TREASURY DEPARTMENT
Washington

(The following address by Randolph E. Paul, General Counsel of the Treasury, before the Agricultural Outlook Conference, of the Bureau of Agricultural Economics, in the Auditorium of the Department of Agriculture, Washington, D. C., is scheduled for delivery at 10 a. m. Eastern War Time, Monday, October 18, 1943, and is for release at that time.)

WILL WE "HOLD THE LINE?"

It is a privilege to raise the curtain at the 21st Annual Agricultural Outlook Conference. I suspect that I have been placed in the position of prologue rather than epilogue, because there is a psychological, if not a therapeutic, value to be derived from administering the bitterest pill first. Taxes are a bitter pill. No layers of sugar coating, no admonitions that they are good for what ails the country, can disguise that fact. Because of my close association with taxes, I have become a kind of symbol of something that's hard to take. If I had not known this before, I should know it now. I wish I could repeat to you some of the names I have been called. By way of mild example, I was once advised to "close my bureaucratic trap." My friendly critic did not explain what he meant by the term "bureaucrat". I wish I knew, so that I could appraise his indictment. Sometimes I wonder whether a bureaucrat is not just a person who doesn't believe the same things everybody else in his set thinks are vital to the American way of life.

In relating tax policy to inflation, I shall start with the premise that inflation is bad -- a premise that all of us, as consumers, are willing to grant, but one that some of us, as producers, are reluctant to accept. I propose to show two things: first, that a forceful tax policy is a prerequisite to effective wage, price and rationing controls; and second, that the answer to the question, "will we hold the line?" depends, insofar as taxes are a critical factor, both upon the amount and upon the kind of taxes we have the courage to levy.

I. The anatomy of inflation

If we are to understand the role of tax policy in holding the line, we must know something about the anatomy of inflation. What causes price increases and on which causes can taxes operate? Close inspection will reveal whether the taxes we have, and are likely to get, will merely snap at the heels of inflation or whether they will strike at its very vitals.

A. Rising Costs.

In dealing with the problem of wartime inflation, it is customary to concentrate on the enormous excess of consumer spending power over the available supply of goods and services. And this, to be sure, is the central issue. But it is not the only issue, and we are likely to make mistakes both in our appraisal of inflation, and in our choice of tax measures to combat it, unless we recognize that economic forces other than excess spending power cause price increases. It is not merely that dangerous dollars are exerting a strong upward pull on prices. Costs are pushing hard from below. In choosing tax measures to reduce the pull from above it is important to avoid increasing the push from below.

As output in the factory and on the farm rises, costs are affected by conflicting forces — some operating to raise costs and some to lower them. But as production is pushed toward the limits of capacity, as at present, conditions working toward higher costs are very likely to predominate. This tendency is especially noticeable in agriculture, where record crops are achieved by more intensive — and often more expensive — cultivation of land already in use and by resort to inferior land normally held out of use. Costs of industrial production are increased by the necessity of using less efficient labor and substitute materials. Where necessary to secure essential production these costs must be covered. This is entirely consistent with a realistic anti-inflationary program and with a tax policy that is part of that program.

Apart from the consequences of having to use less efficient labor, land, and materials, costs tend to rise because prices paid by producers are prone to rise. The intensified demand for labor, for example, places workers in a better position to bargain for higher wage rates, and in addition requires overtime work commanding higher pay. Competition for scarce raw materials and machinery also tends to raise prices, thus again increasing costs of production. These are some of the forces that are constantly straining to break through wage and price controls -- forces that must be denied in all but the most exceptional cases where it is clearly necessary to accept higher costs to get indispensable output not otherwise obtainable.

The role of tax policy with respect to the leverage of increased costs on prices is negative rather than positive. It should carefully avoid interference with the cost-price and parity relationships which underlie present price ceilings. Taxes which add to producers' money costs, or to the prices of goods entering into the farmer's parity base, may breach rather than bulwark the line we are trying to hold against inflation.

