

BOARD OF GOVERNORS  
OF THE  
FEDERAL RESERVE SYSTEM

# Office Correspondence

Date January 29, 1942.

To Mr. Eccles

Subject: Income vs Sales Taxation  
as an Anti-Inflationary Control"  
by Simeon Leland.

From Mr. Szymczak

Leland has some sense in what he says in this paper. He doesn't suggest the sales tax now, but thinks that it is inevitable eventually. He analyzes the whole tax problem as you do; only you say we shouldn't have a sales tax while he says although we shouldn't have, we will have one just the same, and it won't be bad as an anti-inflation tax.

MSS;mks

## INCOME VS. SALES TAXATION AS AN ANTI-INFLATIONARY CONTROL

By

Simeon E. Leland \*

Taxation is an appropriate anti-inflationary control device in situations where the causes of inflation are due to governmental fiscal policies or to threatened changes in the general price level arising from increasing individual purchasing power available for expenditure on decreasing quantities of goods. Where inflation is associated with government financing, the cause has usually been excessive borrowing via bank credits or paper money; or to state it another way, the inability of governments to finance current operations by taxation and borrowing from income. The escape by fiscal means from inflation so induced is by the balancing of budgets through retrenchment or increased taxation. This requires the reversal of fiscal policies responsible for the plight of the government. Inflation of such a type occurred in Germany and France following World War I. It is not the kind of inflationary danger we face today.

### INFLATION DUE TO MONETARY FACTORS

Where inflation is due to monetary factors, such as an influx of gold, the expansion of currency or movements of foreign exchange, taxation may be specially directed at such conditions.

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Where the danger of inflation from such causes is not great, banking controls, such as through open market operations, are the usual remedy. In any war emergency the danger of inflation through excess borrowing from commercial banks is always present. The policies followed by this nation in financing World War I were directly responsible for the price increases of that time. Not only did commercial banks subscribe heavily to successive issues of Liberty Bonds, Victory Notes and short-term issues,<sup>1/</sup> but they financed a substantial portion of individual subscriptions by means of deposit credits.<sup>2/</sup> This is a story the lessons from which were so well learned as to

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<sup>1/</sup> For example, United States government securities held by member banks in the Federal Reserve System were as follows:

In Millions of Dollars			
1917-March 5	\$ 700	1918-May 10	\$3,200
May 1	700	June 29	2,500
June 20	1,100	Nov. 1	3,600
Dec. 31	1,800	Dec. 31	3,500
1919- March 4	\$4,700		
	June 30	3,800	
	Nov. 17	3,500	
	Dec. 31	3,300	

Annual Report of United States Federal Reserve Board, 1932, pp.128-29.

<sup>2/</sup> During World War I banks loaned about three billion dollars on government securities. Cf. Hansen, "Defense Financing and Inflation Potentialities," Review of Economic Statistics, Vol. XXIII, No. 1, February, 1941, p.5, col. 2.

need no repetition here. The Treasury, to date, has sought to avoid their recurrence, first, by increasing the amount of taxes relative to loans to be employed in financing present war activities; <sup>1/</sup>second, by attempting to borrow such funds as are needed in a non-inflationary manner <sup>2/</sup>-- that is, from current income.

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<sup>1/</sup> In World War I funds to cover expenditures were raised one-third by taxation and two-thirds by loans. Annual Report of The Secretary of Treasury on the State of the Finances for the Fiscal Year Ended June 30, 1919, pp.25-26. In connection with defense financing Secretary Morgenthau announced that the ratio should be two-thirds from taxation and one-third from loans. See The New York Times, April 18, 1941. The Secretary was of the opinion that this "would certainly be a strong deterrent to inflation." Ibid.

<sup>2/</sup> Defense Savings Bonds, Series E, F and G were designed for subscription by individual investors. Series E Bonds are not transferrable and are payable only to named registered holders except in case of death or disability. They may be neither sold nor hypothecated, but are redeemable at discounted values prior to maturity, the discounts being arranged to foster holding until maturity. Individual subscriptions were limited to \$5,000 in any one year. Series F and G Bonds were issued in registered form, were non-transferrable, matured in twelve years but were redeemable before maturity at fixed values (after six months from date of issue) on one month's written notice. Holdings of bonds of F and G Series were limited to \$50,000 during one calendar year. Subject to this limitation banks (other than commercial), corporations and individuals could subscribe. Series F Bonds were issued on a discount basis while Series G were income bonds. -- United States Treasury Circulars, Nos. 653 and 654, April 15, 1941.

## ALL-OUT ATTACK ON INFLATION

The conditions leading to inflation created by war, or by equally intensive preparations for war or defense, call for a unified attack using all available instruments of control. It makes little sense to talk about monetary or credit controls as being the ones to use, or about fiscal policies as being the proper instruments, or about direct price controls, rationing, allocations and priorities as being best adapted to check inflation, or about other single methods of attack. What is essential is an all-out attack on inflation with all available instruments. Since there must be some limitations of space on the compass of discussion, other measures than income and sales taxes will be excluded from consideration here. <sup>1/</sup> This

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<sup>1/</sup> Sales and income taxes are of various types; not all of them can be discussed. The sales taxes to be considered here are excises levied on specially selected commodities and a general sales tax, perhaps, with the exemption of some commodities such as food. As a device for controlling inflation, a retail sales tax is superior to a manufacturer's or a wholesaler's sales tax. It is imposed at the time of more final sales than would otherwise be the case; it decreases the extent of pyramiding and therefore has less effect upon prices; the levies would be more conspicuous and less concealed in final prices. The resistance to a retail sales tax might be greater than to other types of sales taxes, but this would tend to limit the duration of the tax to the emergency period. If administrative costs were higher, they would be worth it. States have effectively operated these taxes for a considerable period and the Federal government, just as in the case of income taxation twenty-five years ago, can learn much from their experience.

