

IMPLICATIONS OF FEDERAL FISCAL POLICY

by

Homer Jones

Washington, D. C.

Delivered before the
Sixth Annual Symposium
of the
Tax Institute
Philadelphia, Pennsylvania
December 1, 1941

There seem to me to be four chief implications of the fiscal policy which we follow during this military effort.

1. Our fiscal policy will be a prime factor determining what kind of an economic system we will have in the post-war period.
2. If we decide to follow a fiscal policy which will be conducive to retaining a free enterprise economic system, there must be enormously heavy taxes paid by the middle class and the fixed income groups not only after but before total civilian production declines.
3. A fiscal policy which will permit retention of free enterprise will incidentally limit the increase in the public debt.
4. If we retain the private enterprise system and keep the public debt within reasonable bounds, we will be able to face the problems of post-war economic adjustment with considerable confidence.

In order to establish these implications we need to consider briefly the imminent magnitude of government expenditures and the chief possible fiscal policies.

Magnitude of the Current Fiscal Problem

As a base, let us take the fiscal year ending June 30, 1940, in which the Federal Government spent \$9 billion. Under the impact of defense outlays, Federal expenditures rose to nearly \$13 billion in fiscal 1941 and will probably approach \$30 billion in the current fiscal year. In fiscal 1943, or fiscal 1944, it is not unreasonable to expect them to achieve a rate of \$50 billion. If national income by this time has reached \$100 billion, roughly half will have to be taken by the Federal Government.

Whether or not Federal expenditures in fiscal 1943 actually do amount to half of the national income, this estimate will surely prove realistic sometime during the prolonged military effort which now appears probable. If and when we commence

in fact as well as in words to engage in an "all-out" military effort, we should be able at least to match the proportion of income now devoted to such purposes by the belligerents. England and Germany are now devoting more than half of their income to military ends quite aside from other government expenditures. Since these countries are poorer than ours, since their per capita real income in peacetime is far below our per capita real income, we can devote a greater proportion of our production to military ends than they, and still can retain the minimum essentials of civilian life. Accordingly, in its minimum dimensions, the task confronting the fiscal authorities is to devise a program which will cause half the income of the country, or some \$50 billion at present prices, to flow through the Federal Treasury.

Possible Reductions in Non-Defense Expenditures

Confronted with such a rapid acceleration of defense expenditures, we may reasonably expect that non-military expenditures of both Federal and local governments shall decline. Many voices have recently urged such action--especially reduction of Federal expenditures on non-defense activities--and considerable heat has been generated in discussions of this question. While I am convinced that a very substantial cut in non-military expenditures is appropriate, such a policy should be considered in its proper perspective. In comparison with the necessary expansion of military expenditures, the possible cuts in non-defense outlays are of a rather small order of magnitude. Even if Federal non-defense expenditures were reduced by as much as \$3 billion, for example, such a drastic reduction would not materially decrease the dimensions of the immediate fiscal problem. It would, therefore, be very foolish, if not disastrous, for us to consider reduction in non-defense expenditures as an alternative to a proper fiscal policy. Similarly,

those who assert that we should first reduce non-defense expenditures and then commence to consider the revenue problem are surely misguided. These steps need to be taken simultaneously.

Without detailed consideration of the particular non-defense expenditures, we may nevertheless indicate certain basic principles which should govern the reductions proposed. First, government expenditures arising from the absence of full employment (in other words, expenditures designed primarily to promote employment or to provide relief for the unemployed) should be abandoned. Second, government investment which does not contribute to the war effort (e.g., the building of post offices or non-defense highways) should be curtailed for the same reasons that private investment should be curtailed. Third, public civilian consumption (e.g., provision of recreation) must be reduced in the same manner that private civilian consumption is reduced.

Methods of Financing the Defense Effort

Broadly speaking, there are three ways in which the government can gain control of the purchasing power it needs to finance its military endeavor. First, it can levy taxes sufficiently high to obtain all the funds needed except for the amount which can be raised by non-inflationary borrowing. Secondly, it can borrow either newly created or hitherto idle bank deposits, or can turn to the printing press. This method can end only in inflation. Finally, if the government is determined to avoid a sharp rise in the level of prices and yet cannot face the necessary increase in the tax burden, it can resort to price fixing and rationing, borrowing the public's unspent funds to purchase the goods and services which it requires.

