

*Reserve
Trust*

May 6, 1941

DRAFT OF TESTIMONY BEFORE THE
HOUSE WAYS AND MEANS COMMITTEE

Mr. Chairman and Members of the Committee: I particularly welcome the invitation to present my views to you, because of my conviction that the effects of the present defense effort upon our national economy will depend greatly upon the tax program now undergoing formulation by this Committee. In appearing before you I speak merely as an individual and not in behalf of the Board of Governors of the Federal Reserve System.

The basic problem in our defense program is not financial but physical; it is, at bottom, one of getting the goods, not of getting the money. Production for defense can come only from expansion of total output or curtailment of non-defense output. So far expansion has predominated. Production of civilian goods, instead of declining, has increased along with the growth in defense activities. The requirements of the defense program have now reached a point, however, where civilians will be obliged to reduce substantially their purchases of certain specific products which absorb materials, machines, and skills needed in defense work. This is true particularly of durable consumers goods, such as automobiles, radios, and electrical refrigerators. *etc* As time goes on, the needs of the defense program will trench upon a widening range of civilian goods. When we have reached the point of full employment and full production, further enlargement

of defense output will be possible only as we curtail the supply of civilian goods in general. As the slack of idle resources becomes progressively smaller and as the defense program draws scarce materials, machines and skills from their customary peacetime uses, at first in only a few specialized fields and, later, more widely, expansion will give way to curtailment over a growing range of civilian products. The supply of goods and services available to meet civilian wants will be determined by our productive potentialities, on the one hand, and the requirements of our defense program, on the other. The sacrifices necessitated by the defense program have their origin in these physical facts, rather than in purely financial considerations.

The function of taxation in our present economic situation is to keep the money expenditures of the civilian population from rising more rapidly than we can expand the supply of civilian goods. Under the impetus of defense our national income in money terms is increasing more sharply than ~~we can expand~~ the physical production of civilian goods. Unless we withdraw this excess purchasing power through taxation, it will bring about price advances and inflation.

In the light of our present and prospective economic situation, I am completely in accord with the recommendation of the Secretary of the Treasury that ^{3 1/2 billion} \$3,500 millions of revenue be obtained from increased taxes. This goal seems to me a reasonable one. I believe, however, that the objectives of taxation policy stated by the Secretary could be better implemented by certain changes in emphasis in the Treasury's program. Before discussing these changes in detail, I think it desir-

able to state briefly my general views regarding the sources from which increased revenues should be obtained.

The first source of defense revenue should be corporation taxes, particularly the excess profits tax, because, in general, corporations are the greatest beneficiaries, directly and indirectly, from defense expenditures. The surplus accruing from the expanding national income tends to become concentrated in the first instance in the possession of business corporations. The most certain way to insure against inflation is for the Government to levy on these earnings and divert the proceeds directly into the defense program before they are distributed into the general income stream through higher wages and higher dividend payments. If these surplus funds are not thus collected in the first instance at the source, but are later distributed through large wage increases and large dividend payments to the community, it becomes necessary subsequently for the Government to abstract excess incomes through the personal income tax and other forms of ~~individual~~ taxation. The problem is not avoided but only delayed and made more difficult by failure to tap the profits at the source.

After we have strengthened our corporation taxes to collect a substantial part of the increased national income at its point of origin, we should rely predominantly on the individual income tax and on estate and gift taxes to meet most of our remaining revenue requirements. These are, after all, the "ability to pay" taxes par excellence.

Adherence to the principle of ability to pay is always important, but when taxes begin to require real sacrifices, as they must if they are to perform their function in the present emergency, when they begin to mean lard instead of butter in the frying pan, a vacation spent on the front porch instead of in the mountains, a college education for only one child and not for all the children, it becomes doubly important that taxes be obtained where they can be spared with the least sacrifice.

I am strongly opposed to general sales taxes or to any widespread imposition of excise taxes. These taxes may have been appropriate in poverty-stricken countries of the Old World where governments must extract revenue from their citizens in any fashion that is expedient. They are not appropriate taxes in this country where other sources of revenue are ample and the people are prepared to support an equitable tax program by the payment of direct taxes. Consumer expenditure can be restrained either by an increase in income tax, or by a tax on articles of mass consumption. The difference lies in the fact that the individual income tax does this frankly and directly and does it in a fashion which adjusts the burden to the taxpayer's ability to bear it. A tax on articles of mass consumption does it surreptitiously and indirectly and in a fashion that makes the burden proportionately heaviest on those least able to bear it. Indirect taxation is taxation by autocracies, income taxation is democratic taxation. Before democratic government came

into the world indirect taxation was the only type known. The history of direct taxation, and in particular of the income tax, is the history of the expansion of democracy.

Our existing tax structure is already too heavily weighted with regressive taxes. According to the estimates furnished to this Committee by earlier witnesses, the income group below \$500 paid 22 per cent of its income in taxes of all sorts in 1938-39, while those with incomes above \$500 paid no more than 18 per cent until the \$10,000-\$15,000 income range was reached.

Nor does taxation of luxuries and semi-luxuries provide a fruitful source of revenue. Whatever revenue can be obtained from this type of tax can be raised with fewer administrative difficulties and with less arbitrariness through individual income taxes.

The only appropriate role of excise taxes in our present economic situation consists in limiting the civilian demand for durable goods competing with defense. It is already evident that defense requirements will necessitate a considerable curtailment of such goods as passenger automobiles. Since no workable method of rationing goods of this type has been devised, the only way of allocating a limited supply in a growing consumer market is through sharp price advances. Since these advances are inevitable in any event, the increased proceeds should be taken by the Government instead of being left with manufacturers and dealers. Steep excise taxes on this range of articles will not impose additional burdens on consumers but will serve only to capture the windfall profits

of manufacturers and dealers. In my judgment this is the only field in which increased excise taxes are justified and desirable.

I beg permission to describe in somewhat greater detail the tax proposals that I wish to advocate.