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DRAFT OF TESTIMONY BEFORE THE
HOUSE WAYS AND MEANS COMMITTEE

Mr. Chairman and Members of the Committee: I particularly welcome the opportunity to present my views to you, because of my conviction that the effects of the present defense effort upon our national economy will depend greatly upon the tax program now undergoing formulation by this Committee. In appearing before you I speak merely as an individual and not in behalf of the Board of Governors of the Federal Reserve System. One of the most important factors in determining whether economic dislocation will be great or small -- I think we all recognize that there must be some dislocation -- is the way in which we raise the great sums we spend for national defense. Not only how much we tax as contrasted with how much we raise by borrowing, but also, after we have decided how much tax revenue we ought to have, the kinds of taxes we use to get it.

The Secretary of the Treasury has recommended that during this emergency two-thirds of our Federal expenditures be covered by taxes. I am completely in accord with this recommendation. Viewed in the light of the financial history of this and other countries, this goal may seem an extremely ambitious one. No great nation, to my knowledge, has passed through a period of world disturbance like the present without borrowing a much larger proportion of its expenditures than one-third. Viewed, however, in the light of our present and prospective economic situation,

the goal is reasonable and, indeed, a modest one. During the past eight years I have repeatedly expressed the conviction that a large Federal deficit is appropriate during a period of widespread unemployment and depressed national income, and I have always accompanied that statement by saying that a large Federal deficit is inappropriate to a period of virtually full employment. It is true that the speed with which unemployment is likely to vanish has been greatly exaggerated by some. I fear that anyone who expects to see unemployment disappear by the summer or fall of the present year is in for a sad disappointment. It is much nearer the probabilities to say that by the end of the calendar year 1942 we may be close to a general condition of having more jobs than people to fill them. Even before that time there will be many specific products which we shall have to ask the civilian public to forego altogether, or to consume in greatly reduced volume, because those products require the use of skills, materials, and machines that are needed for defense production. At the present moment we are on the verge of this situation with respect to a wider range of products than is generally realized and as time goes on the needs of the defense program will increasingly trench upon goods available for civilian consumption.

Meanwhile the national income, expressed in money terms, is rising and will continue to rise as expenditures are made for the huge volume of defense orders now on the books. As the wages, profits, and other income paid out in connection with this activity begin to be spent,

it will become difficult to provide enough goods for civilian use to meet these increasing demands arising out of military expenditures. Such a condition, when it prevails for a sustained period in consumer markets generally, brings about price advances and results in inflation.

That is what is likely to happen to us unless we do what is necessary to prevent it. One of the things to do to prevent it is to impose adequate taxes. The Government when it levies taxes asks its citizens to give a part of their money to the tax collector instead of spending it in the stores or shops. In this way civilian competition with the Government for the use of men, materials, and machines can be reduced.

In imposing these taxes the guiding principle should be that they be levied in accordance with ability to pay. This is always important, but when taxes begin to require real sacrifices, as they must if they are to perform their function in the present emergency, when they begin to mean lard instead of butter in the frying pan, a vacation spent on the front porch instead of in the mountains, a college education for only one child and not for all the children, it becomes doubly important that taxes be obtained where they can be spared with the least sacrifice.

That is why I find myself in general agreement with the main outline of the Treasury proposals. That is also why I am doubtful whether it would be prudent, as some suggest, to raise more revenue from excise taxes than the Treasury proposes to raise, especially if these taxes are to fall heavily on commodities like coffee, cocoa, tea, and sugar. These

commodities may be regarded as proper objects of taxation in a poverty-stricken country of the Old World where governments must extract revenue from their citizens in any fashion that is expedient. They are not appropriate taxes in this country where other sources of revenue are ample and the people are prepared to support an equitable tax program by the payment of direct taxes. Consumer expenditure can be restrained either by an increase in income tax applied to the lower brackets of individual income taxpayers, or by a tax on coffee and other foods. The difference lies in the fact that the individual income tax does this frankly and directly and does it in a fashion which adjusts the burden to the taxpayer's ability to bear it. A tax on coffee or any other article of mass consumption does it surreptitiously and indirectly and in a fashion that makes the burden proportionately heaviest on those least able to bear it. Indirect taxation is taxation by autocracies, income taxation is democratic taxation. Before democratic government came into the world indirect taxation was the only type known. The history of direct taxation, and in particular of the income tax, is the history of the expansion of democracy.

I am therefore in general agreement with the Treasury's program both in its aggregate amount and in the general type of taxation it provides. It is my wish, however, to suggest certain changes in emphasis with respect to the sources of revenue on which it draws. I beg permission to describe in some detail the changes that I wish to advocate.

