yield from the tax. A fairer arrangement would be a method by which consumers would be given certificates enabling them to buy a certain amount of necessities free of tax. The number of certificates given to a family could be regulated by a recognized standard of consumption. But this would present very real administrative difficulties.

There are many who argue that political considerations might possibly justify a sales tax in combination with a moderately severe income tax, provided these safeguards can be worked out. It is estimated that a 5 per cent general sales tax might yield from a billion and a half to two billion dollars a year, after excluding minimum consumption needs from the tax. More severe, but perhaps feasible, rates might raise the yield to three or even five billion.

Social Security Taxes

The necessity for cutting down spending has led many persons to suggest that the payroll taxes levied under the Social Security Act be increased. Up to the present these taxes have ordinarily totaled 5 per cent of the payroll of firms covered by the act. Of this, 1 per cent is deducted from the pay of workers covered by old-age and survivor's insurance. The employer pays an additional 1 per cent for his employee's old-age protection and 3 per cent for unemployment insurance. Under the law the tax for old-age insurance was sup-

posed to advance to 2 per cent for the employee and for the employer on January 1, 1943. Congress, however, has refused to permit this advance to go into effect.

The social security levies should not be regarded as ordinary taxes. They are insurance premiums which are later to be returned in benefits. A sharp increase in the social security taxes can only be justified, therefore, by a similar increase in benefits. Some increase in the benefits provided under the act has long been advocated. But since most of these benefits will not have to be paid until after the war, and the premiums might be collected now, a broadening of the Social Security Act would help to curtail consumer spending during the war.

Proposals to increase the social security taxes should be considered in connection with income tax policy. Although the two taxes are quite different, they both cannot be applied severely on the same persons at the same time. Before we decide whether to raise additional funds through the social security system, we should consider the reaction of the man who pays the taxes. It is quite possible that the average person would feel a lot better about paying increased taxes if he knew that he would get his money back when he most needed it. But it must be recognized that a sharp increase in the social security taxes will limit the amount by which it is wise to increase the income tax on persons with low incomes.

GOVERNMENT BORROWING

EARLIER in this pamphlet it was pointed out that we might safely count on borrowing 20 billion dollars a year to help pay for the war. Unless taxes are increased far more than now seems likely, we may actually borrow much more than that. It is important, therefore, that we consider how this borrowing can best be carried out.

Certain kinds of borrowing are more likely to lead to inflation than others. The test in each case is: Does the borrowing lead to a corresponding cut in spending? If it does, the increase in government spending is offset by a decline in civilian spending. This will not lead to inflation. But if civilian

spending is not cut, spending by the government will increase the amount of money being used to bid for a limited supply of goods. This may endanger the entire system of price ceilings.

When the government persuades you to buy war bonds with money you otherwise might have saved, the effect is not inflationary. For unless you hoarded your money, it would have been spent by someone. Money used to pay life insurance premiums or money that is deposited in a savings bank will not do any harm if the life insurance company or the savings bank uses the money to buy war bonds.

Many business concerns and quite a number of persons have a considerable amount of idle money in bank accounts or cash which they do not intend to spend immediately. It has been estimated that these balances totaled as much as $13,400,000,000 in 1939. Perhaps as much as eight billion might be borrowed by the government. This type of borrowing tends to be inflationary since the government would be using money that would otherwise be idle.

When a commercial bank buys government bonds, it may merely use money that has been deposited with it to make the purchase. This will not lead to an inflation since there will be that much less money available for other purposes. But it is also possible for a bank to buy bonds merely by a bookkeeping transaction—that of crediting the Treasury with the purchase price. This is inflationary since it involves the creation of *new* money. The government does not know, of course, which method the bank has used in any one transaction. But if a large amount of bonds are sold to the banks, the effect is almost certain to be inflationary.

If we are to avoid inflation, one rule, then, is clear. The Treasury must try to sell as large a proportion of its war bonds to individuals and as small an amount as possible to the banks. This will not be easy. It is much harder for the government to persuade individuals to buy war bonds than to persuade the banks to do so. But it is essential that as much money as possible come from persons and institutions. If the money cannot be obtained voluntarily, the government may be forced—in order to prevent inflation—to resort to a plan for compulsory savings.

This brings us back to Jim Hogan and his wife Mary. They are already making considerable sacrifices for the war. But the sacrifices they are making now are nothing compared to those they might have to make if we had an uncontrolled inflation. If someone took the time to explain all of this complicated business of war financing to Jim, he probably would not complain about his taxes but would want to see them made even heavier. But he also would want to make sure that the taxes were levied in such a way as to tap the surpluses as shown in the chart on page 14. He would continue to buy all the war bonds he could, and he would not be too disturbed if the government started a plan of compulsory savings to supplement its tax program. For once he understood the purpose of these further drains on his pay envelope, he would know that he was paying not only to help win the war but also to protect himself and his home.

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