

ADDRESS AT THE
29th ANNUAL MEETING
OF THE
CHAMBER OF COMMERCE OF THE UNITED STATES
AT
WASHINGTON, D. C., MAY 1, 1941

BY
MARRINER S. ECCLES
CHAIRMAN OF THE BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

FOR RELEASE IN AFTERNOON NEWSPAPERS OF

MAY 1, 1941.

FINANCIAL PROBLEMS OF DEFENSE

The problem of financing defense is not solely the responsibility of Government. The business interests of the country have a very important role to play. For this reason I appreciate the opportunity, as a public official having some responsibility for the conduct of public affairs, to speak on this subject at this meeting of leading business executives from all parts of the country.

The financial problems of defense arise from the unprecedented size of public expenditures, concentrated mainly in the field of heavy industry, and the necessity for calling forth in the shortest possible time the maximum amount of defense production both for ourselves and for those we wish to aid. The financial problem is not how to provide an adequate supply of money but how to direct the use to which money and credit are put in such a way as to further the success of the enterprise and to avoid inflationary consequences. The avoidance of inflation is as essential for the preservation of our political and economic system as the defense effort itself. I am using the word inflation in the popular sense of disruptive price rises, whether confined to some segments of the economy and due to non-monetary causes or of a general nature and due to excessive monetary and credit expansion.

We can meet defense needs and supply our civilian population only to the extent that we utilize our man power, materials and productive facilities. Defense must come first. What is left over will determine the extent to which we can meet civilian requirements. We have no problem insofar as an ample supply of money is concerned. The volume of demand deposits and currency

- 2 -

now in existence approximates \$45 billions, or 50 per cent in excess of the peak amount of the twenties. The present volume could be increased almost indefinitely by further expansion of bank credit in loans to corporations, to individuals and to the Government. Merely to increase the supply of money would not in itself bring about needed production, but might result in inflationary developments.

Rather, a primary concern of defense financing is to avoid an increase of the means of payment, that is, of money in the hands of those who would spend it faster than our economy could produce goods. This would result in a rapid bidding up of prices. The problem in general terms is simple, but in detailed application it becomes difficult and complex. In general terms, it means that we should aim to finance defense entirely out of taxation and savings, preferably taxation as full employment and production are attained. It means priorities in certain fields where both civilian and defense requirements cannot be immediately supplied out of available raw materials, existing capacity, or available skilled labor supply. It means price controls in cases where demand for essential basic materials exceeds present supply. It means a program of taxation that will transfer back to the Government in the aggregate a substantial portion of the funds spent by Government, thus reducing the funds available to the public for private expenditure. It means encouraging a maximum amount of savings by all groups and classes of the population. It means avoidance of unneeded expansion of bank credit which adds to the supply of money and thus of purchasing power.

- 3 -

It is evident that the general problems of defense financing, which I have enumerated, are interrelated and must be dealt with by a coordinated series of measures. For instance, inflation cannot be dealt with solely by monetary and credit measures. As a matter of fact, at this stage of our defense effort such measures are of secondary importance. Fiscal policy, involving both the type of Government financing and taxation, and direct controls are far more important at present.

Let us consider briefly some of the more important aspects of this general summary.

In order to limit the need for price controls and priorities every means possible should be used to increase the output. This can be done by expanding the facilities of production, by increasing the available labor supply where there is a shortage of certain skills, by the working of longer hours, by preventing strikes and unjustified wage and salary increases, and by utilizing to the fullest possible extent existing plant and facilities wherever they may be. To be sure, this is a difficult and a complicated task, requiring full information and full cooperation on the part of Government, industry and labor.

In my opinion, taxation is the most important single means of maintaining stability in the economy and of preventing either general inflationary or deflationary developments. We must abandon the idea that taxation is merely a means of securing revenue. The effects of taxation on the economy should be the primary consideration. For a tax system to be equitable, ability to pay should be the guiding principle. For this reason, a general sales tax, which has been strongly advocated by business groups, would be a great mistake because

- 4 -

it would fall heaviest on those least able to pay. Selective sales taxes which would have the effect of reducing demands for certain products, such as automobiles, mechanical refrigerators and other articles that use resources greatly needed for defense, are justifiable and necessary at this time. Sales taxes on foodstuffs, clothing and other necessities are wholly unwarranted, particularly when surpluses exist. Taxes on such items would tend to diminish consumption, thus reducing effective demand. This, in turn, may create localized unemployment as well as idle capacity that could not be used for defense.