The actual fiscal policy which this country will pursue will in all likelihood embody at least a partial application of all three of these devices. However, a

clear understanding of their nature requires that they be discussed separately.

Taxation and Non-inflationary Borrowing

If it is desired to keep the price level fairly stable and to avoid general price fixing and rationing, the simple answer to the problem of raising the purchasing power required by the government would seem to be to tax it away from the public. The public, having less to spend, would buy correspondingly less; the government, having more to spend, would buy correspondingly more. In large measure this approach is correct as well as simple. However, there are certain impelling reasons why some borrowing is desirable. First, there may be some savings which do not find an outlet in private investment. If these funds were hoarded, purchasing power would decline and unemployment or deflation would result. Second, if the defense effort starts from a point at which there are substantial amounts of unemployed resources in the country, it is clearly desirable that these resources be brought into use. To do this, the government should not limit its borrowings to uninvested savings alone but should engage in income-expanding borrowing at the maximum rate consistent with maintenance of fairly stable prices. As the point of substantially full employment is approached, pump priming should be cut down until government borrowings equal, but no more than equal, uninvested savings.

Before going any further it may be worthwhile to make clear the exact sense in which I am using the terms savings and investment, respectively, in this paper. Savings include the savings of both corporations and individuals. Savings of corporations are their undistributed earnings after taxes plus depreciation and depletion allowances. Individual savings are the difference between current income on the one hand and taxes plus consumption expenditures on the other. The

term investment includes all expenditures incurred privately on plant, equipment, maintenance, increases in privately owned inventories, and the net "favorable" balance of trade with foreign countries.

In practice it may be difficult to borrow an amount exactly equal to uninvested savings. Increased income will certainly tend to cause savings to rise at a rapid rate. Investment will likewise increase in the early stages of the military effort. When consumption becomes stabilized or declines, however, and as the military demands upon the resources necessary for production of capital goods limit the possibilities of construction, investment will decline and indeed may almost entirely disappear. But while the increase in savings and the decline in investment will both tend to increase the possibilities of non-inflationary borrowing, another factor will constitute a counteracting influence. Since government expenditures must increase so rapidly and must bulk so large, there is no chance that uninvested savings can keep pace with expenditures. Therefore, taxes must be increased to supplement the borrowing of uninvested savings. But an increase of taxes, unless the most regressive tax system conceivable is adopted, will result in a decline in savings. As the rise in government expenditures outstrips the increase in national income and the decrease in investment, the amount of non-inflationary borrowing which the government can do will be reduced to very small proportions relative to total government expenditures. Since most savings come from the higher income groups, the more progressive the tax system the less will be the volume of savings and the smaller will be the amount the government will be able to borrow without inflationary consequences.

We thus see that if inflation is to be prevented without resort to price fixing and rationing, we must place our chief reliance upon the instrumentality of taxation. In the light of our discussion, it is clear how useless is some

arbitrary ratio between borrowing and taxation, and how inaccurate the idea that the defense effort can in large measure be paid for by the savings arising from the increased national income associated with defense expenditures.

The essential problem of financing the war effort may be illustrated by the following highly simplified model. This model assumes that the national income becomes stabilized, and that investment outside the Federal budget has fallen to the irreducible minimum.

	<u>"Calendar 1942"</u>	<u>"Calendar 1943"</u>	<u>"Calendar 1944"</u>
National Income	100	100	100
Federal Expenditures	35	45	55
Federal Taxes	20	35	50
Federal Borrowing	15	10	5
Saving	15	10	5

Since saving is not increasing, borrowing cannot increase, and taxes must increase. Taxes will come partially out of savings, so borrowing must decline. Therefore, after a certain point, as Federal expenditures increase borrowing must decline not only relatively but absolutely as well.

We may also apply this analysis in evaluating some of the methods frequently suggested for financing the defense effort without inflation. For example, there is a widespread notion that inflation can be prevented and higher taxes in some substantial measure forestalled by having the government borrow directly from savers rather than from commercial banks. A related idea is that the form of the bonds employed in financing the government will significantly influence the effects of the fiscal program on the price level. It is frequently urged that the government should issue securities of such characteristics that banks could not or would not invest in them so that no additional bank deposits would be created to swell the volume of circulating medium.