B. Excess of monetary demand over physical supply.

When we recognize that rising costs are a source of wartime price increases, we have not yet touched the core of wartime inflation. That core consists of the great and growing unbalance between the volume of spending power and the supply of civilian goods and services. Each is uncomfortable in the presence of the other. So-called "wartime prosperity" fills the pockets of consumers with unprecedented money incomes. Yet, unlike peacetime prosperity, it does not fill civilian markets with the goods and services which alone can put meat on the bones of prosperity. When more than half of our manpower and equipment is devoted to supplying the sinews of war, it follows that the resultant flow of incomes to consumers cannot be matched by a corresponding flow of goods to civilian markets. Thus, we are confronted with the paradox of wartime prosperity; consumer buying power cannot keep pace with consumer spending power. The response to a large part of wartime civilian spending is not more goods, but higher prices.

Quantitative evidence that we are confronted with a dangerous excess of spending power is plentiful. Present prospects are that citizens will receive incomes of about $152 billion during the current fiscal year. Some $21 billion of this total will be skimmed off by existing personal taxes, primarily the Federal individual income tax. Available supplies of consumer goods and services, at present ceiling prices, will account for close to $89 billion. That leaves an inflation potential of $42 billion, which threatens to break through the lines established by our price and rationing controls. Any part of the $42 billion which is used to push consumer spending beyond the $89 billion level will be inflationary money in the purest sense of the term. In the aggregate, it will not buy goods; it will simply raise prices and thus further inflate the cost of living. And back of it, also ready to raise prices and further inflate the cost of living, are billions of dollars of accumulated savings. Since the beginning of 1940, the total figure adds up to $55 billion. Of this increase $24 billion are in the form of currency and checking accounts. From the standpoint of inflation, it is no exaggeration to call these savings liquid dynamite.

The record of commercial bank lending also yields ominous evidence of "dangerous dollars." War financing through bank purchases of Government securities expands the assets held by the public. To the extent that bank depositors lend their deposits to the Government by buying bonds, no new funds are created; funds are merely transferred from private to Treasury accounts. But when banks buy Government securities for themselves they have no right to make charges against their depositors' accounts. In payment for Government bonds they customarily set up "war loan accounts" payable to the United States Treasury. As the Treasury draws on these accounts to finance war expenditures, new funds are created -- funds that very promptly flow into the pocketbooks and bank accounts of individual citizens and business firms.

During the fiscal year 1943 banks thus increased their holdings of Federal securities by about $30 billion. This constituted the bulk of the increase in bank investments, which in the same period expanded by about 36 percent the total of coin, paper money, and checking deposits held by the public. These holdings are liquid fuel which constantly threatens to fan the fires of inflation.

Qualitative evidence that inflationary money is straining our rationing and price controls is also uncomfortably ample. A recent sampling of prices by OPA indicated that in many instances actual retail food prices are above legal ceilings. Illicit trafficking in ration coupons and the tendency of meat, poultry, and gasoline to leak out of regular channels, and into black markets, are further threats to price stability. But markets, like many other things cannot be clearly divided into fields of black and white. Black markets have many penumbral shadings. In the shadows lie the "gray" markets, the corner stores where housewives, sometimes knowingly and sometimes unknowingly, pay higher-than-ceiling prices, and where inferior goods are sold at superior prices. This is another persistent menace to price stabilization. These leakages indicate that inflationary money is not easily discouraged: they tell us that unless tax policy puts an increasing portion of easy dollars out of temptation's way, price and wage policy may be unable to hold the line. It is unfortunately true that many people will make illegitimate use of money when they can find no legitimate use for it.

C. The effect of inflation on production.

Before I go on to describe the specific part that taxes may play in holding the line, I should like to address myself briefly to the persistent minority who feel that inflation is a tonic for the economic system, that it invigorates production, and that it should therefore be allowed to run its course. When our economy is running at less than full capacity, it is true that rising prices have a stimulating, albeit not always wholesome, influence on production. In the Thirties when we were faced with deflation, the stimulus of rising prices was to be welcomed, and even invited by means of deficit financing.