The income taxes to be considered will be the usual net income tax, two features of which are exemptions and progressive rates. Payroll taxes will also be discussed. They are distinguished from personal income taxation by the absence of family deductions and exemptions.

exclusion, however, carries no implications of unimportance for the measures not discussed. It must be assumed, moreover, that the various alternative controls are used in complementary fashion. If, for example, inflationary borrowing should finally be resorted to -- and the present volume of subscriptions by individuals makes loans from commercial banks a likely possibility <sup>1/</sup> -- it should not be assumed that heavier taxation would be the only control to be applied. This discussion will be less speculative if it may be assumed that non-inflationary borrowing and rigorous direct efforts at price control supplement tax policies aimed at preventing inflation. It is to be hoped that the national government will also attempt to control wage rates and other cost-raising factors. If these things are done, the chances for success in preventing inflation are greatly increased. If nothing is done about them, little can be expected of fiscal measures acting alone.

#### WAR CREATES INFLATIONARY CONDITIONS

It is inevitable that war or intensive rearmament should produce conditions favorable to inflation. The physical task of creating war material presupposes the conversion of industrial plants from the manufacture of civilian to the manufacture of military goods. The increase in the armed forces reduces the number of people available

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<sup>1/</sup> For example, if comparisons are made for May through September for 1940 and 1941, it may be observed that income payments in the United States are increasing at a more rapid rate than subscriptions to Defense Savings Bonds. The new tax bill has not yet affected the increased incomes, nor have the tax anticipation notes greatly reduced the funds available for current expenditure.

for the satisfaction of peace-time wants. These transfers continue (if the war lasts long enough) until civilians are left with just enough goods and services to preserve morale and to maintain the efficiency of the population as a laboring force. Pressure to increase the supply of munitions draws into war industries continuously increasing amounts of labor <sup>1/</sup> and usually at ever larger rates of pay. The result is that the population outside of the armed forces finds itself in possession of larger and larger amounts of income. <sup>2/</sup> If taxes are not raised sufficiently, such funds can be spent on a decreasing quantity of civilian goods. <sup>3/</sup> That is just what is happening today.

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<sup>1/</sup> Much of the labor used in war industries is highly skilled and its withdrawal seriously handicaps peace-time production.

<sup>2/</sup> The index of factory payrolls has risen from 97.8 in May, 1940 to 163 in September, 1941. The average hours worked per week by wage earners in manufacturing industries rose from 37.2 in April, 1940, to 41.0 in August, 1941. Average hourly earnings in these industries rose from 66.5 cents per hour in April, 1940, to 74.5 cents in August, 1941. Federal Reserve Bulletin, July, 1941, pp.676-77, November, 1941, pp.1177-78.

<sup>3/</sup> The indices of producer's and consumer's durable goods, compiled by the Federal Reserve Bank of New York, have been growing farther apart since about March, 1940. Since August, 1941, there has been a marked decline in the index of production of consumer's durable goods. Monthly Review of Credit and Business Conditions, Federal Reserve Bank of New York, November 1, 1941, pp.87-88.

The budgetary aspect of war is also inflationary. The military arm of government when engaged in large-scale operations demands increasing amounts of materials to be purchased on government account. Little thought can be given to the cost of needed goods if victory is to be won. Whatever is necessary in the way of goods and material must be made available to the army and navy. If cash is lacking or taxes are inadequate, claims for goods must be met either from the proceeds of loans or from purchasing power otherwise created. There is a tendency, too, for obligations for material to accumulate prior to and in larger volume than taxes accrue. In general, neither tax legislation nor tax collections tend to be speeded up sufficiently to offset these current obligations until decisions have been reached on battlefields. The government has no choice except to underwrite whatever scale of expenditures is required by military necessities. Demands for retrenchment play into the hands of the enemy. Failure to cover the expenditures by taxes tends to create inflationary pressures, which can be reduced only by continued increases in taxation and non-inflationary borrowing. Important as is the type of borrowing, it too must be excluded from this paper.

If price inflation is to be prevented, the surplus of earnings, above the cost of maintaining the labor supply (civilians) in a state of efficiency and contentment, must be kept from bidding up the price of the dwindling supply of consumer's goods. This reduction of income available for consumption can be accomplished (1) by voluntary hoards to be held for the duration of the emergency; (2) by



direct investment in non-negotiable securities to be held "for the duration"; (3) by taking, through taxation, income above living costs. Investments in non-negotiable bonds deprive individuals of funds until such time as bonds are paid or redeemed. Taxes take personal resources and permanently transfer them to the use of government. As government expenditures take place, these funds flow back into personal income streams and the process of income-sterilization must commence anew. <sup>1/</sup>

On the production or physical side, the increase in goods for civilian consumption may keep pace with, or even keep ahead of increases in civilian purchasing power in the early stages of the war effort. In the first place, the transfer from a peace to a war-time economy takes time. Not all industries can be transferred at once. While a gradual transition is being made, the production of goods for civilian requirements can continue. Likewise, if the rearmament program finds the country with unemployment and unused productive facilities these can be absorbed before production for non-military use needs

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<sup>1/</sup> Firm resolutions not to spend, if carried out, keep individual resources out of the market place and do not affect prices, but the idle resources are of no service to the government in financing defense if the hoards are outside of financial institutions. True hoards, nevertheless, are not inflationary. From the point of view of controlling inflation the larger they are the more effective the damper. At the present time hoards are not a practical problem. Undoubtedly, if hoards were accumulated in substantial amount, patriotic and other reasons would probably compel the government to adopt forced loans, capital levies or increased taxation in some other form.

to be curtailed. This is the basis for "guns and butter" in the recent discussions. <sup>1/</sup> The danger, of course, is that butter will continue to be churned long after the manufacture of guns should have been multiplied. It is folly, in a military sense, to argue for the continued production of civilian goods. The greater the quantity of such goods to be exchanged for the growing salaries and wages, the less will be the price rises and the danger of inflation. The more remote also will be the military victory and the smaller the quantity of guns, munitions and battleships in the hands of those who need them.

