THE SECRETARY OF THE TREASURY

WASHINGTON

November 10, 1942

My dear Mr. Byrnes:

We in the Treasury have been investigating a great variety of measures intended to accomplish the objective mentioned in your letter of October 9, 1942, to control inflation through the restriction of civilian spending. We have been particularly interested in measures which combine effective inflation control with a substantial contribution to the financing of the war. We welcome the opportunity to give you some of our thoughts on these questions. We shall be glad to submit more extended studies at your request, and also to discuss them with you at your convenience. Such discussions should be helpful to cooperation in the related fields of economic stabilization and fiscal policy.

We have come to the conclusion, in the course of our own investigations, that an effective and equitable solution of the problem of inflation will require measures more fundamental than any yet adopted. We are convinced that wage and price ceilings alone cannot control inflation. Our estimates

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

indicate that, at present price levels, next year will see a surplus of purchasing power of about $40 billion over and above the supply of consumers' goods available during the year. Unless much of this excess of $40 billion of purchasing power is withdrawn, price ceilings will be broken through on a broad front, causing empty shelves, large-scale black markets, widespread evasion and dealer favoritism, and illegitimate profits. In such a situation, distribution of the necessities of life will be inequitable and wasteful, and competition to buy the means of living will be reduced to a time-consuming and disorderly scramble. Severe hardships will be suffered, especially by families in the low income groups.

We find that on the basis of the most optimistic estimate possible, not more than $70 billion, at present prices, of consumers' goods and services will be available for purchase in the calendar year 1943. Income received by consumers in the same period will be about $125 billion. Not more than $15 billion of this consumer income will be taken away by Federal, State and local taxes paid directly by individuals, including the new Federal taxes levied in the revenue act just passed. Therefore individuals will have left, to spend or to save, about $110 billion. If we are to prevent irresistible pressure of excess demand for an insufficient supply of goods, consumers must be induced --

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

through additional taxation or otherwise -- to refrain from spending some $40 billion, or $4 out of every $11 of the income they have remaining after present taxes.

It is true that voluntary savings are now being made at an unprecedented rate. It has been estimated that individual savings -- government bond purchases, insurance premiums, currency and deposits, debt repayments, etc. -- during the second quarter of this calendar year were at the annual rate of $24 billion, which was approximately double the rate for the same quarter of the preceding year. This acceleration of savings is far greater than can be accounted for by the large increase in individual incomes. It is without doubt due in part to inability to buy automobiles and certain other consumer goods and to the promulgation of the general maximum price regulation. It has undoubtedly also been strongly influenced by the campaign for reduced spending carried on in connection with the sale of war savings bonds. It is doubtful, however, that this rate of voluntary saving can be substantially increased or even maintained during the coming calendar year in the face of substantially increased taxes and somewhat higher living costs, unless strong governmental action is taken. If prices rise, savings will, of course, also rise, but the objective of our policy must be to increase savings while at the same time preventing prices from rising.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

If we are to reduce consumer spendings to the value of supplies available at present prices, this governmental action must immobilize an additional $16 billion of consumer income in 1943 over and above the $24 billion current rate of saving.

To induce consumers to make gross savings of $40 billion out of their next year's incomes is not sufficient. Those consumer savings must be net, i.e., after account has been taken of the fact that some people will be eating into their savings. If, for example, some individuals next year consume their capital to the extent of $10 billion, other individuals will have to save $50 billion to give us net individual saving, for the economy as a whole, of $40 billion.

There already exist abundant capital assets which in effect are large pools of purchasing power that could easily be tapped for spending by individuals. We have outstanding about $13 billion of United States Savings Bonds, all of which could be presented for redemption in a short period. Individuals hold billions of dollars of other securities, which they might sell to other individuals, to business firms, and to banks. Individuals hold billions of dollars of bank deposits and currency in excess of any previous year's holdings. Billions of dollars could be borrowed on insurance policies. If more and more of the current income is taken

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

away by taxes or is immobilized through forced lending to the Government, then these reserves of purchasing power will be increasingly tapped by persons reluctant to accept a decline in their standard of living, or desirous of cushioning such a decline. If price stability is to be maintained, we must see to it that these capital assets are not used to increase consumption expenditures to a level in excess of the available supply of goods at present prices. It will do us no good merely to shift savings already being made from a voluntary to an enforced status, nor will it do us much good to require lending to the government that will come out of accumulated savings represented by liquid assets in the hands of individuals. If, with taxation on the basis provided by existing law, we fail to add at least $40 billion to our accumulated individual savings next year, prices will rise—in an open or a concealed way.