The first source of defense revenue should be the corporation tax and the excess profits tax because, in general, corporations are the greatest beneficiaries, directly and indirectly, from defense expenditures. In other words, 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.

Thus, the most direct way to attack the inflation problem is through heavy corporate income and excess profits taxation. 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, excise taxes, and other forms

of mass taxation. The problem is not avoided but only delayed and made more difficult by failure to tap the profits at the source.

High taxation of personal incomes and excise taxation will be necessary in any event, but the amount needed from these sources will be reduced by a prior collection at the points where the profits originate, namely, in the business units. If excess profits are not tapped, they will lead to demands for higher wages. Apart from the question of equity and the problem of allaying industrial unrest, is the question of going directly to the source of the increased flow of income and diverting it into the defense program before it spreads out into the community and adds private mass purchasing power on top of the Government's demands springing from the defense program.

With greatly increased surtax rates, especially in the middle income brackets, and in the absence of an undistributed profits tax, there will be a tendency on the part of some corporations to hold back disbursements of dividends. This is a further reason for heavy normal and excess profits taxes on corporations.

In addition, the tax program, to be effective and equitable, should close important loopholes in the gift and inheritance tax laws. Similarly, the setting up by corporations of annuity and pension plans which are charged to expense and provide large benefits to individuals in lieu of increasing salaries and paying bonuses, should not be permitted to become an avenue of tax avoidance.

With reference to the individual income tax, the normal tax and surtaxes on individual incomes have been moderate, compared with other countries, except in the very highest income groups. They can and must be substantially

- 6 -

increased. With expanding employment and payrolls resulting from defense expenditures, it is equitable and necessary that some of the benefits be recovered by the Treasury. Exemptions should be reduced, thereby spreading the base and increasing the number of income taxpayers. This is a more direct and equitable way of raising revenue from the lower income groups than by imposition of certain indirect excise and sales taxes.

To the extent that wages are increased and prices are controlled, corporation profits are less than they would be otherwise, and Federal revenue from this source is accordingly diminished. Under these circumstances, it is only fair that this loss of revenue be made up by taxing directly the beneficiaries of the increased wages.

The tax system should be so designed as to prevent any group from profiting out of this great national emergency at the expense of others. Neither industry nor labor should be permitted to take advantage of the emergency. Men drawn into the Army and Navy are called upon to make great personal sacrifices. Neither unity nor morale can be built upon inequality of treatment of our citizens.

It is a perhaps natural but none the less false notion that either capital or labor can make up now for lean years. If they were to reap great profits and higher wages, they would be inviting inflated prices and in the end the added profits and wages would buy fewer goods. I think it is of great importance that we grasp fully the fact that we as a nation cannot profit out of world calamity. We cannot turn our industrial machine largely to making the things of war rather than the things of peace and have a higher standard of living.

- 7 -

We have to start from the first principle -- and I believe that most of us accept it -- that the burdens to be borne and the sacrifices to be made should be equalized so far as possible. And that principle applies particularly to taxation. Therefore, those corporations and individuals who profit most should be the first to be taxed. They must be the primary ones from whom the Government recaptures the proceeds of its expenditures.

I am wholeheartedly in accord with the objectives of taxation policy recently announced by the Secretary of the Treasury when he appeared before the Ways and Means Committee in advocacy of measures to raise an additional \$3-1/2 billions of revenue. As he stated then, the purpose is to design our tax program, first, so that we may pay as we go for a reasonable proportion of our expenditures; secondly, so that all sections of the people shall bear their fair share of the burden; third, so that our resources may be mobilized for defense while reducing the amount of money that the public can spend for comparatively less important things; and finally, so that a general rise in prices may be avoided by keeping the total volume of monetary purchasing power from outrunning production.

The Secretary of the Treasury has proposed that we raise at least two-thirds of the sums necessary for defense out of taxation, and with that purpose I am likewise heartily in accord. The rest should, so far as possible, be raised by the sale of Government securities to the public, thus utilizing existing funds, instead of by the sale of securities to the commercial banks since the latter method creates additional bank deposits. As I have indicated, we need to use existing funds, which are abundant. Expansion of bank

credit which creates new funds would only tend towards inflation.