#### CONSUMPTION CONTROL VIA EXCISE TAXES

It may be argued that the sale of goods to civilians can be reduced by artificially raising prices by means of taxation. This doctrine rests upon the assumption that, as a result of price increases, consumers will purchase in decreasing quantity those goods for which demand is elastic. To the extent that such facts exist, excise taxes may be employed to reduce the consumption of certain goods, but the tax increases and price changes resulting probably have to be unconscionably large and the goods to which the taxes can be applied may not be as numerous as is commonly supposed.

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<sup>1/</sup> Cf. Bloch, Lange, Harbison and Lewis, Economic Mobilization, p.12.

If excises are to reduce consumption, those goods with relatively inelastic demands must be excluded. Tax policy and tax rates will have little effect upon their consumption unless the rates are practically prohibitory. The cardinal folly of sumptuary taxation has been the selection of goods the demand for which is highly inelastic. The list includes tobacco, liquor, cosmetics, gambling devices and playing cards. Moderate changes in price have little effect on their consumption. It is not accidental, therefore, that the most productive of the Federal excises are on liquor and tobacco. <sup>1/</sup> The consumption of gasoline, to which the sumptuary principle has not been

<sup>1/</sup> The importance of these excises may be indicated as follows:

Year	Total Tax Revenues	Total Excise Taxes	Excise on Tobacco		Excise on Liquor	
			Amount	: Per Cent: :(Col. 2):	Amount	: Per Cent :(Col. 2)
1917	1,118,174,126	392,188,000	102,577,000	9.2	284,009,000	25.4
1939	5,910,778,701	1,707,000,000	580,159,000	9.8	587,800,000	9.9
1940	6,154,073,297	1,851,103,000	608,072,000	9.9	624,064,000	10.2

"Total Tax Revenue" is defined as all Federal taxation including tariffs.

"Total Excise Taxes" include only taxes levied on specific commodities.

The compilations were based on the following sources:

United States Annual Treasury Report, 1918, pp.976-77.

Ibid., 1940, p.644.

Ibid., 1940, pp.696-697.

applied, is also little affected by price changes. It is no doubt true that great increases in price accomplished through excises could affect the consumption of these goods, but such a policy would interfere with the revenue yield of the most productive of the Federal excises. It is doubtful if the reduction in the sale of tobacco, liquor, or even gasoline (the aviation brand excepted) would contribute as much to the war effort as the fixing of the revenue at the point of maximum return. <sup>1/</sup>

From the standpoint of inflation control it is not enough to affect the price of the taxed goods. Inroads must be made into the aggregate of funds available for expenditure so that individuals will have less to spend than before. Excise taxes may also be used to change the direction of spending from goods relatively scarce to those more abundant (or even available in almost unlimited quantities.) If individuals are made poorer because they buy goods to which excises have been attached, the incidence of such taxation is upon them. The fact that they are poorer may also change the quantity and quality of other purchases. At any rate they will have less money with which to buy other goods or bid for them. The danger of inflation is thereby lessened. Excises on goods with elastic demands tend to change the direction of spending as individuals seek to avoid paying increased prices for goods -- in short, to avoid the burden of consumption excises. The government, therefore, can so select its excises as to

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<sup>1/</sup> It is believed that if consumption were to be reduced, the revenue to the government would be reduced as well.

direct consumption away from the goods needed for the war effort and into those channels where increased demands will neither tend to raise general prices nor develop shortages in materials. This change in the direction of consumption seems to be possible wherever demand schedules are relatively elastic -- that is for most things -- but the doses of taxation required may be quite large. And if the plan worked, the revenue from the excises so employed would not be large. The more successful the diversions of consumption to untaxed fields (or to those less taxed), the smaller would be the revenue produced. Congress would have to depart from its idea of excises for revenue and use excises to implement consumption controls. This is more important than the negligible revenues received from excises other than on liquor and tobacco.<sup>1/</sup> There is little reason, however, to change the revenue policy on these two commodities. In other fields the policy of consumption control would require the development of very different schedules for excise taxation. They could be developed in conjunction with priorities. Those goods which were scarce and urgently needed for defense, such as copper, manganese, tin steel, etc. with their final products, could be heavily taxed to the consumer and their use discouraged. New automobiles, radios, refrigerators, building materials, electrical appliances would certainly be singled out for substantial excises, while theatres, night clubs, bowling alleys and similar diversions requiring few critical materials could be made relatively and absolutely more attractive.

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<sup>1/</sup> In 1940, 42.7 per cent of tax revenues of Federal government were derived from excises. Tobacco and liquor excises equaled 27.4 per cent of tax revenues, other internal revenue stamps provided 9.9 per cent, while the manufacturers excise accounted for 4.5 per cent. Annual Report of Secretary of Treasury, 1940, p.696-7.

The more money spent on the latter class of "goods," the less are the inflationary dangers. <sup>1/</sup>

If an adequate brake for inflation is to be developed, the direct reduction of individual resources available for expenditure is far more promising than their eventual reduction through excises collected at the time of expenditure. In short, income or general sales taxes seem to be far better as anti-inflationary measures than special sales taxes, consumption taxes or excises, by whatever name they may be called. But what is the choice between them?

