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# POSSIBILITIES OF POSTWAR INFLATION AND SUGGESTED TAX ACTION

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Your Chairman asked me to discuss taxation from the standpoint of controlling inflation in the postwar period. I feel that the subject would be incomplete unless I took account also of the importance of taxation as a means of controlling deflation. Taxation is never neutral in its economic effects, and since the war, it has been more and more generally recognized that even if levied ostensibly for revenue only, taxes have a direct influence on those basic factors of consumption, savings, and investment which, by getting out of balance, produce economic ups and downs. It is appropriate to discuss these matters in this forum. It is important to consider what type and what amount of taxation will best help to keep the economy moving ahead on an even keel when the war ends and looking to the longer future.

At the same time, it is of paramount importance not to lose sight of the stark fact that we are still in the midst of this war. It is not yet won. No man can say when it will end. No man can say what it will cost in blood and resources before it ends. The imperative needs of this hour are more determined and united effort, more manpower, more taxation and more restraints. If in the discussions of the postwar world -- in the debates going on all over this country about postwar plans and problems -- we blind ourselves or others to the urgent necessities of this war, if our will as a nation to exert every effort to achieve an early victory is in any way weakened by thinking too much about our dollars in the future and too little about our duties now, we will have done our country, and ourselves, a grave disservice.

Proper fiscal policies are, of course, essential to the successful management of our war economy. They will be equally essential to a full utilization of our resources later on. In bringing the problems of fiscal policy before the public, your Institute is making an important contribution towards the promotion of those policies which should contribute to the successful financing of this war and to the maintenance thereafter of the institutions which our armed forces are fighting to preserve.

Our home front fight against inflation will have to continue for a considerable time after the war ends. The eventual answer to the inflation problem must be found in the production of goods in quantities sufficient to meet all the demand, but that will not be possible until industry has been able to resume full peacetime production and has been able to supply the most urgent backlog needs. In the meantime we will still be confronted with a situation in which individual and business consumers, if permitted to buy freely, would in many fields try to purchase greatly in excess of what is available. Thus the pressure on many prices will continue. In order to assure orderly transition to a high and stable level of production and employment in the postwar period, it is absolutely essential that further price increases be prevented. This cannot be done without maintaining wartime taxes, wage controls and also rationing and price controls over essential goods until such time as the supply is sufficient to meet demand. Also, control of goods for export should be maintained for some time.

I shall not undertake to restate my views on war finance, but in discussing the problems of inflation control after the war, we must realize that the chances for success at that time will be vitally affected by fiscal policies during the war. Our tax effort so far has been entirely inadequate in relationship to our huge wartime expenditures and it has lagged far behind that of our allies. A family man with an income of $5,000, for instance, pays $754 of income taxes in the United States (including State income tax at the rate paid in New York State) as against $1,655 in the United Kingdom or $1,747 in Canada. Not only is the present level of income taxes much higher in these two countries, but the increase over prewar taxes has also been much sharper. In addition, the American pays considerably less in sales and excise taxes than does the taxpayer in either of the two other countries.

A few illustrations will show the relationship of the current war financing program to postwar developments. For every dollar of income currently received in the United States, less than 65 cents worth of consumers' goods are currently available for purchase, and for every dollar of disposable income which is left to the consumer after the payment of his personal taxes, there are less than 75 cents worth of goods that can be bought. Our failure to accept a substantial increase in taxes at this time thus leaves us with an excess of consumers' income which greatly increases the difficulties of effective rationing and of holding the line against further wage and price increases. We should strengthen in every way possible our stabilization program during the war period, since it will be impossible to do so after the war, when the impulse of the people to return to normalcy will make it very difficult even to maintain established controls.

Another difficulty which will confront us in the postwar period will arise from the huge amount of purchasing power held by the public. This will largely be the result of our heavy reliance upon borrowing in the financing of our war expenditures, and, in particular, upon borrowing from the banks. In the two years from January 1, 1942 to January 1, 1944, the public debt increased by 105 billion dollars, and of this increase the commercial banks and the Federal Reserve Banks have absorbed 48 billion dollars. Of the total of 169 billion dollars of Government debt outstanding at the end of 1943, 72 billions were held by the commercial banks and the Federal Reserve. This extensive borrowing from the banks resulted in a corresponding increase in our money supply. Including currency as well as demand deposits, the total money supply held by the public at the close of the year amounted to over 80 billion dollars, or nearly twice as much as two years ago. To this must be added over 30 billion dollars of time deposits and the many billions of U. S. Government securities held by the public. This huge volume of liquid funds is the basis for the inflationary problem in the transition period.