These ideas are in error. Borrowing by the government which exceeds uninvested savings, except insofar as total production can expand, must be inflationary. Borrowing which does not exceed uninvested savings is not inflationary no matter what the apparent source of the funds. This is true regardless of who the individual or institution buying the government bond may be. A defense savings bond paid for by reducing someone's cash balance at a bank may be just as inflationary as the sale of a bond to the bank itself. Only to the extent that the form of the obligations issued actually induces more savings or discourages investment can it exert any influence in preventing inflation. It is difficult to believe that any campaign to sell savings bonds to small investors or to encourage insurance companies to buy more governments can substantially reduce either consumption of goods and services or private investments.

Inflation

The military effort can conceivably be financed in whole or in part by borrowing or creating new money in excess of uninvested savings and beyond possibilities of production expansion. By using this newly created purchasing power the government can acquire the goods and services which it needs. Since a corresponding purchasing power will not have been taken from the public and since production cannot expand by an equal amount, the total purchasing power in the market will exceed the supply of goods at erstwhile prices and prices will rise. So long as this system is used and to the extent to which it is used, the price level must continue to increase.

In addition to classic objections to inflation, there are three particular reasons why it is not a satisfactory device at the present. First, in order for the system to be used with reasonable success, the increases in prices must result primarily in increased incomes which will not be spent and consequently

in an increase in uninvested savings. Insofar as increased disbursements find their way into the hands of persons who will spend them, this method of financing will result in a very rapid and probably intolerable rise in prices. Inflationary financing has worked in past wars because it resulted in high profits which were paid as taxes or which increased uninvested savings. Thus the inflationary process was kept within reasonable bounds. On the other hand, during the present military effort a large portion of the disbursements of new credit in all probability will find its way into the hands of those who will spend it. Adjustments of rates of remuneration to increases in the cost-of-living index have become accepted as an essential part of the prevailing concept of social justice.

A second factor which makes the inflation device a more vulnerable financing method than in the past is the great volume of additional funds now in existence. If there is any substantial increase in prices and the public anticipates still further rises, a great dishoarding may occur which will give an intolerable impetus to the price movement.

Thirdly, the inflationary device is feasible only when the job that is to be done is not too big. The current effort is so stupendous that primary reliance cannot be placed upon this time-honored device.

Price Fixing and Rationing

If we are unwilling to impose sufficiently heavy taxes, or to bid goods and services away from the public by the use of newly created money, we must finance the military effort in a third way. By the rationing of goods, we can limit the

total amount of money which the public can spend. Then the government can borrow, either from the public itself or from the banks, the equivalent of the unspent portion of the public's income.

It is probably safe to say that governments stumble into this means of financing themselves rather than adopt it consciously. The first step in the process is the fixing of maximum prices in an attempt to hold down the cost of living. The vast majority of the public and even most politicians probably believe that this is all that is necessary in order to solve the price problem. But they are soon disillusioned. At the prices fixed, demand for goods exceeds their supply. This is not at all surprising, for otherwise there would be no occasion for setting an upper limit to prices. With the amount demanded exceeding the amount supplied and the automatic price mechanism for equalizing them suspended, someone must decide how much each of the would-be buyers may obtain. In the absence of other arrangements, this duty or prerogative naturally falls on the seller of the goods. Such a procedure quickly results in corruption, favoritism, discrimination--in short, in a condition of chaos in the distribution system.

Under these circumstances, the government is compelled to take to itself the responsibility of apportioning the available supply of goods. This is rationing. When the system of price fixing and rationing becomes widespread throughout the economy, people find that they are forced to save part of their income either in the form of cash or of government bonds because there is no way of spending it. The government can then borrow on a much larger scale without bringing about an increase of prices. If the rationing system is so administered that the amount the public will take of all commodities is no greater than the government is

prepared to let them have, then the government can borrow 100 percent of its needs without fear of inflation, and a new method of financing the government is evolved. We thus see that by indirection and without conscious realization of what is happening, governments stumble upon a third system of financing. With inadequate taxes, prices rise; this leads to price fixing which in turn entails rationing; with an adequate rationing system the government can finance itself through borrowing without inflationary consequences.