But in time of total war, when we approach, or actually reach, the limits of production, and when our resources and efforts must be focussed on victory, it is sheer madness to maintain that inflation will have a wholesome effect on production. Unless inflation is strongly resisted, consumers will bid up the prices of civilian goods and thus stimulate the wrong kind of production. This will increase the difficulty of diverting resources to war industries. When total production is at a maximum, there will even be a tendency to divert production from war into non-war channels. If the

Government does not check the rise in prices of consumer goods, its only alternative is to outbid consumers in order to get necessary war production. The process of outbidding consumers greatly magnifies the costs of war and virtually guarantees runaway inflation.

Inflation may also impede war production by shifting the emphasis of industry and labor from the real job of producing the implements of war to the monetary job of keeping up with prices. If profit is to be found not in producing more, but rather in outsmarting inflation; if higher wages are to be had not by working harder, but by bargaining on the basis of rising costs of living -- in short, if inflation calls the tune to which our economy dances, our output will surely fall and our war effort will surely suffer.

The damage inflation inflicts on production cannot be adequately described in the present tense. The future tense is equally important. One has to venture prophecy. The wake of inflation will greatly magnify the problem of economic readjustment after the war. It will leave us with a price system that is seriously out of joint. The shaking-down process will increase business risks and discourage enterprise. Instead of a vigorous resurgence of civilian production, an inflated and disjointed price structure will promote a policy of "watch and wait" until prices are again in line. And once they are in line -- that is, when they have come down from their heights -- all debts incurred at high levels will become immeasurably harder to pay. The great farm debt was one of the most disastrous economic legacies of inflation in the last war. It exercised its depressing effect on agriculture for more than a decade. The aftermath of inflation would impair our peacetime efforts after this war, just as inflation itself would impair our effort during the war.

II. The role of tax policy

From our brief survey of the anatomy of inflation, the role of taxes in the fight to hold the line becomes clear. Taxes impound spending power, and reduce to manageable limits the strain on the defense line of rationing and price control. Taxation is thus a companion of, not a substitute for, other control devices. By striking at the spending power root of inflation, taxes reinforce our stabilization program.

It is true, of course, that wage, price, and rent controls in themselves impose limits on the creation of income and thereby reduce spending power. But even if wage rates and the prices of, say, farm products were held constant, it would not follow that workers' and farmers' incomes would also remain constant. Even in the face of fixed prices per unit of output, farm incomes rise in response to expanded output. Similarly, even in the face of rigid wage rate control, such factors as overtime pay, the upgrading of workers into more lucrative jobs, and the drawing of women into industry, will generate greater total wage payments. And remember that a large part of current production is not available for civilian consumption here at home. The direct control of prices and wage rates, however effective, cannot prevent the creation of an overflow of spending power. It is the job of tax policy to dam the overflow, and thus to buttress our wage and price policy.

In cutting down excessive spending power, wartime taxes serve another purpose, namely, to reduce the threat of postwar inflation. The record of past wars indicates that the peak of the inflation danger comes after a war. Pent-up desires, backed by accumulations of cash and Government bonds, are ready to express themselves in a spending spree. At the same time an individualistic public is impatient to cast off irksome wartime controls. Administrators of such controls are anxious to go back to peacetime pursuits. The unhappy result of this apparently happy combination adds up to uncontrolled inflation.

Our best insurance against postwar inflation, our best guarantee of prompt "decontrol" and return to the free economy we are fighting to retain, is a vigorous wartime tax policy. Part of our postwar planning should take the form of wartime taxes designed to hold liquid savings within manageable limits, and to curb excessive spending immediately after the war.