I may state in advance a few of the underlying principles to which in my opinion we should adhere:

1. Raise enough additional taxes to avoid inflation.
2. Raise them in a way to cause a minimum of dislocation in the economy.
3. Raise them in accordance with ability to pay.
4. Raise them in a way that will prevent anyone from profiting unduly from the defense effort.
5. Consequently raise them, in so far as possible, out of the increase in income caused directly or indirectly by defense expenditures. X

We expect the national income to increase sufficiently, so that a third to a half of the increase would be sufficient to provide the expected revenue. Realization by the public that the Government will take away for defense needs only a part of what the expenditures will add directly and indirectly to the national income and that no one will get rich by supplying the national needs will make the tax program generally acceptable and will prevent discontent and social unrest which would hamper the national effort. X

I. Excess Profits Tax

In my opinion an effective excess profits tax is not only the keystone of a well balanced tax program; it is an essential element in solving the economic difficulties which are beginning to confront the nation over a very wide field. Any tax program that you may frame, whether it follows the exact lines of the Treasury proposals or not, will have to include a substantial increase in the rates of taxation for corporate incomes in general as well as for individual incomes. At the same time you cannot reasonably ask the great numbers of business concerns of small and moderate size who are not participating in defense contracts to assume the additional tax burden involved in an increased normal corporation rate (or in the special surtax on corporate net income),

and ask millions of individual taxpayers to assume the additional burdens involved in increased individual income tax rates until you have given them every reasonable assurance that the funds they are being asked to provide will not go to swell the excessive profits of ^{some} a few corporations which profit handsomely from expenditures on defense.

The excess profits tax now on the statute books does not give such assurance. If you allow the idea to take root in the public mind that through these vast expenditures a few are being made rich and a few who are already rich considerably richer, the result is bound to endanger the success of our defense effort. We cannot afford to let our citizens remain doubtful on this important point. Many of us believe that in order to prevent an inflationary spiral of price and wage increases we ought to ask labor to moderate ^{usually the skilled organized groups} the demands for increased wages which are now being ^{made} heard and which will be heard in increasing volume as employment increases and employers find that they are bidding for labor on a seller's market. Such a counsel of moderation to labor cannot be wholly effective if employers are permitted to retain ^{large} huge profits. Will labor forego wage increases if we permit corporate earnings after normal tax to rise during 1941 to ^{from 25 to} a level 75 per cent above 1939 and permit many individual corporations to realize, after payment of taxes, profits ^{much} vastly higher than at any previous time in their corporate history?

It is often said that these corporate profits when they are paid out to stockholders are effectively taxed under the individual income tax.

If that were strictly true they would be effectively reached by the surtax schedules which the Committee has under consideration. But, as you gentlemen who frame our revenue legislation know, it is not true that corporate earnings feel the full force of our individual income tax rates. Corporate earnings may now be withheld from distribution without penalty; I need not recall the short and unhappy history of the undistributed profits tax. Since we do not have an undistributed profits tax we must have heavier corporate taxation along with heavier taxation of individuals. In the taxation of corporations primary emphasis should be placed on the excess profits tax.

(Suggested insert on page 10 before last paragraph).

I suggest addition of a sentence or two to the effect that "I should also suggest that consideration be given to making taxes heavier for increases in incomes than for stationery incomes. This should apply only to incomes above a stated minimum and below a stated maximum. Sub-standard incomes should be lightly taxed, even if they have increased, and high incomes should be heavily taxed - whether they have increased or not. This would be in accord with the principle underlying the proposed excess profits tax."

(If this suggestion is adopted - you may wish to modify the proposed schedule of rates.)

Summaries

Possible substitute for two paragraphs beginning at the end of page 2.

Our problem is to produce enough goods to meet the needs of defense as well as necessary civilian needs. Primarily it is a problem of production, or of output. We can neither use for defense or consume goods unless they have been manufactured. Consequently, the necessary increase in output for defense can come out of three sources and only three: (1) Use of resources, human and material, that have been idle or not fully utilized; (2) Increased efficiency, and (3) Curtailment of non-defense consumption. We shall probably have to use all three sources.

The problem of financing is secondary to that of increasing output. In the material and fundamental sense we can pay for defense only out of current production; you cannot fly a plane, or sail a ship, or drive a tank that has not yet been produced. The role of finance is to help so to distribute the effort as to contribute to maximum efficiency, to maintain justice, and to minimize post-defense readjustments.

The money for defense has been appropriated - it is merely a question of what is the best way to raise it. To the extent that we raise it out of taxes - we do not add to buying power - we merely convert a potential demand for civilian goods into a demand for defense goods. Thus we avoid inflation. Inflation arises from an increasing effective demand for a supply of goods that does not increase correspondingly. One way to reduce the danger of inflation is to increase output by working harder, longer, and more exclusively on necessary things. And another way is to

reduce the demand for unnecessary things and divert it to the things that we need most. And this is the role of taxation.

Everyone agrees that we should avoid inflation and that in order to accomplish this someone will have to give up something. The disagreement arises at a subsequent point. Every group tries to shift the burden on to other groups. Some want to meet the expense by reducing non-defense expenditures - and a sales tax. This would put the burden on the underprivileged and the lowest income brackets. It would relieve the well-to-do. Others want a high exemption and no excise taxes. This would completely relieve the lower income groups and put the entire burden on the others. It seems to me that in the present emergency - no group should be completely exempt and all groups should bear an equitable share, no more and no less, of the national burden.

who have the least to defend
who have the most to defend