TREASURY DEPARTMENT
WASHINGTON

July 9, 1942

Dear Marriner:

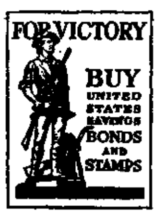
I enclose herewith a copy of a recent speech at the Harvard Business School which may be of interest to you.

Sincerely yours,

Randolph E. Paul
Assistant to the Secretary

Honorable Marriner S. Eccles,
Chairman,
Federal Reserve Board.
Washington, D. C.

Enclosure



Speech delivered by Randolph E. Paul
Assistant to the Secretary, Treasury Department,
at the Cabot Conference
Harvard Graduate School of Business Administration
Boston, Massachusetts
on Saturday, June 20, 1942

FEDERAL TAXES AND INFLATION

We are all aware of the possibility and the threat of inflation. Mr. Gilbert has just dealt with the problem in terms of price control. I am going to speak about the possibilities of taxation as a weapon in the fight.

Thinking and writing and speaking about inflation can be very involved and complicated. But the problem, it seems to me, reduces itself to the rather homely fact that if there is more money to spend than there are goods to buy, there will be a strong tendency for prices to rise. And once prices yield substantially to this pressure the spiral effect becomes such that it is extremely difficult to stop the upward flight.

When you have a situation involving pressure there are two things that you can do. One is to use some strong and rigid means to block the pressure. Another thing to do is to try to reduce the pressure. And best of all, of course, is to do both these things, under an integrated plan which seeks both to reduce and to confine the economic force which would play havoc if left unreduced and unrestrained.

That is, of course, exactly what the Government is now trying to do. Through ceilings and priorities and rationing the authorities of the OPA and other branches of the Government are trying to strengthen the forces which will check the economic pressure. But they all agree that that is not enough, that their controls do not have the strength to withstand the full undiminished force of the economic pressure. That pressure, the inflationary gap, must also be reduced just as far as lies in our power.

One means of reducing pressure is by restrictions on consumer credit. Those restrictions are now being put into force. They are important, but they are not nearly enough. The major means of reducing the inflationary force of excess spending power is through taxation, which will take the money out of the spenders' hands and put it into the public treasury where from the revenue standpoint it can also serve to help finance the stupendous costs of War.

The economists tell us that, for fiscal 1943, that is the year starting this July 1, this inflationary gap, this excess of the amounts people will want to spend over buyable goods is of the order of $20,000,000,000. They estimate that even in the absence of any substantial wage increases, the national income for the coming fiscal year will be of the order of $115,000,000,000 or $120,000,000,000, of which about $100,000,000,000 will be available to consumers to spend or save, the rest being absorbed by taxes on the savings of business. Of this $100,000,000,000. consumers cannot be expected to save more than about $20,000,000,000, leaving about $80,000,000,000 that they will be trying to spend. The goods available at present price levels will amount to about $60,000,000,000. It is the remaining $20,000,000,000 that will exert pressure on the price structure.

The Treasury has put before the Ways and Means Committee of the House of Representatives a program which on an annual basis will add $8,700,000,000 to our tax revenues. The Treasury is also sponsoring a War Savings Program which will absorb a considerable portion of additional spending power. I am here, however, to talk to you primarily about the part which will be played by taxes. Where is the $8,700,000,000 coming from? What other sources might be reached? What further types of taxes might be devised or utilized in carrying out the program of curbing inflation?

Increased taxes on large incomes

One thing is clear. The War cannot be financed and inflation cannot be restrained merely by increasing taxes on the largest incomes. The Administration has recently presented to the Ways and Means Committee a recommendation for a super tax which would take all income in excess of $25,000 free and clear after other taxes. Such a tax is important for other reasons; it may contribute substantially to war morale. But the best estimates are that its revenue yield would be only about $184,000,000. If the tax program is to be successful, therefore, it must be directed at smaller incomes.

The reduction of the personal exemptions

The presently developing tax program takes a long step in this direction. On May 6, 1942, the Secretary of the Treasury recommended to the House Ways and Means Committee that the individual income tax exemptions be reduced to $600 for single persons, $1,200 for married couples, and $300 for each dependent. It was estimated that this would produce about $1,200,000,000 of additional revenue, of which only about $100,000,000 would come from new taxpayers, but of which over $1,000,000,000 would come from taxpayers with incomes below $5,000. The Committee tentatively accepted the proposal as to the exemption for married persons, but outdid the Secretary by reducing the exemption for single persons to $500. It left the dependency credit at $400.