III. The magnitude of the tax job

A few moments ago I cited figures showing that money incomes will exceed available goods and services by more than $40 billion in the fiscal year 1944. Consumers will be able to buy only 70 cents worth of goods per dollar of income left burning in their pockets. Thirty cents out of each dollar can go only into savings, additional taxes, or higher prices. This excess offers striking evidence, not only of acute inflation dangers, but also of enormous taxable capacity. If we were to apply the most rigorous possible standards of anti-inflationary war finance, and if we were to disregard the implicit hardships for persons who have not shared in wartime prosperity or are bound by pre-war commitments, the Treasury's proposed $10-1/2 billion tax program would seem modest indeed. Even allowing for $20 billion of savings out of the $41 billion inflation potential, a strong case could be made for $21 billion of additional taxes, or just twice the Treasury proposal.

But the Treasury has recognized that taxes of sufficient magnitude to trim off all the fat of excess spending power would inevitably cut into the lean of justifiable expenditures and necessary savings. The resultant inequity and hardship would impair morale and productive effort, and would leave many citizens in weakened financial position at the end of the war. To avoid such results, the Treasury tax program was limited in amount. Furthermore, the proposed taxes were carefully selected.

IV. Specific taxes

Tax programs are not merely a matter of over-all goals and impressive aggregates. They are composed of specific tax measures, some of which are more effective, others less effective, and still others ineffective or even harmful, in the fight against inflation. Taxes available to the Federal Government include principally, those on personal incomes, on corporate profits, on estates and gifts, and on sales. It is from these materials that the backstop to wage and price controls must be constructed.

A. Taxes on individual incomes

The individual income tax is our chief reliance to date, both as a source of wartime revenue and as a damper on inflationary spending. Moreover, from the standpoint of equity, taxable capacity, and ability to reach excess spending power, the individual income tax looms as the predominant source of additional taxes.

More than half, or $6.6 billion, of the Treasury's $10-1/2 billion proposal, consists of increases in individual income tax rates. This strong emphasis is put on the individual income tax because by the use of this tax we can best achieve our standards of justice and fairness in taxation — standards which, if important in peacetime, become crucial in wartime. The income tax enables us to distribute burdens fairly among income groups, and with due regard to size of income and family status. No other tax can be imposed with the same assurance that a fair and intelligent distribution of the tax burden will be achieved. When taxes reach present and proposed high levels, it becomes increasingly vital that they be levied in accordance with the principle of ability to pay.

Income payments to individuals have increased $87 billion since 1938. In the same period, individual income taxes have risen only $18 billion. This means that we have absorbed only about one-fifth of the increase in income payments generated by defense and war activities.

This is impressive evidence of aggregate taxpaying ability. But it is aggregate evidence. We should not let it blind us to the sharp differences in individual circumstances. We are all keenly aware that the monetary gains and losses of the war are unevenly distributed. Some persons have had large increases in income, others, little or none at all. Some have suffered a deterioration in economic status as a result of the dislocations of the war. The current ability of many persons to meet wartime tax bills is also limited by fixed commitments for life insurance and for repayment of debt on their homes. To avoid inequity, and even hardship, in our tax system wartime taxes must distinguish between those who are debt-ridden and those who are debt-free, between those whose economic status has been improved, and those whose economic status has been impaired, by the war.

In drawing up a necessarily severe schedule of wartime income tax rates it is important also to guard against impairment of the postwar security of those in the low income groups. Normally, such persons have little or no capital reserve for emergencies. The great majority of our people have low or modest incomes. Four-fifths of the national income goes to persons earning less than $5,000 a year. It is these people who must bear by far the largest share of the wartime increases in taxation. As individuals with low or modest incomes are called upon to shoulder an ever larger proportion of the total tax load, the problem of protection against postwar insecurity becomes ever greater.