The general characteristics of a regime of price fixing and rationing are insufficiently recognized. Rationing is the distribution of the resources and economic products of a nation through some method other than prices. It is a planned economic system. The quantities and types of goods produced are determined by the judgment of government officials. The consumer is no longer free to use his money to buy what he wants at the ruling prices, but someone decides for him which articles and how much of each he may buy. Instead of the present system of consumer choice and free enterprise, the economic system is operated by those who determine the prices and the rations. This means that the government in effect operates the economic system.

In judging whether or not we wish to adopt such a system in this time of emergency, the following seven factors should be given consideration. First, the administration of such a system will be one of immense difficulty. We have no assurance that the government will be able to create a bureaucracy which can satisfactorily determine how much of each commodity shall be produced and how it shall be distributed. The enforcement of rations among millions of consumers through hundreds of thousands of outlets and the determination of thousands of prices is a stupendous task. In European countries rationing has necessitated the creation of a gigantic bureaucracy supplemented by a system of espionage. In

spite of all this, enforcement is extremely difficult and evasion is rampant. In this country with our vast expanse of territory, our large number of actually or potentially self-sufficient persons, and our disinclination to bow unquestioningly to authority, the difficulties would be immensely greater.

Second, each individual will be told exactly what he can consume. Third, persons in the middle and upper income groups will have no consumption advantage over those in lower income groups. Fourth, this completely equalitarian distribution system may greatly reduce the efficiency of the economic system by reducing incentives to work extra hours or to work at more difficult tasks or to move to tasks where there is greater need. If getting an increased income will not increase the amount which one may consume, there will be little pecuniary incentive for the individual to attempt to increase his income. And, if there is no adequate pecuniary incentive for the individual to apply his services where they are most needed on a basis of what he is paid, then, fifth, the state will have to dictate to every individual where he shall work and how much he shall work, thus achieving a system which might be termed state slavery.

Sixth, a system of rationing would necessitate a much more powerful government than would a system of taxation adequate to prevent inflation and to carry the war burden. Seventh, an economic system not operated by the government is much more possible in the post-war era if we have not instituted a system of government operation during the war.

The Choice

In carrying on the war effort, therefore, we have to choose between heavy taxes, inflation, or a system of rationing which implies essential abandonment of the private business system. The public need to recognize that this is the choice which is being made. They know that both taxation and inflation are disagreeable. They do not realize that if they refuse to accept either of them they

will inevitably find rationing forced upon them. They may not be much impressed by the abstract argument that rationing and price fixing involve suspension of the system of free enterprise, but they should be impressed with the effects of rationing on their daily lives. If they could be convinced that an all-out war effort involved, for example, either giving the government fifty percent of their income while remaining free to spend the other fifty percent as they pleased, or, on the other hand, having the government--through a gigantic and cumbersome bureaucracy--dole out to them an amount of goods in prescribed proportions equal to fifty percent of their customary consumption, they might greatly prefer the former arrangement. If it is true that we must have either taxation or rationing, the public need to understand the essential characteristics and implications of both systems and to choose between them on their merits, rather than blindly to accept the rationing system by default.

Unfortunately, the character of the approach to the problem common in many quarters indicates that the inevitability of this choice is not generally understood. It is sometimes urged that, whatever the level of taxes necessary to prevent inflation may be, increases to this level should be made gradually because of the extreme hardship involved. Those who argue this way either are ignorant of, or refuse to face, the fact that in our present situation we have no escape from extreme hardship. If we refuse to pay the price of military security in the form of adequately high taxes, we must pay it in the form of a higher cost of living in relation to our income or else in the form of reduced rations of the things of daily consumption. But pay we must, and the sooner everyone understands this the sooner will it be possible to make an intelligent decision as to the least harmful and least disagreeable way of paying.

The future structure of our economic system depends very largely upon the fiscal policy which we follow during this military effort. Widespread opinion has long existed that fiscal policy is not merely a means of raising given revenues, but a primary device for monetary control, business-cycle control, and determination of the amount of the national income. Now we must recognize that fiscal policy, particularly at a time like the present when government expenditures bulk so large, is one of the keys to the nature of our future economic system. If we wish to preserve a private business system, we may be able to do so by means of taxes of the order of magnitude of government expenditures. If we keep taxes low and adopt a system of price controls and rationing, we shall effectively promote government operation of the economic system. Those who object to financing the war through taxes cast their vote for an administered economy.