The Treasury's three new types of savings bonds, together with savings stamps, are being offered to the public beginning today. They are excellently designed to give all of our people an opportunity to participate in the financing of the defense program. They are designed to attract the smallest savings of the people as well as those up to \$50,000 a year. Apart from that patriotic purpose, however, they are important in helping to protect the country against inflation and they are a store of buying power for the future when supply can again be matched to demand.

Another very large store of savings which should also be tapped consists of idle balances in banks held by corporations, by wealthy individuals and by trustees as well as by various public and private bodies. These funds are frequently not of the type that can or will go into long-term Government securities, nor can they be attracted into short-term Government securities now available because practically no return can be obtained upon them. I believe many of them would be invested in registered short-term issues (not available to banks) of two years' maturity, if such issues were made available at interest payable semi-annually, of from one-half to one per cent, depending upon the length of time they are held, and were redeemable on any interest payment date on 30 days notice. So far as long-term rates are concerned, I think they are fair and that the Government would not be justified in paying more than two and one-half per cent for long-term money on fully taxable securities.

To the extent that we pay for defense out of taxes and through borrowing from savers rather than from the commercial banks, thus using existing funds and not creating new funds, we help protect the country against the hazards of monetary and credit inflation. To the extent that people pay

- 9 -

taxes or invest in Government bonds, such as the new savings bonds, these funds will not be available for the public to bid up prices in the market place and they will aid in financing defense, thus avoiding inflationary effects.

This is the time for the public to build up a backlog of future requirements, especially of consumers' durable goods, such as automobiles, housing, etc., that now are using some of the materials needed in defense. Instead of spending existing funds and mortgaging future income for these goods, it would be far better to defer these expenditures until the time when the Government's defense outlays can be reduced. At such a time the backlog of buying power coming into the market will be an offset to the reduced Government expenditures and help to sustain employment and national income.

We should consider the advisability of providing a method of controlling the volume of forward buying on installment credit. Further expansion of installment credit at this time would be an inflationary factor. Installment credit has tended to expand as employment and payrolls expanded and to contract when both were declining. It has thus tended to be an unstabilizing influence on the economy when it might have been made a stabilizing influence.

I have said that monetary and credit factors are at this time less important than other factors in the situation. Nevertheless, with the existing large volume of deposits and the vast reservoir of excess reserves which could serve as a basis for doubling the existing volume of deposits, it will probably become necessary at some future time to absorb into required reserves a portion of the idle funds held by the banks. This would diminish the

- 10 -

pressure on the banks to find outlets for their funds in Government securities and would facilitate the placing of a larger part of the new issues with non-banking investors. It would also make the banks more careful about avoiding unsound or speculative extensions of credit and would restrain further growth in the already abundant volume of bank deposits. Consequently it would diminish inflationary dangers.

There is one additional matter of importance in connection with defense financing that should be given consideration. It is the subject of public expenditures for purposes other than defense. I do not believe that agricultural benefits should be curtailed, particularly in those fields where agriculture does not profit as other groups do from defense expenditures or is adversely affected as the result of the present international situation; nor do I believe that we should abandon social efforts on the part of the Government in those cases where the problem is not adequately met by the improved employment situation resulting directly or indirectly from defense expenditures.

We are hardly justified in spending billions to aid other countries and billions more in our own defense effort if at the same time we shut our eyes to urgent social needs at home that must depend upon government assistance. However, reductions should be made wherever this can be brought about through increased efficiency as well as in those fields of Government activity which utilize men or materials needed in private enterprise or in defense.

I have attempted to outline briefly the general public policies which I feel should be pursued to facilitate the financing of defense

- 11 -

effectively with a minimum of economic dislocation now and after the defense effort has been completed. The successful carrying out of such a program as I have discussed -- and it is a program designed to preserve all of the essentials of our democratic system -- depends primarily upon the understanding of and acceptance by the people of this country, particularly the leaders in business and industry.

We have every reason to succeed. We are in a much stronger position than any nation in the world today. We have a vast endowment of natural resources. We have abundant and high-calibre man power. We have existing and potentially great productive facilities. We can provide, without inflation, all of the monetary and credit resources we require.

We will fail only if we are ignorant of the social and economic problems confronting us or if through blind self-interest we imagine that we can make others bear the sacrifices and burdens which all must share in the greatest undertaking upon which our nation has ever embarked.

ooOoo