#### AFFECTING CONSUMPTION THROUGH INCOME TAXATION

If a net income tax is to affect consumption appreciably, it must reach down into the brackets in which the bulk of consumption takes place. Incomes above the personal exemptions must be so reduced as to leave substantially smaller aggregates available for expenditures. Inasmuch as over 97 per cent of the consumer units receives incomes of less than \$5,000 per annum, this is the group toward which anti-inflationary taxation must be directed. This group also accounts for 88 per cent of consumption expenditures measured in dollars. <sup>2/</sup> In 1936, a year which corresponds with the time these consumption statistics

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<sup>1/</sup> A natural consequence of directing consumption from scarce to more abundant goods is the decrease in the pressure for inflation.

<sup>2/</sup> Consumer Expenditure in the United States: Estimates for 1935-36. National Resources Committee, Washington, D.C., 1939, p.4.

were compiled, only 4.22 per cent of the population of the nation filed Federal income tax returns, and only 2.23 per cent of the population were subject to this tax. <sup>1/</sup> In that year the total revenue receipts of the Federal government, including postal revenues, were only 12.1 per cent of the consumption expenditures of families and single individual units. <sup>2/</sup> In 1938 the total taxes of Federal, State and local governments were estimated to take 20 per cent of total consumer incomes in that year. <sup>3/</sup> Federal taxes took but 9.2 per cent. <sup>4/</sup> When these data are distributed by income brackets, it appears that approximately 80 per cent of consumer incomes for 1938-39 are found in the income classes of \$5,000 and less, yet these income classes paid 69 per cent of the total tax bill (Federal, State and local). <sup>5/</sup> Although their tax bills are heavy, their consumption must be affected

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<sup>1/</sup> In 1936 the total number of returns filed was 5,413,499; the number of taxable returns was 2,861,108. Population estimate for that year was 128,237,965. For comparisons for years 1916-1939 see Leland, "Defense Financing and Monetary Problems," Hoosier Banker, June, 1941, pp.26-28, 50-57.

<sup>2/</sup> Total revenue receipts were \$4,781,299,971. Annual Report of Secretary of Treasury, 1940, p.645. Aggregate consumption was \$39,458,000,000. Consumer Expenditures in the United States, 1935-36, p.48.

<sup>3/</sup> Who Pays the Taxes, Monograph No.3, Temporary National Economic Committee, Washington, 1940, p.6.

<sup>4/</sup> Ibid.

<sup>5/</sup> Ibid., p.28.

if inflation is to be checked. This cannot be done if Federal taxes are limited to a small proportion of the nation's population and to a fifth of consumer income.

The 1941 tax bill has been amended to bring within its scope an increasing number of taxpayers. Exemptions have been reduced to the lowest level in our history - to \$1,500 for married persons and heads of families and to \$750 for single persons. This change is expected to raise the number of returns from 15,160,000 filed this year to 22,108,000. The total number of taxpayers, individuals and corporate is expected to rise from 8,000,000 to 13,200,000. <sup>1/</sup> The new income and excess profits taxes are expected to produce about twice as much revenue in 1942 as was produced in 1941. <sup>2/</sup> From the standpoint of consumption control this is not enough. Too large a fraction of consumer income is either not taxed at all or else not severely enough, and the income tax is too slow in reaching the increased income from

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<sup>1/</sup> The New York Times, October 27, 1941.

<sup>2/</sup> These taxes produced \$3,470,000,000 in the fiscal year which ended June 30, 1941, and are expected to produce \$7,079,000,000 in fiscal 1942. Ibid.



which taxes are paid. <sup>1/</sup> The lag between income earned and income tax payments is at least one year (measured from the midpoint of the year of earnings and the year of payments). To shorten this gap, the Treasury has introduced tax anticipation notes. But the sale of these notes, like the sale of Defense Bonds is proceeding at a slower rate than incomes are increasing. From May through October, 1941, the sale of defense bonds amounted to \$1,775,000,000. Tax anticipation notes sold from August through October, 1941, amounted to \$1,818,000,000. <sup>2/</sup> During the months of May, June, July and August, 1941, money payments in the United States were \$4,808,000,000 more than in the corresponding months of 1940. Salaries and wages rose over \$3,875,000,000 in these four months of 1941 over 1940. The national income rose from an annual rate of \$90,000,000,000 in August to \$92,000,000,000 in September, yet during September only \$232,000,000 in defense bonds were sold, while subscriptions to tax anticipation notes aggregated \$306,000,000 of which only \$8,000,000 were of the Series A variety designed for smaller

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<sup>1/</sup> There is reason to believe that the practice of setting aside reserves out of current income for the payment of taxes is not general. The practice is confined largely to firms, corporations and wealthy persons. The lower the exemptions the greater will be the number of those who do not set aside tax reserves out of current income. Data are not available to confirm this hypothesis. It is doubtful if tax payment reserves affect the bulk of United States consumption.

<sup>2/</sup> Federal Reserve Bulletin, November, 1941, p.1081.

taxpayers. <sup>1/</sup> Voluntary subscriptions to defense loans plus the sale of tax anticipation notes are not taking place in sufficient volume to remove the danger of inflation. Likewise, loan subscriptions are being financed largely from idle bank balances -- which is inflationary in high degree. Additional controls should, therefore, be attempted.