The increase of individual rates

In addition to the reduction in the exemptions the new Bill will, of course, substantially increase rates. Under the present law the normal tax is 4 percent and the first bracket of surtax is 6 percent; this means that income immediately above the exemption is first taxed at an aggregate rate of 10 percent. Under the recommendations of the Treasury the surtax rates would be increased all along the line. The Treasury's proposal would increase the individual income tax by about $3,500,000,000 so that it would yield about 70 percent more revenue than under the present law. The Committee's rates are somewhat lower. Every reduction of this tax adds to the pressure of inflation.

Collection at the source

In connection with the individual income tax many questions may be raised. How effective will it be in fact, particularly among taxpayers with smaller incomes who have not previously paid an income tax? You will easily imagine the administrative difficulties connected with enforcing the filing of returns by large numbers of new taxpayers. But let us assume that administrative means can be found, through comparison with reports of employers and otherwise, so that substantially all the returns will be filed. Is there not risk that many of the taxpayers simply will not have laid by the money which they will need next year to pay the taxes on this year's income? It will not be an easy problem for the individual taxpayer. The tax on a moderate war income of, say, $2,500 will be a substantial amount; and for persons accustomed to spend their earnings about as fast as they come in, it seems likely that there will be many cases where the necessary cash for taxes will not have been laid by. Every time that this happens, the tax bill will have failed in its two major purposes. It will not have produced the revenue intended. And, probably of more immediate importance, it will not have reduced purchasing power, for the money will have been spent.

The obvious method of attacking this problem is some sort of a system for withholding the tax at the source. Such a plan would have great advantages and it has been recommended to the Ways and Means Committee by the Treasury. Like all good plans in the tax field, it presents some problems along with its advantages.

One of the major advantages is the convenience of the taxpayer. At present exemption levels approximately 20,000,000 taxpayers are expected to pay a tax on their 1942 incomes. Under the exemption levels tentatively adopted by the House Ways and Means Committee the number of taxpayers would be about 28,000,000. With the increased tax rate, the result would be a burden that many persons would find very difficult to meet under the present method of payment. The burden of the taxpayer would be considerably lightened if the tax were taken from his income week by week or month by month as he receives it. Collection at the source would probably be the most nearly painless method of tax collection, because the tax is paid in small amounts before the taxpayer receives his income and has a chance to spend it.

The second advantage of collection at the source has direct relation to the control of inflation. Under the present system there is a substantial lag between the receipt of income and the payment of taxes. The tax on this year's income is not due until March, 1943, and some of it is not due until December, 1943, or nearly 24 months from the time when the first income on which the tax is paid is earned. Collection at the source would largely eliminate this lag. The tax on the income would be paid at the time the income is received. This is an obvious advantage from the point of view of inflation control.

The final advantage of collection at the source is the one already referred to, the improvement of collections from small taxpayers.

The income tax is no longer a tax on the fortunate few; it has become a people's tax. This change in coverage demands a change in methods of collection. Collection at source is the only method that is suited to the needs of a multitude of small taxpayers. In my opinion, the income tax cannot play its proper role in our revenue system without the adoption of this new collection device.

I will not pause long to consider the difficulties. They are real, though I am sure that they are not insurmountable. They have in fact been surmounted in other countries where collection at the source has long been the customary plan of income taxation. Despite these difficulties, the additional administrative costs of collection at source, while large in absolute amount, would be extremely modest considering the magnitude and importance of the job.

Sales taxation

We come now to another major type of tax which has been urged both as a source of revenue and for its anti-inflationary effects. That is, of course, the sales tax. Sales taxation has become highly controversial. I may as well say at the beginning that I am opposed to a general sales tax, and that this is the position which the Administration has consistently taken in connection with the pending revenue bill.