The more taxes we obtain, the less net savings do we have to induce. We have not nearly reached the economic limits of taxation. Our first recourse should be to additional taxation. There are three important advantages of withdrawing as much

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

excess purchasing power as possible through taxation. These are:

(1) Each dollar of taxes avoids the accumulation of a dollar of public debt. Therefore increased taxation reduces the interest burden and gives the Government greater fiscal freedom to meet whatever conditions may arise in the post-war period.

(2) Increased taxation reduces the danger of post-war inflation that could come from the spending of war-time accumulations.

(3) Taxation reduces the necessity for extensive and administratively costly war-time controls on what people may do with money that remains in their possession.

Notwithstanding the advantages of taxation, it would be highly unrealistic to contemplate tax revenue along traditional lines on the scale requisite to absorb enough current income to bring the level of spending down to the level of goods available for purchase at current prices. Even a doubling of the present $15 billion of personal taxes would not suffice, for if anything like $15 billion of new personal taxes were enacted the level of voluntary savings would certainly not remain at $24 billion. Part of the increase in

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

taxes would merely replace savings. In fact, it is likely that any effort to do the whole job by absorbing purchasing power through taxation along traditional lines would involve the levying of additional personal taxes well in excess of $20 billion. In view of the magnitudes involved it will clearly be necessary to supplement taxation by additional measures designed to curtail consumer spending.

Specific commodity rationing and price control already help to enlarge the volume of individual saving, but they alone are inadequate. To extend specific rationing sufficiently to cover the bulk of consumer spending would be costly and irksome, although extensive specific rationing may have to be adopted eventually. Therefore, we believe that other measures should be considered in order to limit spending to the necessary extent.

We have particularly examined four general measures, any of which could contribute substantially to price stability and to an equitable distribution of scarce supplies. Each would also give substantial direct or indirect assistance to financing the war. These four measures are Compulsory Lending, Compulsory Saving, Expenditure Rationing, and Expenditure Taxation. Two of these types of control are mentioned explicitly in your letter of October 9. We have chosen to dis-

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

cuss the other two at the same time because they are closely related methods of dealing with the same question.

1. Compulsory Lending   Compulsory lending is the legal obligation to lend to the Government an amount equal to a specified fraction of income, expenditure or some other base.

Compulsory lending may have exemptions and graduation. It may therefore be quite progressive in its incidence. It would contribute to the control of inflation in the same general way as taxation, namely, by withdrawing money from the hands of consumers. If individuals had to lend some of their funds to the Government -- provided they did not normally save anything, did not have capital, and could not obtain credit -- they would be compelled to reduce their spending by an amount corresponding to their lending. In general it is the lowest income groups who save little, have few assets and limited credit; therefore a dollar withdrawn by compulsory lending from a man in the lowest income groups might cause almost a dollar's reduction in spending. At the top of the income scale, a dollar withdrawn in compulsory lending might cause no reduction at all in spending; the compulsory lending obligation would be met out of accumulated savings or out of current income which would have been saved anyway. The effect on most individuals would be somewhere between these two extremes, so that for them part of the funds

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

lent would come out of a reduction of consumption and part out of the accumulated savings or out of new savings which they would have made in any case.

It might also be desirable to require compulsory lending by corporations as well as by individuals.

The following advantages are claimed for compulsory lending:

(a) It would justify a greater restriction of the consumption of the lower income groups than if this restriction were effected by outright taxation;

(b) It would make larger levies on all income groups politically acceptable;

(c) It would not reduce the incentive for individuals to undertake harder and longer work for additional pay as much as would additional taxes of corresponding amount;

(d) It would create a reserve of individual purchasing power for the post-war period;

(e) It could provide a means of raising money to finance Government expenditures with no obligation to redeem or to pay interest during war-time.

However, any given amount of compulsory lending would be less effective in reducing spending than the same amount of taxes. Because the amount turned over to the Government would be a loan to be returned after the war, there would

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

be less inducement to save in other forms, and individuals with accumulated assets would be more willing to sell assets or borrow on them to meet the lending requirement than to meet a tax obligation. Persons who were already saving as much as their current lending obligation or who had a large amount of accumulated wealth might find no need to reduce their spending at all. Therefore any compulsory lending schedule would in practice be less progressive in its incidence on consumption than it would appear to be at a first glance. The dollar value of the reduction of consumption through compulsory lending would be much less than the dollar amount of the compulsory lending.