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<sup>1/</sup> SALES OF DEFENSE SAVINGS BONDS AND TAX NOTES  
MAY-OCTOBER 1941  
(Issue price. In millions of dollars)

	Defense savings bonds			Tax anticipation notes		
	Total	Series E	Series F and G	Total	Series A	Series B
May .....	350	101	249	...	...	...
June.....	315	103	212	...	...	...
July.....	342	145	197	...	...	...
August....	266	118	148	1,037	18	1,019
September.	232	105	127	306	8	298
October...	271	123	148	475	7	468
Total ....	1,775	694	1,081	1,818	33	1,785

--Federal Reserve Bulletin, November, 1941, p.1081.

Further inroads must be made into incomes as they are being received in order to decrease the amount available for subsequent expenditure. This calls for instalment payments at least monthly, or the withholding at the source of a certain percentage of all income payments, or the collection of taxes based on expenditures as income is in fact spent. In short, the alternative is the current collection of income taxes or the imposition of an emergency sales tax.

#### MORE FREQUENT COLLECTIONS

If income taxes are collected monthly, the increased payments under the 1941 law can be paid more conveniently by most taxpayers. In spite of the administrative inconvenience and increased cost of collection to the Treasury, under the increased schedules now in force a change of policy in this direction is in order. True, taxes on 1941 incomes would not be payable monthly until 1942 and on 1942 incomes until 1943. What is really needed is payment from incomes as earned, taxes on 1942 incomes payable from incomes during 1942. If this were done, taxpayers might have to pay two years' taxes in one, but an effective move against inflation would thereby be made. Individuals would be paying during 1942 taxes on incomes earned in 1941, taxable under the 1941 act, and taxes on a monthly basis on 1942 incomes (under an act yet to be passed) as the income of 1942 was being earned. This was the essence of Secretary Morgenthau's proposal tentatively and informally ventured to the House Ways and Means Committee a few weeks ago.

## INCREASE AGGREGATE TAX

It is not enough simply to increase the frequency of income tax collections. The aggregate tax bill will have to be increased greatly if the income tax is to be an effective curb on inflation. In 1939 the national income was \$70,674,000,000, out of which \$14,090,000,000 (or 19.94 per cent) was paid in Federal, State and local taxes inclusive of Social Security taxes. In 1940 the national income was \$76,035,000,000 and the total tax collections were \$14,562,000,000. The national income increased by \$5,361,000,000; the total tax bill increased only \$472,000,000. <sup>1/</sup> On the assumption that the national income for 1941 will be \$90,000,000,000 a \$14,000,000,000 increase in national income will compare with a tax bill probably increased by not more than \$5,000,000,000. <sup>2/</sup> If the subscriptions to Defense Bonds and Tax Notes are doubled to allow for additional purchases during the remaining two months of this year, <sup>3/</sup> approximately \$2,000,000,000 of the increase remains unaccounted for.

*How much?  
Increase in tax should  
be constant.*

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<sup>1/</sup> Data taken from Tax Yields: 1940, p.25.

<sup>2/</sup> It was assumed that 1940 tax collections would increase by 10 per cent, and to this sum was added \$3,553,400,000, the additional revenues estimated under the Revenue Act of 1941. For the latter see Federal Reserve Bulletin, November, 1941, p.1079.

<sup>3/</sup> Cf. data previously given. Total is \$7,186,000,000.

If the national income achieves the annual rate of \$92,000,000,000 on the basis of September data, two additional billions will be added to the inflationary pressure. On the other hand, there are probably some slight offsets as well as increases in consumer's goods to be taken into account.

#### REDUCE EXEMPTION OF MARRIED COUPLES

If income taxes are to be increased (and they should be), where shall the increases be made? If equality of treatment is to be provided between married couples and single persons, the exemption for married persons should be reduced from \$1,500 to something between \$1,000 and \$1,250. <sup>1/</sup> The Federal income tax exemption for single persons is \$750. The differential is greater than costs of family living justify. It is worth mentioning, too, that the intolerable inequality of treatment between community-of-property states and others with reference to joint returns for husband and wife should be removed. <sup>2/</sup> Income is really family income anyway in all but exceptional cases, hence all

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<sup>1/</sup> Single persons in the income bracket \$750 - \$1,000 have negative savings of 0.5 per cent of income. Families in the \$1,250 - \$1,500 income level save on the average 1.0 per cent of their incomes; those in the \$1,500 - \$1,750 income level save 3.5 per cent of their incomes. Negative savings for families do not begin until income levels drop below \$1,250. In the \$1,000 - \$1,250 bracket negative savings equal 2.8 per cent of income. If these data were used in fixing exemption limits, the exemption would fall in the \$1,000 - \$1,250 income class if single and married were to be treated more on a par. Consumer Expenditures in the United States, 1935-36, pp.20, 32.

<sup>2/</sup> Cf. Secretary Morgenthau's statement before Senate Finance Committee. The New York Times, August 9, 1941.

returns between husband and wife should be joint. This alone will add \$323,000,000 to the tax revenues of the government.<sup>1/</sup> It is worth, as an anti-inflationary control, more than the average monthly sale of Defense Savings Bonds to date. Decreases in exemptions will be worth even more.

#### INCREASED RATES

It is undoubtedly true that tax rates can be increased somewhat even in the lower brackets if tax payers are willing to make further sacrifices for defense. For single persons earning \$1,000 the 1941 rates take less than 50 cents per week. If they earn but \$800, they can spread the \$3 tax bill over an entire year. Married couples with one dependent and \$2,000 of income are taxed at the rate of about twelve cents per week. Taxes payable under the 1941 act for other situations and earnings up to \$10,000 are shown in Table I. (p.21a). Purely nominal payments are the lot of too many individuals and families in the United States (irrespective of war or peace).