There is perhaps some question as to whether a general sales tax is anti-inflationary. As a matter of fact, it is obvious that such a tax necessarily increases the prices at which goods are sold, or at least prices which consumers have to pay for goods. In that sense, then, a sales tax is really inflationary. It increases prices. On the other hand, it operates to reduce the amount of goods which can be bought with a given amount of money. In that sense, a sales tax is anti-inflationary. But, in the same sense, inflation itself is anti-inflationary because the very fact of an increase in prices necessarily reduces the amount of goods which can be bought with the same amount of money. The difference, and it is an important one, is that the increase in price resulting from a sales tax is paid to the Government and is not available to be spent by the seller, whereas an increase in price in the absence of a tax increases the income of the seller and the amount he has available to spend. Consequently, on this score alone, the sales tax would prevent prices from rising as high as they otherwise would, and hence is anti-inflationary. But this is not the end of the story. The sales tax increases the cost of living and thereby affects all workers in much the same way. It therefore provides a much greater stimulus to wage increases than an income tax, which exempts many workers entirely and makes allowance for the special needs of others. The indirect effects of such wage increases might go a long way towards offsetting the direct effect of the sales tax in absorbing purchasing power.

There is another aspect of the sales tax problem which seems to me to be of major importance. That is the matter of the fairness with which the tax and inflation burden is apportioned among our whole population. Sometimes it is a little difficult to avoid a cynical attitude when one is working on the development of a tax bill. Everyone agrees that we must raise revenue, and in enormous sums. Everyone agrees that we must use taxation as one of the instruments to combat inflation. Witness after witness appears before the Committees of Congress and emphasizes the fact that we must make substantial sacrifices to pay for the War. But, after lip service to these generalities, many of the witnesses then devote themselves to the proposition that the burden should be borne by someone else.

The sales tax is perhaps the best example possible of willingness to have taxes paid by the other fellow, in this case the fellow least able to pay. This is the most important reason underlying the Treasury's opposition to the sales tax. It was expressed very well in the statement made by the Secretary of the Treasury before the Ways and Means Committee on March 3, 1942. The Secretary then said, "The general sales tax falls on scarce and plentiful commodities alike. It strikes at necessaries and luxuries alike. As compared with the taxes proposed in this program, it bears disproportionately on the low income groups whose incomes are almost wholly spent on consumer goods. It is, therefore, regressive and encroaches harmfully upon the standard of living".

The figures show clearly the factual basis for the position thus taken by the Secretary. The low-income groups are now carrying a heavy burden of taxation. A single man with an income of $750 per year is now subject to a total tax burden, Federal, State, and local, of about $135, and a married couple with an income of $1,500 now bears a total Federal, State, and local tax burden of $250 per year.

On the basis of the best figures now available, if we imposed a general retail sales tax on consumer purchases large enough to equal 10% of the income of a person with consumer income under $500, the tax would amount to only 6% on an income between $2,000 and $2,500, and 3% of an income above $10,000. It would have an effect similar to imposing an income tax without exemption at the rate of 10% on an income of $500, at 6% on an income of $2,500 and at a 3% on an income above $10,000. Such a tax would, of course, be fantastic, and there seems to be little reason for achieving the same distribution of the tax burden through a sales tax. The elimination of some types of consumer goods and the drastic curtailment in others, arising from the war program, may change the precise figures but they will not change the general pattern that these figures reveal.

We need not go to the statistician to learn how little relation the sales tax has to ability to pay. The man who must spend for the bare essentials of life every cent he can scrape together is certainly not better able to pay taxes than the man who can buy the necessaries, some luxuries to boot, and who then has money left for other things.

The question is not just a matter of fairness and equity. It is bad economics to reduce the standard of living of persons who even now are not able to purchase enough consumers' goods to maintain their productive efficiency. To reduce further the standard of living of the low income groups through a sales tax would increase sickness and decrease ability to produce.

Some opponents of the Treasury program say that we must forget principles of tax justice and tax the small incomes because only thus can we curb inflation. Much of the demand for a general sales tax probably springs from the mistaken assumption that the bulk of increased national income is going to defense workers in low brackets who escape the income tax. There is no basis for this assumption.

All available figures indicate that most of the increase is going to persons who are now subject to the income tax. The most effective and the most equitable way to tap these increased incomes is through the income tax.

Sales taxation brings further problems which require discussion. There are at least three places in the economic chain where such a tax could be imposed. The tax could be imposed on manufacturers, on wholesalers, or on all retail sales. The task of administration varies enormously according to which one of these taxes might be adopted. The tax on manufacturers would probably be much the easiest to administer and enforce. It is estimated that such a tax would be directly paid by 157,000 manufacturing taxpayers. A tax on sales by wholesalers would not be greatly different from the administrative point of view. It would be directly paid by some 306,000 taxpayers. Either of these taxes could be administered by a relatively small force.

