July 19, 1946

As a result of the war, the country is confronted with an inflationary danger which could have very grave consequences. War finance, chiefly because of heavy reliance on borrowing from the banking system, expanded public holdings of liquid assets from about 75 billions in the middle of 1941 to more than 220 billions by the end of 1945. At the same time a huge volume of backlog demand accumulated. Inflation was avoided during the war years only because the economy was harnessed in a system of direct controls. Since the war, the pressures of demand have increased still further. Consumer incomes after taxes are above the wartime peak and the rate of savings has fallen sharply. Corporations are in a highly liquid position and large, amply financed foreign demands compete with domestic buying. At the same time, direct allocations, building permits, wage and price controls, and rationing have been abondoned or greatly weakened. No adequate fiscal adjustments have been made to compensate for the impairment of direct controls. As a result, inflation pressures have been rising and price controls have become increasingly unequal to the task of holding the line.

Conditions have thus been created under which no price control measure, much less a weakened bill, can now be expected to function effectively. Direct controls, enumerated above, which are necessary to reinforce price controls cannot be effectively reestablished. The months of uncertainty preceding the current legislation, the long delay by Congress in getting the bill enacted, and the drastic cutting of appropriations to administer such controls as might be extended, all compound the difficulties of continuing effective price controls. Unworkable price controls would be worse than none.

Production is the ultimate answer to the inflation problem. That takes time. It is imperative meanwhile that ways be found to check the excessive demand. Since effective direct controls cannot be reestablished, other means must be found for dealing with the problem. The three most important are:

(1) Reduction of public expenditures and raising of taxes to achieve as large a Federal budget surplus as possible;

(2) Elimination of unnecessary expenditures, private, state, and local;

(3) Curtailment of credit and disposal of Government surplus.

FISCAL POLICY

During the deflation of the 'thirties, fiscal policy required a budget deficit, putting more purchasing power into the economy through public expenditures than was taken out through taxation. Now, under reversed conditions of inflation pressure, a budget policy is called for which will take more purchasing power out of the economy through taxation than is returned through public expenditures. A fiscal policy which brings about a substantial budget surplus is by far the most effective means left at our disposal to meet inflation pressures. Unless the Government sets the example in greatly reducing its expenditures and increasing its savings, the people cannot be expected to follow the Government's admonition to postpone their purchases and to maintain their savings.

(1) Reduction of Expenditures. The expenditure outlook in the budget has deteriorated during recent months. Expenditures for the fiscal year 1947 are now estimated at a little over 40 billion dollars, without allowance for the terminal leave bill. This is an increase of 5 billion over the January budget estimate. Nearly one-half of the budget is for national defense expenditures which have continued at a very high level, despite the fact that the war ended nearly a year ago, that large supplies of every kind were left after V-J Day, and that the armed forces have been reduced to about 20 per cent of their wartime strength. Large sums are still being spent for construction that could be postponed and further supplies which are not urgently needed. Scarce material and labor are thus being diverted from acutely pressing civilian needs. To remedy this situation, all procurement and construction activities under the national defense program should be screened. All these which are not of an immediately urgent character should be postponed. To this end, it is recommended that a committee be appointed, to include prominent representatives of civilian groups, and that this committee be instructed to recommend reductions or deferments of national defense expenditures, aggregating not less than 5 billion dollars. These expenditures should be deferred for the remainder of the current fiscal year or until dangerous inflation pressures no longer exist.

While it is evident that major budgetary savings will have to come in the defense program, other non-urgent Federal expenditures should also be deferred or reduced, especially those on public works.

The terminal leave bill if framed to provide for cash payments will be highly inflationary. Every effort should be made to provide for payment at such time when deflationary pressures are developing. This will help to stabilize the economy and will be in the interest of the veterans who will be able later on to obtain more and better goods for their money.

Public agencies, finally, should defer for the time being all food purchases for relief purposes. I understand that foods currently purchased will not add to deliveries to foreign countries prior to their harvest. Accordingly, temporary postponement of purchases until more ample supplies are available in the American market would not impair the relief program.

