

FINANCING DEFENSE IN THE UNITED STATES  
DURING THE PRESENT EMERGENCY

I. The Background for Appraising Federal Fiscal Policies

A. The Role of Fiscal Policy in Wartime Emergency.

1. Fiscal Policy is a minor aspect of war economics.

The major problem is the diversion of resources--men and materials--from civilian to military consumption, with only enough left for civilian use to allow population to retain productive efficiency and maintain the morale requisite for winning the struggle.

The production needed for military purposes can be secured by:

- a. Increasing the level of industrial activity--i.e., by putting to work idle men and materials; by working existing facilities to capacity; by increasing hours of labor. All of this can be done without undue interference with civilian consumption and in considerable part will be accompanied by rising standards of living due to increased money wages and greater employment of both labor and plant facilities. This is largely what has been taking place to date and represents the first stage in the transition from Peacetime to War Economy. Soon the possibilities of increased production from this course come to an end.
- b. Diversion of production from Peace to War needs. As industrial capacity is expanded further output for military purposes can be secured only by encroachments on the rest of the economy. New plants

must be built. This requires the transfer of materials and labor from peacetime production to military production. Tools and equipment to make munitions, tanks, guns, bombers etc. must be secured. If these tools are to be secured for military use producers of civilian goods must go without them. The volume of civilian goods inevitably shrinks. As military production facilities are completed labor is needed to man the machines. Skilled employes can be trained but that takes time; mechanics can be most quickly put on defense orders by transferring them from peacetime production. This again interferes with the volume of civilian production. These interferences with the attendant reduction in the volume of civilian goods continue until the production of military goods is maximized. Eventually only enough may be left to civilians to keep them well and strong as producers, and reasonably happy as patriots.

Thus, the fundamental economic problem in war time is maximizing military production. It is accomplished both by increasing productive activities and by decreasing the availability of goods for civilian or non-military use. It is within this framework that financial problems should be considered.

2. The first task of fiscal policy in a wartime emergency is the avoidance of interference with production, or the creation of

conditions likely to prevent the attainment of maximum production for war.

Taxes which tend to retard production—, or which make entrepreneurs unwilling to assume risks of increased production are to be avoided. The effects of tax policy were clearly illustrated in this regard by the controversy over rates of depreciation and amortization of defense facilities in the early stages of the national program. Likewise taxation policies should not interfere with the productive efficiency of labor.

3. The second major task of fiscal policy in war time is to implement the economic program. This involves the use of taxing, borrowing and even spending powers, if necessary, for non-fiscal ends. (*non-revenue*)

In order to simplify the discussion, let us limit the exposition to the use of the taxing power.

The use of taxes for non-fiscal ends has long been advocated for the attainment of objectives ranging from the establishment of an industrial nation to the equalization of income and wealth. At the present time, we are not interested in these objectives or in the historical antecedents of this doctrine. Its one important contribution, however, is that it indicates that the taxing power may be intentionally used to assist in the attainment of certain economic conditions. That taxation has been so used by the U. S. is common knowledge. Approval or disapproval of the policy is to be judged by the effects produced,

or the conditions created by its use.

It should be recognized also that different taxation policies produce various economic effects even though the taxes were not adopted with a view to producing them, or were enacted in complete ignorance of their probable effect. Regardless of the intention to use taxes for non-fiscal ends it is imperative to know the conditions likely to be created by the enactment of particular taxes. Those who are primarily concerned with revenue, or who look upon taxes only as revenue measures, should know the probable economic effects of the measures they propose. It may easily happen that the conditions produced by given taxes are far more injurious to the national economy than the gains which arise from the expenditures of the revenues actually collected. In short, taxes are good or bad in terms of the net effects they produce.

It should be recognized, too, that as an instrument of economic control taxation is only one of many instruments available for use.<sup>1/</sup> The problem for the policy maker, therefore, is to find that instrument which can most effectively be used in a particular situation at a given time. It may be that direct prohibitions or embargoes may, in certain situations be most effective; or that monetary controls should be employed; or that prices should be fixed, wages limited, goods rationed and so on. At other times taxation may be more effective than the other alternatives. This appears to be true today.

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<sup>1/</sup> Cf. Your address before U. S. Chamber of Commerce, May 1, 1941, Mimeo. p. 3.