The administrative difficulties of a retail sales tax

But a retail sales tax presents a wholly different problem. There are over $2\frac{1}{2}$ million business units selling at retail. A tax on retail sales would require constant tax collections and frequent tax returns from every one of these more than $2\frac{1}{2}$ million taxpayers. The administrative force required would be very large. Not only is the problem one of number of employees, but it is also one of their skills, and of giving them the special training they would need. Personnel of the type needed are in great demand by war industries and by many branches of the Government in connection with the management of the fighting effort. Accounting and business machines, desks, chairs, filing cases, stationery, forms, office space, and transportation for the field staff all raise additional problems.

The administrative difficulties increase greatly if the tax is to be anything but a straight tax on all retail sales at a fixed rate. It is often suggested that certain basic necessities, such as food, clothing, and medicine, should be exempted from the sales tax. Others urge that the tax should be at varying rates, with necessities bearing a very low rate, or none at all, with other items taxed at a medium rate, and with luxuries of one sort or another paying a high rate. On any such basis, however, the problems of classification become almost insuperable. What is food? How about popcorn, ginger ale, candy? And suppose all of these questions can be decided by administrative officers sitting in Washington. Is it going to be feasible to educate all the clerks in all the stores in the whole country to know just which items are taxable and which are not, and at what rate the tax should be imposed?

These difficulties are very real. The natural force of competition will tend to induce stores to impose the tax at as low a rate as that used by any of their competitors. There will thus be a necessity for constant policing. Experience in the States shows that a sales tax is often widely evaded or avoided. In some cases it operates simply as an additional source of profit for the retailer because he collects the tax from the customer, and then, because of inadequate accounting machinery, or for other reasons, fails to make adequate and complete return to the Government.

The price control aspects of a manufacturers or wholesalers sales tax

If these are the difficulties with a retail sales tax, why not then go back a stage and impose the tax on the manufacturer or wholesaler? We may assume, at least for the sake of argument, that such a tax would greatly minimize the tax administrative difficulties. But a tax imposed at any other stage than the final retail sale plays havoc with our whole system of price control. As you doubtless know, this question was presented to Leon Henderson, the Administrator of the Office of Price Administration. Mr. Henderson pointed out that a tax imposed at the manufacturing stage would in many cases "have to be treated as an ordinary cost of doing business." This would lead to the necessity of determining how the tax affected the cost of each particular product, of examining each situation to see whether the purchase could absorb the price increase, and if not, of granting increases above the ceiling price. Each such increase would necessitate still further increases at subsequent stages in the productive and distributive process. The difficulty of preventing the maintenance of percentage margins might lead to increases greater than the tax imposed. In the light of these difficulties it is not surprising that Mr. Henderson wrote: "I confess that I shudder at the thought of how our Office would be swamped if such a tax were passed."

These arguments are so forceful and persuasive as to make it very plain that in the present circumstances a general sales tax can be imposed only on retail sales. We are thus forced squarely up against the major problem of administration which I have outlined to you before. These problems are such, in my judgment, as to make the imposition of a retail sales tax a matter of the very last resort.

The revenue yield of a sales tax

There is one aspect of sales taxation about which there has been a great deal of confusion. That is the amount of revenue which such a tax would produce. The difficulty comes largely from determining what classes of sales would be taxed. At the present time a very large proportion of sales made are for use by contractors in war production. Should such sales be taxed? Would anything be gained by that? Would it mean anything more than an increase in the cost to the Government of war supplies probably in excess of the amount of sales tax produced?

If all sales to the Federal and State Governments and to contractors for use in war production were excluded, a retail sales tax at the rate of 5% would yield, it is estimated, about $2,400,000,000 of revenue in a full year of operation. If, in addition, articles which are already subjected to Federal excise taxation were excluded, the yield of the 5% sales tax would be reduced to $1,700,000,000. This, however, would leave the tax on all the necessities of life. We might, then, exempt sales of food and medicine. To do this, though, would eliminate more than half of what is left of the tax. It would reduce the yield to $824,000,000. If in addition we exempted all sales of clothing, the yield would be reduced to $404,000,000. If we should also exempt sales of fuel, the yield would be reduced to $394,000,000.