We may well ask why we should expect results to follow from this war effort which did not follow from the war effort of 1917-18. Though we did have an inflation, though we did control prices and ration goods, we did revert after the war to an economic system quite comparable to that which prevailed before.

Several brief points suggesting the answer to this question may be made. First, we know that many European countries which were more intensively involved in the first war than we were never did achieve anything approximating their pre-war economies. Second, our military effort during the first World War was of much shorter duration than it bids fair to be in this war. Third, a smaller proportion of our national income was devoted to military purposes than we very likely will devote in this effort. Fourth, we depended primarily upon the taxation and inflation devices and took only a few tentative steps in the field of

price fixing and rationing. In conclusion, we may say that if in this effort we do depend upon taxation and inflation to the same relative extent and make no more use of rationing than we did in the last war, then it is true that so far as this type of economic consideration is concerned, there is no more reason to suppose that we will have difficulty reverting to our pre-war status than on the previous occasion.

The Positive Case for Rationing

While as a political reality rationing is adopted by default and not as a deliberate choice, a body of doctrine has developed supporting the system as the most desirable of possible procedures. Its defense rests on two bases-- equity and productivity.

Nothing very conclusive can be said about the equity argument. There are always many intelligent and high-minded persons who think that an equalitarian system of economic distribution should be adopted. We are all acquainted with the very plausible arguments in support of a communist economic system, both on the distribution side and on the production side. To date we have voted to retain a non-equalitarian system. There are some of us who believe that while a great deal may be done to limit inequality, retention of a substantial amount of inequality, giving rewards in some relation to productivity, is conducive to efficiency and to the greatest human welfare. These matters are not capable of conclusive proof. Certainly it is futile for me to say any more on the subject here.

If an equalitarian system is not desirable in peace, however, in my opinion, it is not desirable in war. I do believe that we can and should reduce inequalities during the war. The burden of the war should be borne largely by

the higher income groups, not by the lower, and as the war burden increases, the costs should be met not by increasing the levies on the lower income groups but by moving downward the line of demarcation between the high and the low. Thus we can, through progressive taxation, while still retaining a system of income differentials, keep the costs of the war off the poor. Indeed, if for no other reason, we should do so merely on the grounds that their incomes are now no more than is necessary to maintain efficiency.

Looked at from one standpoint, the rationing system is one of spurious equalitarianism. If a high progressive tax system were used to finance the war, the higher income classes would be able to increase their wealth very little during the war. If the rationing system is used, the high income groups will increase their wealth during the war and have much greater economic claims in the post-war period. On the other hand, a highly progressive tax system may, in fact, result in about as close an approximation of equalitarianism as rationing. If the income after taxes of the \$5,000 man is \$2,500, and the income of the \$1,500 man is not touched, the former may have sufficient obligations in the way of house amortization, insurance premiums, etc., that he will be able to buy goods in the market at no greater rate than the \$1,500 man.

Let us now turn to the productivity argument for rationing. Those who argue for rationing on the basis of maximum productivity claim that to institute heavy taxation as soon as prices begin to rise is to restrict production unnecessarily. Price rises, they assert, are the result of bottlenecks; and when a large segment of the economy is given over to the production of military goods, bottlenecks are reached more rapidly than in peacetime when different types of resources are utilized at a more uniform rate. If an attempt is made to keep

the price level from rising by the use of the over-all method of taxes, the result will be to cut off prematurely the increase in the national income and to prevent the utilization of resources which are still unemployed. It follows, so the argument runs, that the military effort is prevented from attaining its maximum potential effectiveness. Instead of increasing taxes, they argue, the government should continue to borrow in excess of uninvested savings and, as successive bottlenecks arise, it should fix prices and ration in the affected areas.

This line of argument might be more plausible if the elements of the cost of living which are rising most were not precisely those fields, such as food and clothing, into which purchasing power, according to the theory, might be expected to flow and in which production might be expected to expand without great price increases. Price control and rationing in this case could not have increased production by forcing purchasing power into fields operating below capacity since the fields of the price rise are presumably the classic fields of overcapacity. The use of the fiscal device to prevent undue rises in the costs of living will not, in the main, limit the expansion in fields of unused capacity, since the chief items in the cost of living, for example, food, clothing, etc., are precisely the fields in which are to be found most of whatever unused capacity does exist.