From a fiscal point of view lower, upper and middle bracket rates can all be increased, if Congress is willing to do it. It could, with much favorable urging from scholars, adopt the Hobsonian principle of taxing surplus incomes<sup>2/</sup> and fix a ceiling on earning after

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<sup>1/</sup> Cf. The New York Times, July 3, 8, 20, 1941.

<sup>2/</sup> Hobson, Taxation in the New State, chaps. II, IV, V.

TABLE I

## TAXES PAYABLE UNDER 1941 REVENUE ACT

Income Classes	Single	Married Couples Living with Husband and Wife			
	Persons with no Dependents	No Dependents	One Dependent	Two Dependents	Three Dependents
\$ 750	\$ 11	\$ ...	\$ ...	\$ ...	\$ ...
800	3	...	...	...	...
900	11	...	...	...	...
1,000	21	...	...	...	...
1,100	31	...	...	...	...
1,200	40	...	...	...	...
1,300	50	...	...	...	...
1,400	59	...	...	...	...
1,500	69	...	...	...	...
2,000	117	42	6	...	...
2,500	165	90	50	12	...
3,000	221	138	98	58	18
3,500	284	186	146	106	66
4,000	347	249	197	154	114
5,000	483	375	323	271	219
6,000	649	521	453	397	345
7,000	825	687	619	551	483
8,000	1,031	873	789	717	649
9,000	1,247	1,079	995	911	827
10,000	1,493	1,305	1,205	1,117	1,033

--Taken from Know Your Taxes, United States Treasury Circular.

the current British pattern. <sup>1/</sup> It is extremely doubtful, however, if that would be as effective a brake on inflation as lowering exemptions further, particularly for the married, and increasing the lower and middle rates. One-third of the families and individual consumer units have incomes under \$780. Approximately 10 per cent of consumer income is in that income group. The middle third of the families -- those in the \$780 - \$1,450 income class - have about 24 per cent of the aggregate incomes. Two-thirds of consumer income is above \$1,450. Almost 85 per cent of family income is above the \$1,000 income level; two-thirds of family income is above \$1,500; about 83 per cent of the income of single individuals is above \$750. Sixty per cent of consumption expenditures are made by those having incomes of \$2,000 and under; seventy-eight per cent by those with incomes of \$3,000 and under. <sup>2/</sup> Exemptions below \$750 for single persons and \$1,000 to \$1,250 for married couples would trench more heavily on already inadequate standards of living than is desirable, or politically feasible. But Federal income taxes should begin at those levels. There is danger, however, that if burdens on the lower income groups are too quickly and too drastically increased, large tax delinquency may result. The income tax as a sound tax measure might become discredited as evasion and avoidance increased. Whatever is done really needs the support of public sentiment.

<sup>1/</sup> Cf. Miss Comstock's paper, "Income and Profits Taxes," supra for summary of British taxes.

<sup>2/</sup> Data taken from Consumer Expenditures in the United States, 1935-36, especially p.77.



There can be no question, however, from a theoretical point of view but that personal taxation in support of government should begin at income levels just above actual subsistence costs. Some writers are even willing to argue in favor of universal taxation without regard to the minimum of subsistence, cases of hardship being met through abatements or a program of social welfare expenditures. Either of these approaches seems to require coordination with state and local tax programs if individual tax burdens are to be fairly adjusted. That low-level income taxes can be effectively administered is indicated by the experience of many states. Too much weight, therefore, should not be given to the administrative objections to lower Federal exemptions.

#### INCREASE PAYROLL TAXES

Another approach to the problem would be to increase payroll taxes. Salaries and wages have already risen to record heights, primarily as a direct result of defense activities. The lot of the wage earner has greatly improved. His pay envelope contains more dollars; he is ready to spend and has been spending his earnings. A payroll tax increase, deducted regularly at the source would operate as an inflationary curb, but presumably it would affect only those now covered by the Social Security program. There are many who believe that these taxes could be increased without causing labor to demand increased wage rates. There are others who think that labor is only interested in what is in the pay envelope, and therefore increased payroll taxes would tend to push up costs and thus give added impetus to the inflationary cycle. Some believe that such strikes could be avoided if the

benefits of Social Security were extended. No doubt the increased coverage would soften the resistance of labor to inroads upon earnings.

Payroll taxes can be appropriately adapted to a cyclical or flexible fiscal policy -- a thing which the nation sorely needs. Payroll taxes can be increased easily during periods of prosperity, provided they do not push up costs in situations like the present. They can be reduced, too, during depressions. We are already aware of some of the consequences flowing from their adoption and increase at such times. The ease with which added payroll taxes could be collected, as well as their immediate impact on current incomes, makes them appropriate instruments for dealing with inflation. Their reduction, along with the reduction of certain other taxes, can help solve some of the problems of depressions. Likewise, their reduction in the post-defense period might be made conditional upon records for continued employment. Their outright reduction might become a stimulus to continued business activity. The main shortcoming of payroll taxes is their present limited coverage. This, however, can be easily cured.

#### GROSS INCOME ALTERNATIVE

A case could also be made for the adoption of a gross income tax without exemptions as an anti-inflationary device. It would reach all income, or all above any fixed exemption. In the lower brackets it would differ but little from either payroll or sales taxes. It would be

*No comment on taxing  
inequity of avoiding taxation  
"non-earned" income?*

more difficult of administration than the payroll tax, although the present machinery for collecting Social Security taxes could be extended to it. Monthly collections would create no problems not present already in aggravated form. Nevertheless, it would be far less convenient of payment for those with small incomes than a sales tax. The effects seem so little different that a sales tax might even be superior.