It is obvious, therefore, that if the sales tax is to yield enough revenue to be worth the effort and complexity it necessarily involves, it must be imposed on all sales to individual consumers without any exemption for food or other necessities of life. And that gets us right back to our point of departure. Such a tax is obviously regressive, bearing most heavily on those least able to pay. We should be able to produce the needed revenue, and reduce spending power which is really excess, by increasing the rates of other taxes, notably the income tax, which do not strike so heavily on persons of smallest means.

The individual excess profits tax

Other plans have been proposed to the Treasury for the use of the taxing power for the combined purpose of producing revenue and combatting inflation. One of these is a tax on the increased income of individuals, a sort of individual excess profits tax. Such a tax has delusive charm. It is urged that it would impose the burden where the burden can best be borne, and where it should in fairness be borne, upon those who have profited from war-time salaries and profit increases. It is plainly true that a mere increase in ordinary income tax rates is far from equal in its operation. Large elements of our population have reduced incomes at this time resulting from the many war-time dislocations. To impose increased income taxes upon them is to add to the burdens which they already carry. This is recognized, and some system which would throw a larger part of this burden on incomes which have in fact increased would have elements of appeal.

Nevertheless, such a tax would itself introduce many elements of unfairness. It would mean that two persons receiving, say, $4,000 a year would pay far different amounts of tax because one of the persons had always received $4,000 a year while the other had only made an average of $2,000 in the years before the tax. It would not be easy to tell the $2,000 man that he must now pay more taxes than the $4,000 man even though their incomes are the same, because his had formerly been less. He would be likely to reply, and with some reason, that he was less able to pay the tax now than the other man because he had gone through the previous years with much less margin.

The administrative difficulties of such a tax would also be very great. It would introduce into every individual income tax return many of the complexities of the excess profits tax, with determinations of pre-war base period income, with complicated adjustments analogous to those in the corporation excess profits tax, and so on. It is hard to believe that it would not be widely evaded. It would certainly greatly increase the problems of auditing and policing in the case of the smaller individual income tax returns.

Corporation taxes

So far, I have said little or nothing about taxes on corporations as a means of inflation control. Such taxes do have substantial anti-inflationary tendencies. The more that is taken in taxes, the less there is available for dividends. High corporate taxes, however, bring their own problems too. Mr. Nelson has recently informed the Committee that too high a rate of taxation on corporate enterprise would distinctly retard the war effort. There is little incentive to a corporation towards efficiency and saving when tax rates are too high. There is, as we have seen in striking cases, considerable pressure to increase costs by paying large salaries and extraordinary bonuses, and this has a definitely inflationary effect by increasing consumer purchasing power.

To meet these objections, it has been urged that part of the excess profits tax imposed be treated as an advance against a post-war credit. In this way current purchasing power will be reduced through payment of the money to the Government, but incentive will remain because of the substantial post-war credit. Moreover, when the credit money becomes available at the close of the war, it may help to soften the economic problems which we will then face. These matters are now being considered. They are not easy. Should we undertake to control the use to which the credit money may be put? May it be used for the payment of dividends? Or should it be restricted to use for capital expenditures or for maintaining employment? Is there any way that such restrictions could effectively be enforced? These are some of the problems which must be faced in dealing with the post-war credit question.

Conclusion

I have touched upon a number of the phases of the use of the taxing power as an instrument to combat inflation. I have doubtless not said anything new to any of those present at this conference when I have shown that the problems raised are often difficult and complex. I have one last thought. Taxation is certainly one of the most important anti-inflationary weapons at our disposal. We should endeavor to use it to that end as wisely and effectively as possible. But taxation alone cannot do the whole job. It must be supplemented by price control and rationing, control of consumer credit, the stimulation of savings, and other devices. Only the firm and intelligent use of all the weapons at our command will hold the line.

July 16, 1942.

Dear Randolph:

Your talk before the Harvard Graduate School of Business Administration, a copy of which you kindly sent me a few days ago, is first-rate. I thought you made a particularly effective case on the sales tax to show not only the administrative difficulties of collecting it, but also the popular misconception of the revenue yield.

I did not overlook the plaintive note in your remarks about the willingness of people generally to have taxes paid by the other fellow.

With best regards,

Sincerely yours,

Mr. Randolph E. Paul,
Assistant to the Secretary,
Treasury Department,
Washington, D. C.

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