These considerations suggest that, if use is made of compulsory lending at all, it should be recognized that its anti-inflationary effect will be largely restricted to the lowest income levels. In order to reduce inflationary spending by the high and middle income groups, it will be essential to resort to supplementary devices designed to effectuate the desired reduction in consumer spending.

2. Compulsory Saving Compulsory saving differs from compulsory lending. Most proposals for compulsory lending permit, as offsets against compulsory lending to the Government, various forms of saving such as the payment of insurance premiums, the repayment of debt,

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

and the voluntary purchase of war bonds. Such offsets are steps in the direction of converting compulsory lending into compulsory saving.

By compulsory saving is meant a legal requirement that every family or single individual save a specified fraction of income. Compulsory saving necessarily contributes to the control of inflation, compulsory lending need not. An individual might lend to the Government and yet not save, simply by lending out of previously accumulated assets. An individual might save and yet lend nothing to the Government. What is primarily significant for inflation control is increased saving, i.e., reduction in spending.

In principle, compulsory saving could provide an effective solution to the inflation problem. The total amount allotted for expenditures on consumers' goods by all individuals and families could be fixed at the level of available supplies by requiring that the difference between total income and total available supplies be saved in one form or another.

A progressive system of compulsory saving would have exemptions and graduation, just as would a progressive system of compulsory lending. For instance, a married person with no dependents might not be required to make any saving at all out of the first $1,000 of income. Out of the next $500 of income he might be required to save 20 percent, out of the

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

next $500, 30 percent, and so on to a point where the spending of further increments of income for consumer goods and services would be prohibited.

It might be desirable to allow credits for personal taxes, rents, medical expenses, tuition and extraordinary expenses of other kinds. For instance, a single individual receiving income at the rate of $2,500 during a given year might be required to save $1,500 for that year. If he had to pay $450 in personal taxes, $400 for rent, $50 for medical expenses, and $100 for insurance premiums, these items might account for $1,000 of his compulsory saving requirement, leaving $500 that he would have to plan to save in other forms -- war bonds, etc.

This plan would solve one of the difficulties inherent in simple compulsory lending plans, that is, the substitution by individuals of the new compulsory saving for voluntary saving which they would otherwise have made. It would also make it impossible for individuals to show fictitious "saving" merely through changing the form of previously accumulated capital. This plan would fix total individual saving: it would be irrelevant whether the individual saved in one form or another, so long as he did not divert into current consumption funds he was required to save. The Government might borrow his funds directly, indirectly, or not at all. In any case, his dollars would not be competing for goods

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

in the market. The Government might spend an amount equal to his saving without fear that its expenditures would exercise any inflationary pressure.

Compulsory saving would simplify the problem of raising funds for financing the war since individuals who were compelled to save would probably invest a large part of their savings in war bonds. To secure the fiscal advantages of compulsory lending, it could be required that a stated proportion of amounts saved be lent to the Government for the period of the war -- perhaps at zero interest. If such a compulsory lending requirement were added to compulsory saving, the requirement could be implemented through collection at the source.

It is absolutely crucial to this plan that a complete report be secured of the net change in any individual's capital position during the period in which he was obligated to save. In calculating the savings requirement of any individual, any purchase of assets or any savings credits would have to be offset against sales of assets, declines in deposits, etc. Only in this way could the compulsory saving plan be protected against being vitiated by the use of existing balances and credit.

Compulsory saving involves serious administrative difficulties. The saving requirement would be for the same year as that in which an individual received the income and

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

would not represent an amount he would be required to turn over to the Government in a subsequent year. To help individuals keep their saving up to the level required by the law, it would probably be necessary to have quarterly returns. Whether an individual had complied with his compulsory saving requirement could not, however, be finally determined until the end of the period to which the requirement related, since neither his income nor his savings would be known accurately until then. An individual might unwittingly spend more than his allotment because of unanticipated fluctuations in income or expenditure needs, and in any case he could not know that he had complied with the saving requirement until after the event.