The major problem in connection with financing defense in the United States and of war in England is the avoidance of inflation. Already prices have advanced substantially.

(Appropriate statistics available)

This is inevitable: Money wages have increased; the volume of goods available for civilian consumption is decreasing. What can an increasing number of wage earners do with the greater amount of money in their possession? Save it? Loan it to the government? Or spend it on a limited number of available goods? If wage earners endeavor to spend their earnings they do so in a seller's market. Competition in the purchase of goods forces up prices. Their increase advances the cost of living; this furnishes the excuse to demand higher wages which if successful enhances costs and so an inflationary cycle begins.

The means to control inflation are numerous. Previously the nation relied largely on monetary measures. Now they are inadequate. Taxes now a more promising instrument.

Cf. Your Fortune Article, "Price Fixing is Not Enough," for more complete statement.

Address before U. S. Chamber of Commerce, May 1, 1941

a. How taxes can help prevent inflation.

By reducing consumer income available for expenditure.

b. What taxes can best control inflation

(1) Sales vs Income Taxes

Cf. Statement in Fortune Article, p. 3. (reprint)

Address before U.S. Chamber, May 1, 1941, pp. 3-4  
(mimeo) Statement Before Ways and Means Committee,  
May 7, 1941, pp. 4 ff (mimeo).

(2) Efficiency of special excises designed to raise  
price of particular goods to consumers.

c. Anti-inflationary Borrowing

Borrowing of proper type can be employed to help avoid  
inflation. It must <sup>tab</sup> top surplus personal incomes above  
adequate subsistence available for expenditures. Investments  
so made must not be available for subsequent expenditure  
except in case of unforeseen personal emergencies such as  
sickness, deaths etc.\* Issues likewise closed to commercial  
banks.

Cf. Fortune Article, "Price Fixing is Not Enough", p. 3.  
(reprint)

Taxes and anti-inflationary loans do not dispense with  
necessity for priorities, price controls, allotments, ration-  
ing etc. but they reduce need for them and intensity of their  
use. These other measures need to be held in reserve and  
need to be applied to direct production rather than to affect  
consumption. In war time the nation cannot afford <sup>not (?)</sup> to have  
every possible control measure available, and ready for use.

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\* I have a feeling that present issues do not make sufficient provision for  
this. Hence "poor men" hesitate to subscribe remembering the penalties  
and discounts for premature redemption.

4. The incidental task of Fiscal Policy in Defense Emergency is to provide Funds for defraying the costs incurred by the national government.

- a. There is no question about the availability of funds. Whole cost could be met from loans. Commercial bank plus Federal Reserve assets adequate. U. S. will never need worry about paying its bills for defense in the predictable future. But it is not wise to finance the war in this fashion.
- b. Government can probably borrow from its citizens to cover the budgetary deficit.
- c. That deficit not as great as is popularly supposed.
  - 1) National income rising
  - 2) 1941 Tax Bill will be productive of more revenue than any previous tax bill.
- d. People can expect heavier taxation in future.
  - (1) They have already indicated willingness to pay greater share of resources in taxes.  
Cf. Gallup Polls, August 11 and 15, 1941.
  - (2) Treasury has announced intention of financing defense by:
    - 2/3 taxes
    - 1/3 loans --just the reverse of World War I policy.<sup>1/</sup>

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<sup>1/</sup> Cf. Your concurrence in U. S. Chamber of Commerce Address, May 1, 1941, p. 7 (mimeo.).

The greater the per cent of defense costs met by taxes, unless individuals borrow from banks to finance tax payments, the less the likelihood of post-war collapse.

Prudence decrees that the minimum (2/3-1/3) program set out by Treasury be attained.

## II. How Far Has the U. S. Gone in the Application of the Principles previous discussed to Defense Financing?

### A. The 1941 Tax Bill

1. Extension of income tax to lowest brackets in history
2. Increased progression in middle brackets
3. Changes in Excess Profits Tax
4. Revival of many war-time excises
5. Changes in Corporation Income Tax

### B. The Borrowing Program

1. Defense Security Issues

Cf. U.S. Chamber of Com. Address, May 1, 1941, p. 8 mimeo.  
Also Fortune Article, pp. 3-4 (reprint)

2. Tax Savings Plan

### C. Control of Instalment Credit through Regulation W.

In addition to what has been done todate, further increase in down payments and adoption of shorter terms for many goods seems desirable.