#### SALES TAX APPROACH

There are many features about a sales tax which make it peculiarly useful under present conditions as an anti-inflationary control. It garners funds for public treasuries immediately after it goes into effect. There is no lag for individuals between the time tax liability accrues and payments are made. As soon as a retail sales tax, for example, becomes effective, consumers start contributing to the cost of government. The only lags involved are (1) the time between the receipt and spending of income, and (2) the time between the transaction on which the tax is collected and the date on which retailers remit to the State.<sup>1/</sup> So far as consumers are concerned, the lag is shorter, on the whole, than even a monthly-collected income tax. A payroll tax or an income tax withheld at the source would, of course, have quicker effects, for under them

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<sup>1/</sup> This lag is for the convenience of business men who act as collection agents for the State. Obviously they could not remit the tax on each transaction. Daily or even weekly remittances would be burdensome. Until remitted the taxes collected may serve as working capital for those who collect from consumers. The more frequent the remittances to the State, the more restricted is the temporary use of these funds.

taxes would be taken out even before income payments were made. This, however, is not true at the moment.

In times past the possibility of quick collections, as well as the regular flow of funds into their treasuries, has been of advantage to many states. Monthly collections of revenue have decreased the necessity for short-term loans made in anticipation of tax collections. During the depression, sales taxes thus relieved several states from temporary financial embarrassments. If inflation should come, the quick collection of sales taxes would again be advantageous. As prices increased, the yield from ad-valorem sales taxes would automatically increase. The government would have additional funds from which to meet its added costs. The more violent the inflation, the more advantageous this would be and the quicker the Treasury would feel the effect of increases in tax rates, should any be adopted. Professor Viner has fittingly called attention to this in connection with French and German post-war inflation:<sup>1/</sup>

"The Germans had the inflation under control twice during its course; then some unexpected political event (as the sudden demand for big reparations payments) broke the grip of the few men who were keeping their hands on the situation. Ignoring these two short periods when what was otherwise wild inflation was gotten temporarily under control, why did the German inflation go wild? A large body of opinion in Germany did not care what happened. They were in a state of despair as to the future of Germany, particularly under the Treaty of Versailles, and did not much care if the currency went to pieces if it brought an end to reparations payments. More important,

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<sup>1/</sup> Viner, "Inflation as a Possible Remedy for the Depression," Proceedings of Institute of Public Affairs, University of Georgia, 1933, pp. 124-25.

the government budget was not in strong shape, the taxation system was not such as to produce an increase of revenue promptly upon any increase in price levels, and the government, without adequate credit to meet temporary deficits by borrowing, found itself repeatedly forced to meet current expenses by resort to the printing press.

"The French inflation started in the same way -- because of a government deficit which in the opinion of ministers of finance could not be met without resort to the printing press, but the French got it under control. The differences between the two situations were, first, that nobody in France wanted the franc to go to pieces, and, secondly, the French budgetary system, and especially its revenue system, was such that inflation did not throw it out of gear as badly as in Germany. The German tax system was more like ours -- it consisted primarily of direct, income, and inheritance taxes, levied on the values of one year, but not collected until the following year. So there was in Germany a lag of a year on the average between the occurrence of an economic event which created a basis for the levy of a tax and the actual collection of the tax. A year during a rapid inflation is a long period, and during a part of the German inflation a doubling or even a tripling of the rates of income tax each month would still not have sufficed to make income tax revenue keep pace with incomes measured in current marks. France on the other hand, relies largely on indirect taxes on gross receipts or on sales collected shortly after the receipts and sales occur. As inflation increased prices in France it also brought an almost simultaneous increase in tax revenues, so that the budget never got as seriously out of hand as in Germany."

It may be questioned whether sales taxes are a good deterrent to booms or to inflation. During the depression sales taxes were criticized for their unfavorable effect on business, and were assiduously avoided by the Federal government. The point has often been made that sales taxes tend to reduce the sale of goods the demand for which is elastic. A boom or the eve of inflation is a good time to produce these very effects. Any thing which will build up sales resistance and reduce consumer demand operates in the proper direction, unless the enhancement

of prices through sales taxation adds impetus to the demand for higher wages to meet higher costs of living. Already strikes in anticipation of increases in living costs have occurred. If sales taxes should add fuel to this fire, resort to them could well be questioned. The authorities may not be agreed as to just how labor would react to them. So far there is little evidence on the point, but it seems reasonable to believe that labor attitudes would be less favorable to sales taxes than to additional payroll taxes related directly to expanded Social Security benefits. The payroll taxes are regarded by many as insurance premiums or benefit payments, but it is probably too soon to decide whether labor will attempt to pass them on. Psychological attitudes toward taxation thus make difficult the choice between tax measures.

#### UNIVERSALITY, REGRESSION AND INFLATION

The coverage of sales taxes is undoubtedly greater than that of income taxes. The sales tax reaches those below exemption limits, as well as groups not effectively reached by present income taxes. Conspicuous among those outside the reach of American income taxes are farmers and others whose income in kind cannot be taxed effectively. They can hardly escape a sales tax unless it is so designed. If it is not practical further to reduce income tax exemptions, <sup>1/</sup> a sales tax may provide the desired universality of payments.

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<sup>1/</sup> "Practicality" is a political rather than an economic judgment. It is the surmise of the writer, however, that Congress will not, in the war future, be willing either to reduce income tax exemptions to the levels suggested in this manuscript, nor to raise rates in the low brackets to the height required to check inflation. "Too little and too late" is almost a maxim of current fiscal performance.