In turning our attention to the transition problem, we would do well to remember what happened after the last war. The collapse of Germany came unexpectedly. It was followed by an abrupt termination of war production. Prompt abandonment of price controls after the Armistice, record agricultural exports, heavy inventory accumulations and high consumers' demand led to the sharp price advances of 1919 and 1920, which, in turn, paved the way for the postwar depression. This time the transition problem will be immensely greater. War expenditures in 1918 amounted to only 16 billion dollars as against 90 billion dollars now. Then, only one-fourth of all goods produced by the economy were for war purposes; now, the war absorbs about one-half of our total output. We need to be far more successful this time in solving the problem. Early resumption of peacetime production by some industries, if properly planned, could help to remove bottlenecks in the reconversion of other industries later on. A gradual demobilization of the services would greatly reduce the danger of flooding the labor market in the earlier stages of reconversion. Should the Pacific war continue for some time after the fall of Germany, a more gradual tapering off of war production and demobilization of the armed forces would, of course, be possible than would be the case if the Axis were to collapse simultaneously on all fronts.

But, we cannot depend upon the Axis to time its collapse to suit our economic convenience. Rather, we must prepare for the most speedy return of industry to peacetime production whenever military requirements permit. We must stand ready to meet inflationary pressures while this shift is being accomplished. A speedy conversion to peacetime production is the most direct and effective way to cope with the inflation problem. On industry's part, this requires advance planning for the return to an expanded production so that a high level of employment can be maintained with the least possible interruption. It is important that the expansion of industry should be only in those fields where it is justified by the promise of a permanent market. Expansion should be avoided where it would merely serve to meet a temporary high level of demand arising from the huge backlog of deferred purchases. This backlog should be met gradually. Otherwise, excess capacity would be created which would accentuate the inflation danger during the transition period and the danger of deflation later on. On the Government's part, an orderly and expeditious transition requires the setting up of effective machinery for the prompt termination and payment of amounts due on outstanding contracts, for the disposition of inventories and Government-owned facilities needed in peacetime production and for assuring an ample credit supply. If claims against outstanding Government contracts are settled promptly, the credit position of business on the whole will be very strong. However, there are a few large enterprises and many small businesses which will be in need of funds, either in the form of credit, equity capital, or both. All necessary steps should be taken to assure that these needs will be met. The funds should be supplied as far as possible from private sources with such Government assistance as may be required.

Even though we may succeed in resuming peacetime production rapidly, there will still be a period of heavy inflationary pressures due to the desire of consumers to satisfy their deferred demands, and the requirements of business for supplies to take care of deferred maintenance and improvements and to restock inventories. Heavy export demands will also continue. It is most important that prices be held from the outset and that the public be confident of this policy. We must give assurance to the millions of bondholders that they will not lose by delaying their purchases until ample supplies are again available. If wartime savings are used gradually after industry has returned to a peacetime basis, they can contribute greatly to the maintenance of prosperity. But if spent too rapidly, the savings would be dissipated in higher prices and would undermine the foundations of the economy.

There can be no doubt, therefore, that inflation controls should be maintained during this transition period. Continued rationing and price controls will be needed in the domestic market, and licensing control of exports should be retained. Wartime taxes should be kept up, including the excess profits tax, although it may be desirable to reduce the present 95 per cent rate to, say, 75 per cent, in order to encourage efficiency, economy and increased production. The drastic reduction of expenditures which will take place will not justify a premature reduction of taxes. On the contrary, every attempt should be made to bring about a balanced budget at the earliest possible date after the war. It is unlikely that the public will be absorbing additional Government securities during that period, but will be tending to sell on balance some of its holdings. Unless the budget is balanced, the banks would not only have to absorb possible sales by nonbank holders, but would also have to absorb the new issues needed to finance the deficit, thus aggravating the inflationary situation by further increasing the already excessive supply of money. A balanced budget, on the other hand, will encourage the owners of Government bonds to retain their holdings because it will assure them that the purchasing power of their money, invested in bonds, will be preserved.