The required amount of saving could be insured by issuing to all consumers licenses to purchase only to the extent of the expenditures to which they were entitled; in this case compulsory saving would become Expenditure Rationing. Alternatively consumers might be required to pay a regular schedule of penalties for spendings above their exempt minimum; in this case compulsory saving would become a type of Expenditure Taxation. Further alternative sanctions for excess spending are criminal penalties, fines adjusted to the individual circumstances, or punitive compulsory lending requirements. The use of any of these last three sanctions, however, would involve great administrative difficulties and would cause widespread public resentment.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

3. <u>Expenditure Rationing</u> Expenditure rationing is the limitation of total consumer expenditures by fixing the maximum amount that every family or single individual is allowed to spend on rationed goods. In principle, rationed goods should include all consumers' goods that have any current cost in labor, materials, or facilities. Some classes of consumption goods and services, however, might well be excluded from Expenditure Rationing, such as: rents, tuition and medical care. Under an expenditure rationing plan consumers' goods other than these could be bought only with one's ration allowance, but the consumer would be free to spend his ration allowance on any commodities or services that he pleased. Furthermore, no limitation would be imposed on the use of income in non-consumption transactions, such as making gifts, paying taxes, paying insurance premiums, buying real estate or securities, or saving in other ways. Business expenditures would, of course, be excluded from expenditure rationing.

Under expenditure rationing the total amount allowed to be spent on rationed goods for the whole economy during any period would be adjusted to a level equal to the estimated value of the supply of rationed goods available during that period. In making the necessary computation, supplies would be valued at the price level which it was desired to maintain. Changes in the total expenditure ration would be made

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

as the expected supply position changed and as more accurate data became available.

Expenditure rationing would yield no revenue directly. However, by limiting consumers' expenditures, it would force them to save in one form or another. Therefore, individuals would be likely to buy larger amounts of Government securities directly or to place their savings with institutions who could in turn buy larger amounts of Government securities.

The impact of any expenditure rationing program upon the various income groups would depend upon the schedules adopted for allocating expenditures. If variations of income, as well as size of family, were factors in determining the permissible amount of spending allowed each individual, there would be differences in permissible expenditures as between income groups. However, the expenditure rationing system could greatly reduce the inequalities in spending that prevail now. For example, a family of four with an income of $1,500 might be allowed to spend the entire $1,500 while a family with an income of $50,000 might be permitted to spend no more than (say) $10,000. It would be easier to reduce inequalities by limiting spending directly than by limiting it through taking away a part of income. On the other hand, remaining inequalities might be resented because they have been given direct government sanction.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Expenditure rationing would attack the problem of excessive consumer purchasing power directly, and would determine the ration allowance from two items (current income and family status) that are in most cases readily ascertainable. For both of these reasons, the allotment of spending power to individuals or income classes would be subject to more effective control than under a program of taxation or compulsory lending.

It would still be necessary to have specific rationing for some basic necessities that were disproportionately scarce. However, in the measure that people with large incomes would be able to spend less on scarce commodities under expenditure rationing, the need for specific rationing would be reduced.

An effective rationing system would require the use of a license to purchase, in coupon or other form. It might be possible to solve this problem without the use of both money and a coupon in every purchase.

The distribution of ration coupons or allowances could be integrated very closely with the present system of payment of incomes:

(a) Persons employed for wages or salaries would file statements with their employers showing their marital and dependency status. On the basis of these returns, the employers would distribute to them the correct amount of ration allowances;

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

(b) Persons receiving income other than wages or salaries would report the amount of their income as well as their marital and dependency status to a bank, post office, or local rationing board. The institution to which this information was reported would be authorized to provide individuals with ration allowances in accordance with the expenditure rationing schedule;

(c) Persons with irregular incomes, seasonal incomes, or living by depleting capital, would require special consideration in the determination of their ration allowances.

A partial check on the accuracy of ration allowances would be obtained by requiring individuals to reconcile the income declared for the purpose of obtaining ration allowances with the income declared for income tax purposes. For consumers, such a system would have an internal self-enforcing element, since the exaggeration of income would lead to additional tax liabilities, while the under-statement of income would diminish the size of the ration allowance.

The above description of expenditure rationing touches only its most salient features. We have gone into expenditure rationing in the Treasury in great detail and shall be glad to give you a more extended study of this subject, should you be interested in exploring it further.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

4. Expenditure Taxation Expenditure taxation has already been the subject of some public discussion in connection with the recent proposal for a spendings tax submitted by the Treasury to the Senate Finance Committee during consideration of the Revenue Act of 1942. We are not concerned in this letter with the details of that proposal but rather with the general question of the way in which a progressive spendings tax would bring about the limitation of consumer expenditure necessary to avoid inflation.