By way of illustration, a two per cent sales tax on mainly tangible property would collect from families under the \$500 income level, \$7.04 per annum; would collect on the consumption of those in the \$500 - \$750 bracket about \$10.86, and \$13.92 from those families in the \$750 - \$1,000 income class. <sup>1/</sup> The bulk of these tax payments

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<sup>1/</sup> These estimates were derived by applying the 2 per cent tax to average expenditures per family for the income levels indicated on food, household operation, clothing, automobile, medical care, furnishings, tobacco, and "other items." Expenditures excluded were for housing, recreation, personal care, transportation other than by auto, reading and education. Consumer Expenditures in the United States, 1935-36, p.23.

would be derived by taxing food; <sup>1/</sup> the whole tax bill would come from taxing basic necessities. This is far from comforting. Moreover, the lower one-third of our families and single individuals had incomes in

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<sup>1/</sup>

PERCENTAGE OF INCOME SPENT ON FOOD: 1935-36.

Income Level			American Families	Single Individuals
Under	--	\$500	65.0	60.9
\$500	--	\$750	49.5	45.5
\$750	--	\$1,000	43.5	40.9
\$1,000	--	\$1,250	38.7	37.1
\$1,250	--	\$1,500	35.7	34.1
\$1,500	--	\$1,750	32.7	31.6
\$1,750	--	\$2,000	30.5	29.6
\$2,000	--	\$2,500	27.8	27.0
\$2,500	--	\$3,000	25.4	24.9
\$3,000	--	\$4,000	22.7	22.2
\$4,000	--	\$5,000	19.4	18.9
\$5,000	--	\$10,000	15.1	14.7
\$10,000	--	\$15,000	10.7	10.4
\$15,000	--	\$20,000	10.3	9.9
\$20,000 and over			5.4	5.3
All levels			28.8	28.5

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Data taken from Consumer Expenditures in the United States, 1935-36, pp.78, 84.



1935-36 of less than \$780 and their consumption expenditures exceeded their incomes by 17 per cent.<sup>1/</sup> The middle third of American consumers with incomes between \$780 and \$1,450 also had budgetary deficits (-1.8 per cent), and spent 98.1 per cent of their incomes on current consumption. When the underfed, the poorly clothed and the improperly sheltered are taken into account, the outcry against regression in sales taxation takes on real meaning. It is revolting to advocate such taxation when living standards for the masses are so low. The consequences of regression can, of course, be minimized by the exemption of food and clothing -- materials also not now scarce. Income taxes, on the other hand, only reach those above whatever exemption is selected.

Nevertheless inflation cannot be controlled effectively unless consumption is affected. To affect consumption by taxes necessitates resort either to regressive sales taxation or to increased income taxation through the reduction of exemptions to subsistence levels and the increase in progressive rates. The effects are determined by the amounts taken from the respective income classes. Scholars differ in their opinions with respect to the amounts to be taken from various income levels. If equivalent sums are to be taken from the same income classes, the convenience of sales taxation to consumers and their immediate effect on consumption must be noted. If income taxes are withheld at the source, these gains of sales taxation are illusory. It is a question, then, of the groups affected by the tax measure selected. In the case of sales taxation, the groups are not usually identical. There is, in addition, the possibility of shifting to consumers more

<sup>1/</sup> Ibid., pp.5, 77.

But what's so bad about inflation that we should prefer highly regressive (cumulative) taxation?

than the amount of the tax. Although the consequences of regressive taxation are harsh, they are as nothing compared with the burdens indiscriminately scattered by inflation. Income taxation beginning above subsistence levels will help prevent both hardships.

Perhaps the greatest risk in connection with the adoption of a sales tax as an inflationary curb is the possibility that such taxes would continue to be a permanent feature of the Federal tax system after the need for them had passed. Sales taxes have a large following of enthusiastic advocates who would like nothing better. Some favor the sales tax for its universality, others hopefully desire to substitute it for a significant portion of the income tax progressions. As a permanent adjunct of the Federal tax system, a sales tax would be undesirable beyond any doubt. As a tax restricted to booms and times of inflation, there is a place for it in the tax system. If the nation has the skill and courage to check inflation, it would probably be able to restrict sales taxes to appropriate cyclical periods. However, the risk that this may not be possible is always present.

#### CONCLUSION

In conclusion it may be stated that the choice between sales and income taxation as anti-inflationary controls is not unequivocal. Dogmatic pronouncements are imprudent. The essential problem of reduction of consumer's purchasing power can be accomplished either through income or sales taxation. It is largely a matter of personal opinion

as to the course of action most appropriate to the situation. The answer depends, in the main, on attitudes toward regression in taxation and the degree to which regression can be tolerated. In the interest of minimizing regression and yet to secure effective inflationary controls the following opinions are expressed:

1. Excise taxes for revenue should be restricted largely to tobacco and liquor.
2. Other Federal excise should be directed at the problem of consumption control with rates fixed as high as necessary to achieve the desired results. The commodities selected for excise taxation should be those essential to defense, the selection being coordinated with the establishment of priorities.
3. As a means of reducing consumer purchasing power, income taxes should be increased all along the line but with primary emphasis on the lower and middle brackets. Later, if war continues to demand greater sacrifice, the doctrines of Hobson and Edgeworth may be applied to upper income classes after the present British pattern. Exemptions for married couples should be reduced at once; joint returns should become compulsory for husband and wife. Monthly collections and check-offs should be instituted even if two years' taxes have to be collected in one.
4. Payroll taxes should be increased and the coverage of Social Security benefits should be extended.
5. If these steps are not taken (for political or practical reasons) to stop inflation, then an emergency sales tax should be adopted to fill the gap. (My preference is for a retail rather than a manufacturer's sales tax even though it would be more difficult and more costly to administer.)

Finally, when the possibilities of increased taxation are exhausted, the other alternatives -- forced loans, deferred wages and the like -- may be considered. But funds for war, for defense and for inflation control should be raised by taxation in ever increasing proportions and amounts.