After the war is won and industry has been fully readjusted to a peacetime basis, American enterprise will meet its greatest challenge, namely, to provide peacetime production on a scale commensurate with the enormous ability to produce which our economy has demonstrated during the war years. This will mean the employment of at least 55 million people, as compared with 46 million in 1940, when more people were employed than in any previous year. At 1943 prices, this means a gross national product of about 160 billion dollars, or close to 45 billion dollars more than in 1940.

To meet this challenge, we must realize that a high level of employment and income requires a high level of expenditures, private or public. We have seen during the war years how greatly our national product can be increased if there is sufficient demand for the country's output. After the transition has been made, we shall be able to maintain a high level of output only if a vast increase in peacetime expenditures replaces a large part of the war outlays. Business will not be able to supply a product of 160 billion dollars unless there is a corresponding demand by the economy as a whole. Demand will not be sufficient unless business distributes its income to the people, and unless the people return their incomes to enterprise in the purchase of its goods and services. This means, first of all, maintenance of a high volume of wages. The aggregate of buying power must be maintained, although some wages may have to be adjusted downward and others upward. This buying power must then be returned to the economy through a high level of consumption expenditures. Of course, not all income will be spent on consumption. There will be savings both by individuals and by business enterprises. We can have saving and a high level of income and employment if the savings are invested in the improvement and expansion of our economy. When savings are thus spent upon the production of new facilities of all kinds, they provide income and employment. But when savings are held idle, or used to bid up the prices of existing assets, they are not returned to production and other dollars must take their place if employment is to be maintained. The basic condition for economic prosperity is thus a steady stream of consumer, business and public expenditures at a volume sufficient to employ all who desire to work. The more fully private enterprise succeeds in providing the necessary volume of income and expenditures, the less necessary it will be for Government -- Federal, State and local -- to provide supplementary employment.

The contribution which monetary policy can make to the goal of maximum production and employment is limited. The banking system and the capital market must provide adequate funds to meet the credit and capital needs of the country. Merely making funds available, however low the cost, will not induce expansion unless business is assured of a market for its increased production. On the other hand, the impact of fiscal policies on the spending stream is far more direct and powerful. Revenue measures and public expenditures can either increase or decrease the income stream. The Government can so shape and time its tax and expenditure policies as to offset variations in the income stream due to variations in the volume of private expenditures. By wise policy, correctly timed, Government can thus be a balance wheel and a stabilizing influence in helping to maintain a high level of production and employment. Taxation, therefore, has become much more than a problem merely of meeting the fiscal needs of the Treasury. It is also a major concern of national economic policy.

There is much discussion currently about incentive taxation, as if it were a panacea. Every taxpayer, individual or corporate, is inclined to think that the best incentive would be to reduce his own taxes. Thus, the argument for tax incentives readily develops into an argument for greatly reduced taxes for everybody. Greatly reducing everybody's taxes, however, is not the way to maintain a balanced budget, as we certainly should do when we have a high level of employment. It is likely that the Federal postwar budget will be well above 20 billion dollars annually. Therefore, wholesale tax reductions are out of the question if we are to maintain a balanced budget, and such tax reductions as we can afford must be applied in a way that will contribute most to the maintenance of employment.

The question is not so much one of incentives as of objectives. If we are to have a high level of national income, then, as I have indicated, we must have a high level of consumption outlays. The most important consideration, therefore, is that taxes should interfere as little as possible with the flow of consumer expenditures. The first step towards this end is to reduce indirect taxes on consumption and, if necessary, to substitute direct taxes on income. Indirect taxes are added to the price which the consumer must pay. The greater the sales tax, the fewer goods the customer can buy, and the less he can buy, the less the business man can sell. That, in turn, means less employment. At the same time, sales taxes penalize those who consume a large share of their income. There is thus a strong case for a drastic reduction in Federal sales and excise taxes just as soon as the supply of consumer goods on the whole begins to exceed the demand. This condition is not likely to be reached until the backlog of deferred consumer demand has been met. The personal income tax should be the main source of Federal revenue in the postwar period because it is the most flexible and equitable type of taxation, and because consumption is less affected by it.

Another important step in maintaining the flow of consumption expenditures would be to expand the social security program, including unemployment insurance, provision for old age, disability and other hazards. Coverage should be broadened, payments liberalized, and in the case of unemployment insurance, the period of payment should be lengthened. Providing an adequate old-age pension and extending it to cover everyone would enable a great many more people to retire, and this will assist in meeting the unemployment problem. Through provisions of this kind, a feeling of security is given to people generally and they are thus put in a position where they will feel free to spend a larger share of their current income, thereby contributing to the maintenance of employment.

Postwar tax policy will also have to be concerned with the flow of capital expenditures. In much of the current discussion, the deterrent effects of taxation upon business spending are exaggerated. Low taxes on business will not bring about a high level of capital expenditures if the demand for the products of business does not justify such expenditures. If demand does justify the expenditures, even high taxes will not keep businesses from expanding to meet the demand, unless they are subject to excessively high tax rates. The existence of markets for their products, rather than taxation, is the decisive factor, particularly in the case of large and well established enterprises, such as those in the steel, oil, automobile and chemical industries, among others. Present corporation tax laws have given considerable postwar protection to those concerns which have made excess profits by providing a postwar credit of 10 per cent of their excess profits tax, as well as a provision for the carry-back and carry-forward for two years of unused excess profits credits and of net operating losses. This is a tax incentive to business which already exists.

The effect of taxes on many of the small enterprises and on the establishment of new enterprises is another matter and needs to be given particular consideration. Perhaps the most important tax deterrent results from the fact that income is taxable under the corporation income tax, and it is again taxable under the personal income tax when it is distributed as dividends to the owners, This procedure has a number of harmful results. It places a premium on fixed debt financing and a penalty upon equity capital since the corporation may deduct interest as a cost item in computing its taxable income, while no such deduction is allowed for the return to stockholders on equity capital, It would greatly help to secure a less vulnerable business structure if more financing were done with equity capital and less with debt forms, Because of the existing situation, investors are reluctant to supply equity funds, particularly to small and new enterprises which are more risky than the larger, well-established enterprises. The personal income taxes upon dividends, particularly when subject to the higher surtaxes, are an inducement to stockholders with large incomes, who influence corporation policies, to prevent distribution of corporate earnings. This situation is likely to be detrimental to the maintenance of employment because corporations are thus led to retain earnings beyond what is needed and, therefore, they are not returned to the spending stream.

Equity investment and the distribution of corporate earnings would be greatly encouraged by adopting a plan somewhat similar to the British method of dealing with dividend income, One effective method would be to give a tax credit to the person who receives the dividends. A tax would be collected from the corporation as now, but when dividends are distributed, the stockholder would be permitted to take a credit on his personal income tax of some substantial fixed percentage of his dividend income. Another method would be to give the corporation a similar fixed percentage credit for that portion of its earnings which it distributes to stockholders. Either method would greatly reduce the amount of double taxation on equity capital and would be a strong incentive to new equity investments.

I think we should consider whether it would help in stabilizing the business structure to continue some form of excess profits tax, together with liberal provision for carry-forward and carry-back of the excess profits tax credit, and also make more liberal provision for carrying forward and carrying back losses than is now made in the tax law. Such provisions would be particularly helpful to small and new enterprises. We must encourage the establishment of new enterprises and safeguard the great number of existing small enterprises if we are to obtain a flexible and competitive business structure and halt the movement tending toward increasingly large combines and monopolies. Another most important step in this connection would be the establishment of patent pools freely available to small and new enterprises as well as to others.

There are numerous other problems, such as changes in the personal income tax which the limits of time do not permit me to consider. Our postwar tax structure must be flexible and adaptable to the changing requirements of fiscal policy. Tax policy must be recognized as part of a flexible fiscal system and must be used wisely to supplement or curtail the flow of consumer and business spending as conditions require.

Underlying all that I have said is the fundamental purpose of avoiding either inflation or deflation -- in other words, what we would all like to have is full and sustained production and employment. The discussions before this Tax Institute -- very properly -- center around the role that taxation plays or should play in seeking this goal. Specifically I was asked to discuss taxation as a means of controlling inflation. I want to conclude what I have to say with this observation -- nothing that can be done now or later to the tax structure, nothing that we can do now or later in any way, will contribute as much to the control of inflation -- and what is infinitely more important, the saving of lives -- as to unite all of our efforts and our energies to bring about victory in this war at the earliest possible moment. That is why I undertook to emphasize at the outset the overwhelming importance of keeping always in the forefront of our vision our duties now rather than our dollars later -- for if we fail in the performance of our duties now, if we fail to do all that each of us individually and collectively as a nation can do to achieve an early victory, our plans and our hopes will never be realized.