It might be suggested that the instalment device could be used as a means of saving for the purchase of goods to be delivered in the future, say after the emergency is over. This would sterilize present

earnings and build a backlog of production for future. This is really a savings scheme of the non-inflationary type.

### III. Suggestions for Future Policy

- A. Greater Use of Excess Profits Tax  
Cf. Statement before Ways & Means Committee, May 7, 1941, pp. 6-8 (mimeo).
- B. Further inroads on consumer income
- C. Greater collection of tax at source  
Possibility of integrating income tax with wage taxes for social security.  
Monthly deductions feasible over vast range of incomes.  
Would require improvement in administration of returns, collections and refunds.
- D. Compulsory joint returns for husband and wife, or correction of inequalities in returns from community-of-property states.
- E. Integration of gift and estate taxes  
Cf. Statement before Ways & Means Committee, May 7, 1941, pp. 10-12 (mimeo)
- F. Greater use of excises for non-fiscal purposes  
Cf. Statement before Ways & Means Committee, May 7, 1941, p. 12.
- G. Changes in Corporation Income Tax
  - 1. ( Removal of progression board on size of income? )
  - 2. Increase in rates  
Cf. U.S. Chamber Address, May 1, 1941, p. 4-5.
- H. Closing of Loopholes in Tax Laws not corrected by 1941 Tax Bill  
Cf. U. S. Chamber Address, p. 5.
- I. Changes in Loan Policies
  - a. Long-term issues, or longer term issues, for insurance co. etc. who would hold to maturity. Such loans non-inflationary.  
See suggestion in Fortune Article, pp. 3-4.

- b. Development of voluntary check-off plans by industries for purchase of Defense Bonds

For e.g. International Harvester has agreed to match 50¢ on each dollar of Defense Bond subscribed for by employees up to 5% of their wages. In case bonds are cashed before maturity contribution of company to go into retirement fund.

J. Extension of Consumer Credit Control

- a. Application of Principle to credit extended by other governmental agencies, particularly F.H.A, except when defense directly is involved.
- b. Extension to Mortgage Financing
- c. Control of Non-defense Plant Expansion

IV. What State and Local Governments Can do to Assist Defense Financing.

A. Avoidance of expenditures which compete with defense

Priorities have reduced such expenditures

States and local governments will save money as well as help defense effort by so doing.

B. Implementation of Defense

Increased expenditures on streets, roads, fire protection etc. in areas affected by national defense. It is suggested that these expenditures represent transfers from other activities and areas rather than increases in aggregate expenditures.

C. Postponement of Capital outlay expenditures until after defense emergency is over.

"Back log" theory of Post-Defense Expenditures

Low cost housing can profitably be expanded in post-defense era.

- D. In connection with postponement of current expenditures state planning for post defense period should be encouraged.

National Resources Planning Board has already undertaken to do this.

Fiscal officers should support this movement.

- E. Considerable expansion in plants of public industries such as water, gas, electricity is required for defense but such expansion as can be postponed should be attempted.

These outlays are of the self-liquidating variety but are capable of some cyclical expansion and contraction. Plans for extension of such industries could be integrated, in many cases with post-defense efforts.

- F. States can profitably extend social security.

Time to do this is during prosperous periods.

1. Many states do not reap full benefit of present federal program and grants.
2. Extension of social service into fields not now covered by act.

- G. State-local governments should develop pension plans for employees, or use present period to place systems on a financially sound (or actuarially sound) basis.

This will help sterilize consumer incomes.

- H. State-local governments should stimulate savings wherever possible.

- I. Enabling legislation should be passed to permit state-local governments, and their agencies, to invest in federal securities

(It is possible that Treasury should bring out securities available to them which might be redeemable at par if funds

are spent on capital improvements within 90 days after notice of redemption is given by Treasury).

- J. States should become actively interested in coordination of taxes with those of Federal government. Time has come when the interrelationship of Federal-state-local taxes should be undertaken. This is a large scale undertaking. The Treasury is now engaged in research on the subject. Other governments should consider the problems too. Until there is developed for the nation a unified or integrated tax system, proper cyclical management of the revenue systems of the country is impossible.
- K. Small amount of applesauce about cooperation of state-local officials with Federal agencies in re Defense.