(2) Increase of Taxes. Tax reductions provided for in last year's legislation have produced a revenue loss of about 5 billion dollars. Had rates been maintained and expenditures been kept within the limits of the January budget estimate, a budget surplus possibly of 10 billion dollars could have been achieved for the current fiscal year. Instead, no surplus is in sight and a deficit is in prospect. To correct this situation,

curtailment of expenditures will not be enough. To provide revenue, and particularly as a means of reducing pressures for higher prices and increased wages, the excess profits tax should be reinstated. In addition, taxation of capital gains should be tightened.

(a) Excess Profits Tax. It is now being widely recognized that repeal of the excess profits tax was premature. The repeal came at a time when it was expected that other controls would be continued and when there was widespread fear of impending unemployment and deflation. Since these assumptions have proved to be unfounded and present conditions are entirely different from what was expected, there is every reason for restoring the tax. The annual rate of corporation profits before tax may in the course of this year reach the wartime peak, which would leave profits after tax greatly in excess of the wartime high. As reconversion is completed and as prices continue to rise, profits will increase generally. Since they are essentially wartime profits, they should be subject to excess profits taxation. Based on inflation prices, they are paid for by the public for whose benefit they should be recaptured through the budget and used for debt reduction. The excess profits tax would not only assist in creating a budgetary surplus but it would exert a powerful influence in discouraging excessive pricing by corporations, and in helping to reduce industrial unrest and demands for increased wages during the inflationary period.

(b) Capital Gains Taxation. The present tax treatment of capital gains, under the individual income tax, encourages speculation. Gains from assets held for only 6 months are treated as if they were long-term gains. They are taxed at a preferential rate of 25 per cent instead of at the much higher surtax rates applicable to other income. The speculation thus engendered is especially harmful in driving up the prices of homes and farms which are at highly inflated levels. Accordingly, it is proposed that long-term gains, taxed at the preferential rate, be redefined to mean gains from the sale of assets held for two years or more. The new provision should be made applicable to gains from the sale of assets purchased after July 1, 1946. This would discourage speculative purchases for the short-term and would thus reduce demand. As the new provision would not apply to assets acquired prior to this date it would not reduce supply.

If inflation pressures continue to increase after curtailment of budget expenditures and application of these tax measures, an increase in excise and personal income tax rates should be considered. In making these tax recommendations, I recognize that there is little likelihood of Congress accepting them at this time, but it is the responsibility of the Administration to recommend what is needed.

ELIMINATION OF UNNECESSARY EXPENDITURES

Having shown the way by carrying out a drastic retrenchment of its own expenditure program, the Federal Government should appeal to all other spending units — States and localities, businesses, and consumers — to follow suit.

State and local governments should be urged to postpone all possible public works and construction projects until the inflationary danger has passed. They should also be urged to maintain State and local taxes at a high level in order to build up a surplus for a later period of need. After the necessary adjustments in the Federal budget are made, the President might call a conference of State Governors to promote cooperative action.

Businesses should be called upon to defer capital expenditures wherever this is practicable and to refrain from building up unnecessary inventories. Non-residential construction should be curtailed more vigorously and high-cost residential construction should be deferred altogether. Only if construction expenditures and capital formation are thus curtailed will it be possible to meet the urgent needs for veterans and low-cost housing.

Finally, every appeal should be made to consumers to exercise the greatest self-restraint in their purchases, and not to follow prices up.

CURTAILMENT OF CREDIT

Public agencies which extend credit directly, or guarantee or regulate credit, should be requested to do whatever they can to bring about curtailment of credit except as it may be essential to maintain or increase production. At the same time consumer credit controls should be maintained at full strength.

In addition, the situation would be further helped by expediting as far as possible disposal of surplus Government property and inventories. This would not only help to relieve shortages but would also bring in revenue to the Government and thus improve the budget situation.

I am aware that the program here proposed is drastic and difficult to carry out. The alternative, however, may well be an inflationary spiral which would undermine the basis for prosperity at home and the foundations we have laid for international reconstruction.

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