The spendings tax would be a tax on consumption rather than on income. It would provide for exemptions and for graduated rates. It would impose a penalty on all spending above the minimum subsistence level, a penalty that would become increasingly severe and even prohibitive as spending increased. Through graduation, it would be made to bear primarily on comforts and luxuries rather than on necessities.

For example, under a spendings tax a married person with no dependents might be allowed an exemption of $1,000 a year. If he spent less than $1,000 on goods and services he would pay no tax. A 10 percent tax might be levied on the first $500 of consumption expenditure in excess of $1,000, a 20 percent tax on the next $500 and successively steeper taxes on additional increments of spending. The tax might ultimately reach rates of 100 percent or more. This would mean that an

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

individual spending large sums on luxuries might be required to pay the Government as much as $1.00 or more for every additional dollar he spent on consumers' goods. (A part of this tax might be treated as a post-war rebate, if desired.)

All forms of savings would be exempt from the spendings tax. The more important non-taxable uses of income would be as savings for the purchase of war bonds and other capital assets, repayment of debt, life insurance premiums, as gifts and contributions, and as tax payments. In addition, it might be desirable to exempt from the spendings tax certain special types of expenditure, such as tuition fees, expenses for medical care and perhaps rent and other items.

The spendings tax would reduce spending on consumers' goods and services in two ways: first, the amount paid in tax would be withdrawn from income and could not be used to purchase goods and services; second, by penalizing spending the tax would provide a powerful incentive to save rather than to spend. Although the savings induced by the spendings tax would not necessarily be paid over to the Treasury, they nonetheless would be removed from the spending stream and would be added to the pool of savings available, directly or indirectly, for financing the war.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

A sufficiently severe spendings tax could reduce total consumer expenditures by any desired amount, and at the same time contribute to a more equitable distribution of the scarce supply of consumers' goods than would prevail without the tax. The exemption provision would enable persons with small incomes to obtain basic subsistence needs free of tax, while the steeply graduated tax rates would operate to bring about a greater proportionate reduction in spending by those persons whose large expenditures would subject them to the higher penalty rates. Individuals would be given an inducement for saving in a way which is not possible with a conventional income tax. By reducing their spending individuals and families would reduce their tax liability and thereby increase the funds available to them for expenditure without penalty after the war or when economic conditions become such as to permit abandonment of the tax.

In addition to controlling the total volume of expenditure and its distribution among individuals the spendings tax would provide some revenue to the Treasury to finance the war and, by reducing expenditures for consumption, it would undoubtedly increase the voluntary purchase of war bonds. It would also encourage the repayment of debt and other forms of savings, since these too would be free of tax.

The administration of a spendings tax would not require that individuals keep a detailed record of all their expenditures. The only report that would be necessary in addition

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

to the information already required for the income tax would be information to determine changes in capital position of the same kind as would be needed under compulsory saving. The total taxable expenditures of an individual are equivalent to his net income, minus or plus the net change in his assets during the year. His taxable spendings could be determined, therefore, from his net income and from the assets he held at the beginning of the year and the assets he held at the end of the year.

The final determination of liability under the spendings tax would be made when the income tax return for the corresponding year was filed. A combined form could be used for the two taxes. However, collection of the tax would not have to be delayed until the tax liability was finally determined. Two methods could be used:

(1) The first bracket of the spendings tax could be collected at the source from all income paid in the form of wages and salaries, bond interest and dividends. Collection at source based on income instead of spending would involve no great hardship. The only persons who pay too much would be those who save part of their income and hence do not need for current consumption the extra amount withheld, although they may need it for outstanding savings commitments. Final adjustment of

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

tax liability would be made with the filing of the return after the close of the year.

(2) Individuals with expenditures subject to tax rates above the first bracket would be required at short intervals, say quarterly, to pay a tentative tax based on the approximate amount of their spending. A final adjustment of their tax liability would be made with the filing of a return after the close of the year.

This statement of the spendings tax is intended to be only a general exposition of its principle features. To bring out more fully its effect in restricting expenditure on consumption at every income level, it would be necessary to present a longer memorandum including a detailed schedule of tax rates, their probable yield, and their effect in inducing savings. We shall be glad to present such a study at a later time should you be interested in going into the possibilites of the spendings tax in greater detail.

. . . .

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Additional data are available on each of the four plans discussed above, and we shall be glad to present them to you at your request.

Sincerely yours,

S/S H. Morgenthau, Jr.

Secretary of the Treasury.

Mr. James F. Byrnes,
Director, Office of Economic
Stabilization,
White House,
Washington, D. C.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis