BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

WASHINGTON

Office of the Chairman

November 13, 1942

My dear Mr. Byrnes:

If we are to control excess purchasing power and preserve reasonable economic stability, we must resort to far more drastic measures to curtail civilian spending than those so far adopted. In the calendar year 1943, we estimate that the gross product of our economic system - the output of our farms, mines, and factories, plus services - will amount to about $175 billion. Out of this vast output, the Government will take no less than $90 billion for war purposes. After non-military governmental functions are provided for and our essential needs for capital goods are satisfied, no more than $70 billion worth of goods and services, valued at present prices, will be available for sale to civilian consumers.

Out of the $175 billion spent for all goods produced, business and Government will make total income payments to the buying public of about $125 billions. Out of this sum, the Government will collect about $15 billion in personal taxes, leaving consumers about $110 billion of expendable income.

Thus, expendable income will exceed by about $40 billion the value of the goods that will be available for sale. If the public follows its customary savings habits, we may expect a considerable part of this sum to be used in paying debts, buying war savings bonds and other Government obligations and saving in other forms. If we had no system of price control, the pressure of the remainder that will be spent, not saved, would drive up the cost of living by at least a third and probably much more. As it is, publicly quoted prices may not increase much; but the pressure of consumer demand, unless we take strong measures to curb it, will be reflected in illegal price increases, the growth of black markets, and, worst of all, shortages of consumer goods everywhere. The general prevalence of such shortages will be the indication to the public of the Government's failure to meet this problem. If we do not tax much more heavily and ration much more extensively, the costs of war will be brought home to the American people by their sheer inability to find goods to buy. Of all the possible ways of distributing the costs of war, this would be the most unfair and hence the most resented.

It is the Government itself that has created this excessive demand for civilian goods and services by its methods of war finance. If we had been able to collect taxes and to borrow (from real savings) as much as we intended to spend, there would be no inflationary gap in prospect. We could have avoided any substantial increase in the cost of living thus far. The record shows how far we fell short of realizing this ideal. We have been placing far too much reliance upon borrowing from the banks, far too little upon taxes and the savings of the people.

Credit created by the banks in buying Government securities is the principal source of excessive purchasing power. In the middle of 1941 the commercial banks held $22 billion of Government securities. By the middle of 1942 this had increased to $29 billion and by the middle of 1943 it will probably have increased to $66 billion. Thus bank holdings of Government securities, which have been increasing at an accelerating rate, will have tripled in this two-year period. As a result, our money supply has increased by approximately the same amount.

This record is not the inevitable result of the necessities of war. The extent to which we are failing to meet the problem on the domestic front is illustrated by comparison with what the British and Canadians are accomplishing. Putting it in general terms, they are financing about half of their expenditures by taxation. We are currently financing only about one-quarter. Of the half that they borrow, about two-thirds is drawn out of public spending power and only one-third from the inflationary process of bank borrowing. The figures are just about reversed in our case. We are getting only one-third of our borrowings out of spending power and nearly two-thirds from the banking system. There are many differences between American, British, and Canadian economic conditions, but none of them justifies our failure to match their financial achievements.

Today our war expenditures are running at the rate of about $70 billion a year. By the middle of next year, they will have reached the level of $88 billion a year. It is increasingly imperative that we meet these inevitable costs of war by a financing program that will reverse the trend we have been following.

I have stated the problem as I see it. What can we do about it? We have already begun to ration certain scarce commodities. Rationing will have to be pushed much further; just how far will depend upon the adequacy of our fiscal policy. We all recognize the limitations on what price control and rationing can do by themselves. These limitations are not imposed solely by the immense administrative problems that the rationing authorities must solve. There is a more fundamental difficulty. The strongest administrative machinery would crumble under the pressure of the excessive purchasing power now flowing into the hands of the American public. A hard-boiled fiscal policy is our only hope of reducing the pressure enough to permit rationing to function.

In framing an adequate program, we must not lose sight of the fact that purchasing power is excessive only because civilian supply is deficient. We must attack the problem both on the production side and on the financial side. We should do everything possible to keep the output of civilian goods and services at the highest possible level consistent with our first objective of maximum war production.

By far the most important means of increasing production is by lengthening hours of work. The emergency we face calls for a 48-hour work week. Organized labor won the 40-hour week after many years of effort and struggle. It should be made unmistakably clear that the Government does not propose to abolish but merely to suspend the legislation guaranteeing this achievement. In Great Britain, for all non-agricultural workers the average working week is about 54 hours. The same group in this country works only about 43 hours. It is abundantly clear that in view of our need for production, our working week is too short. We should couple Federal action with action to modify State laws that prevent the use of the 48-hour week for specific classes of workers. At the same time, we should impose a blanket prohibition on working more than 60 hours a week except in grave emergencies. Such a prohibition would reduce lay-offs, decrease accidents, and increase efficiency on the job.

We should make a more thorough-going conversion of our colleges to military use. The only indispensable job for the colleges, under conditions of total war, is technical training that will help win the war. It is better to use existing training facilities in the colleges for the armed forces than to build new facilities destined for the scrap-heap after the war. In this way, we can economize the use of scarce building materials and labor.

We can also release resources for essential use by cutting down advertising. At a time when the Government's declared policy is to curb civilian demand, advertising of all kinds continues to be devoted to whetting the public's appetite to buy. The Government does not merely permit, it actually encourages, this misuse of resources. We continue to allow generous deductions for advertising expenses under our tax laws, virtually paying for private advertising out of the public treasury. We continue to extend low postal rates to masses of useless printed matter. In these ways we deliberately encourage appeals to the public that are wholly inconsistent with the Government's program for conserving civilian goods and making the most efficient use of our resources. A great deal of labor and scarce materials are thus squandered, to say nothing of the additional burdens on our already over-burdened transportation and postal facilities.

On the fiscal front, we should aim at raising taxes and compulsory savings equal to at least half of our expenditures. As much as possible of our remaining requirements should come from borrowing from the public. We should reduce borrowing from the banks, with its inflationary consequences, to a minimum. The British and Canadian experience shows that it can be done.

In view of the urgency of the situation, it would be appropriate for this Board to recommend to the President that he send a special message to Congress requesting the deduction from wages and salaries, beginning in January, of a 30 per cent withholding rate on income in excess of the income tax exemptions. The Victory tax (already enacted by Congress) should be increased from 5 to 11 per cent; and the Victory tax plus the 6 per cent normal tax and the 13 per cent initial surtax rate should be withheld at source on payments of wages and salaries. We cannot impose this high withholding rate without adopting some form of pay-as-you-go plan.

Raising the Victory tax will be futile unless we make sure that taxpayers will not use the purchase of redeemable or saleable Government obligations as a means of escaping the part of the tax represented by the post-war credit. If we do nothing else, we should at least insure that taxpayers make such purchases out of current income and not by using idle cash, selling their securities, or borrowing. We should make compulsory savings under the Victory tax truly compulsory and truly additional savings.

The arguments for a heavy withholding tax are conclusive. Only in that way can the money now exerting continually stronger inflationary pressures on the civilian markets be drawn off before it has an inflationary effect. Once spent, it not only has this effect but the Treasury may never be able to collect the funds, particularly from the millions of new taxpayers. This is the time to place them under a withholding system on a pay-as-you-go basis. Still another virtue is that funds are thus drawn currently into the Treasury.

Later, of course, as the Treasury has already warned the country, we must have another general revision of the revenue laws and tax rates must be further increased and various remaining loopholes closed. Imposition of a withholding tax, such as suggested, can, however, be accomplished without a general revision. It is by no means sufficient by itself to meet the problem before us, but it is something that can be done promptly, and it is a vitally important step at this time.

It is generally recognized that as tax rates rise, voluntary savings are likely to decrease and many taxpayers may redeem the war savings bonds they hold to meet the increased tax payments. To the extent that this occurs, it of course completely nullifies the anti-inflationary effects of the sale of those bonds. Accordingly, it is clear that we not only must have compulsory savings, but future issues of war savings bonds should not be redeemable until after the war, at such time as the funds may be spent without inflationary results. There is a place for voluntary savings, but it should be supplemental rather than a main reliance.

On the borrowing front, steady progress is being made in elaborating and organizing the Government's program so as to reduce the reliance upon borrowing from the commercial banks and the resulting inflationary creation of new deposits.

I have sought to outline some of the suggestions that seem to me to be appropriate at this time, recognizing that adequate elaboration of our tax system, to embrace possibly the so-called spending tax and sales taxes must be postponed until later. I appreciate this opportunity to present these suggestions at this time, and I would welcome a further opportunity to furnish such additional material as may be necessary for a more thorough consideration of the various proposals outlined.

Sincerely yours,

M. S. Eccles

M. S. Eccles,
Chairman.

Honorable James F. Byrnes,
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