Special provision for the postwar security of those with low or modest incomes and relief for those with fixed incomes or fixed commitments can be provided by the use of a postwar credit under the income tax. The Treasury has, therefore, submitted to the Ways and Means Committee a plan under which over half of the proposed increase in the individual income tax would be allowed as a postwar credit. It has recommended further that part of any such refundable tax imposed by Congress be made available currently to persons with heavy fixed commitments and to persons whose incomes have failed to increase materially. The refundable tax would on the one hand serve to provide a backlog for the income groups most in need of such a safeguard. On the other hand, it would permit current use of the credit to persons whose economic status or commitments would make it a hardship to wait until after the war for their refunds.

As we broaden and deepen the income tax, it becomes necessary to make our tax system as simple as possible. The Current Tax Payment Act of 1943, by eliminating the one-year lag in tax payments and by providing for collection at source of the bulk of our income tax liabilities, has greatly eased the payment of any given amount of income taxes. But a great deal remains to be done on the simplification front.

You will be interested to know that the Treasury has had its research and legal experts working on the simplification of income tax returns to be filed in 1944, and that the Treasury and the Department of Agriculture conducted a special joint project last summer to improve the income tax return for farmers. Hundreds of farm returns from all parts of the country were studied in an effort to find out how the farmer's return could be modified and the job of reporting farm income simplified. I might add that the ulterior motive of promoting more accurate reporting of farm income also played a part in our revision of this form.

The Treasury has also recommended the repeal of the Victory tax and the elimination of the earned income credit, with compensating adjustments in the rate schedule. These recommendations, if adopted, will go a long way toward simplifying our unnecessarily complicated income tax structure. Such simplification is vital to the full utilization of income taxes in the fight to hold the line against inflation. I wish I could now go into the whole question of simplification of our tax laws. But that is a speech in itself and I made it in Chicago last week. I refer you to it, if you would like to pursue the subject.

B. Sales and excise taxes

The major device currently receiving attention as an alternative to increased individual income taxes is the general retail sales tax. A tax of 10 percent on retail sales, designed to raise about $6 billion, is being urged in many quarters. As in the past, the Treasury stands unalterably opposed to a general sales tax. Our opposition is based upon the inequity of this tax, and also on its inadequacy as an anti-inflationary measure.

In war as in peace, the Treasury opposes a tax which impairs the already inadequate standard of living of persons with low incomes. The general sales tax fails to differentiate between rich and poor, between necessities and luxuries, and between large families and small families. The gain in revenue from a sales tax is realized in large part at the expense of the essentials of life for the low income groups. The imposition of the tax would therefore undermine the morale and productive efficiency of these groups. It would strike hardest at the very people who are bearing the brunt of the price increases to date.

In wartime, moreover, the sales tax presents formidable administrative difficulties. Unlike the income tax, which offers an established mechanism for the job of raising new taxes, the sales tax would require much new administrative machinery. The critical shortage of trained auditors, transportation facilities, and business machines would make it difficult to administer and enforce the tax effectively. It is worth noting also that a 10 percent rate would stimulate much more evasion and delinquency than the 2 percent rates prevalent in state sales taxation. Conflict with existing sales tax laws in 23 states would create another troublesome problem. The Bureau of Internal Revenue is already confronted with the huge task of shifting the individual income tax to a current payment basis. To saddle the Bureau with the tremendous additional load of sales tax administration would invite a breakdown of its machinery.

To my mind, the inequity and the administrative difficulties of a sales tax are sufficient reason to bar it from the Federal statute books. But if another nail is needed to seal the coffin of the sales tax, it is certainly provided by the upsetting effect of this measure on our stabilization program.

A general sales tax, more than any other tax, produces an irresistible drive for higher wages and farm prices. Unlike the income tax, it enters directly into the cost of living of all wage earners and into the index of prices paid by farmers which underlies farm parity prices. Both in the field of wages, where increases in response to a sharp rise in living costs would have the sanction of a sympathetic public, and in the field of farm prices, where an increase would have the sanction of law, the line we are holding against inflation would be broken.

I do not mean to imply that a sales tax has no anti-inflationary aspects. Certainly, in skimming off several billions of spending power and in providing a deterrent to spending, a sales tax would in some degree curb inflationary pressure. But to the extent that the tax encroached upon minimum living standards, the result might well be a serious increase in the pressure for higher wages, offsetting the anti-inflationary effect of the tax.

A major threat to stable prices would arise from the entry of the sales tax into agricultural, commercial, and industrial costs and the necessary revision of price ceilings. The damaging effects on our price control structure may be illustrated in the field of agriculture. Directly or indirectly, the ceiling and support prices of most farm products are linked to farm parity prices. This link means that these prices are relative rather than fixed, and that they respond to the parity index. A ten percent sales tax on a reasonably broad basis would increase that index by 6 or 7 percent. The operation of the parity formula would immediately raise the parity prices for agricultural commodities by 6 or 7 percent. Ceiling and support prices of various products would probably have to be adjusted to take the change in parity into account.

If a 10 percent sales tax had become effective July 1, 1943, estimates made by the Bureau of Agricultural Economics indicate that there would have been an average increase of 6 percent in retail food prices during 1944. This increase, added to a 10 percent levy on food sales, would raise food costs by approximately 16 percent. Finally, taking into account both the direct price increases and the indirect tax-induced increase in food prices, it is estimated that the cost-of-living index would rise about 10 percent. These are dull statistics, but they illustrate in concrete terms how a general retail sales tax would breach our first line of defense against inflation.

It seems reasonable to assume also that the direct and indirect price effects of a sales tax would create irresistible pressure on our wage stabilization program. If wage increases had to be granted in contradiction of that program, as I believe they would, the development of inflation would be greatly encouraged by the mutual interaction of price and wage increases.

Fortunately, the defects which discredit a sales tax do not apply to carefully selected excises on specific commodities. The Treasury has proposed additional excise taxes to provide an additional $2.5 billion annually. It is on such objects as liquor, tobacco, communications, amusements, and jewelry that excises would draw for additional wartime revenue. They require little or no increase in administrative machinery. They have been carefully selected in such a way as to avoid burdening the necessaries of life. The items chosen are either luxuries, or goods and services which need to be conserved for war purposes, or they are non-essentials, such as liquor and tobacco. The prices of such items do not enter into parity relationships.

While the proposed excises would lead to some increase in the cost of living, that increase would be far less than that generated by a sales tax designed to raise an equal amount of revenue. Taxpayers with modest or low incomes have a real option to avoid excise taxes by reducing their purchases of taxable items, not the fictional option they would have under a general sales tax, which strikes all commodities alike.

C. Other taxes

Today I shall not discuss the other taxes in the Treasury's 1943 program. Their bearing on inflation is less direct, though they are significant. This is true particularly of corporate tax increases, which are necessary if we are to persuade individual taxpayers to shoulder their part of the total burden.

V. Conclusion

In conclusion, I should like to return to the question which is the subject of this morning's discussion: "Will we hold the line?" Since taxation is a back-stop rather than the front line of defense against inflation, I shall not attempt an explicit answer. The field is open to Mr. Morse and Mr. Gilbert. I shall, however, venture this prediction: if present taxes are not substantially increased with an eye to diverting the stream of dangerous dollars that is battering against price and rationing controls, it will be very difficult to hold the line; and if new revenues take the form of a general sales tax, the line is more than likely to be broken, and then, at best, to be reestablished at a very much higher level of prices.

Let me add to that forecast a related warning. The war against inflation does not end with unconditional military surrender. It may have to be intensified for a time afterward to prevent the disaster of postwar inflation. If we fall prey to economic complacency and thus relax our anti-inflationary efforts, and if we identify the end of the war on inflation with the end of the war on the Axis, we are inviting economic chaos. We could win the war against the Axis and lose a large part of the victory at home.

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