Finally, even if there were some evidence that further expansion of purchasing power coordinated with proper price fixing and rationing would increase production, it does not necessarily follow that such an increase in production would be desirable. We are primarily interested at the present time not in maximum production as such but in maximum military effort. Unfortunately, expansion of civilian goods production in a wartime emergency inevitably involves some alternative military costs, that is, some sacrifice in military production.

There is scarcely a single civilian goods industry which can be expanded without using resources in manpower or materials which could have otherwise made some contribution to the military effort. If price control and rationing will actually expand total production and employment, they will do so at the price of maximum military effort.

Characteristics of a Tax Program

Whether or not either inflation or rationing is employed in part to finance the defense program, substantial increases in taxation have been and will continue to be made. Accordingly, the problem of devising a tax system which will fairly allocate the burden of taxes without imposing undue restraints upon output will become progressively more important.

In this discussion, I propose to include as types of taxes both social security levies and forced loans. Like income and other taxes, both represent direct and straightforward methods of transferring purchasing power from the public to the government. As far as immediate effects are concerned, it makes only minor difference whether the public is given a tax receipt, a claim to benefits in the event of future contingencies, or a government bond. Variations in effect are no greater than variations between different types of taxes.

Criteria of Taxation for Defense Purposes

In general there is no reason why the characteristics of an equitable tax system in time of war should be different from that in time of peace. In either situation a progressive tax system is desirable. I believe that we should aim at substituting the graduated personal income tax for regressive levies in time of peace. Likewise, in the event of war or of other increased need for tax revenue, I believe we should also depend upon the graduated personal income tax for the

bulk of additional revenues.

The type of tax structure we must have will depend in large measure on our decision as to what part of our total requirements is to be raised by taxes and what part by borrowing. Our choice lies between two extremes. We can choose the smallest amount of taxes, i.e., the largest amount of borrowing, consistent with stable prices. This implies a very regressive tax system. Or we can choose to borrow the smallest amount possible, i.e., tax the largest amount possible, consistent with stable prices and full employment. This would require a highly progressive tax system, as progressive as one could impose and still maintain adequate incentives.

It is the duty of public officials to present the choice between these two extremes to the public. I am inclined to believe that if the issues were properly submitted they would choose the latter alternative, namely the high taxes, the low borrowing, the progressive tax system.

Despite the fact that there may not be unanimity of opinion on the proper choice between these two types of taxation, there is scarcely any segment of the population which ought not (in its own self interest) to prefer either of them to the alternatives of inflation or rationing. For this reason it is most regrettable that some groups oppose all proposed taxes which are not to their liking. By doing so, they are in effect opposing any taxation and thus inviting either inflation or rationing.

Allocation of Burden among Income Groups

If it be granted that it is desirable to finance the defense effort principally by taxes and that a progressive system of taxation is the best, the real problem lies in deciding the degree of progression desirable.

The tax system prevailing in this country in the immediate past has not been a satisfactory example of progression. A TNEC study has shown that for levels of income below \$1,000, total tax payments, Federal, state and local, direct and indirect, have been definitely regressive; for levels of income between \$1,000 and \$10,000, tax payments have been roughly proportional to income. Only for income groups above \$10,000 has there been effective progression.^{1/}

If we are to finance an all-out war effort by taxation and the very modest amount of borrowing that will be possible without creating general price increases, it will be necessary to bear very much more heavily on the so-called middle-income groups. This is particularly true because of the present lack of progression in the tax system in this important area in the past. The Revenue Act of 1941 recognized this fact, but did not go far enough either in providing sufficient additional revenue or in stepping up the effective rates on the middle groups. If the war effort should require as much as half the national income, then taxes should amount to nearly half the national income. In this event, in view of the limited productivity of higher taxes on the upper income brackets, and in view of the necessity for exempting from taxation amounts necessary to maintain efficiency, the middle-income groups must certainly bear an over-all tax burden amounting to at least 50 percent of their total income. For example, a man with \$4,000 in income probably should pay 50 percent of this in taxes, and a man with \$10,000 income 70 percent.

^{1/} G. Colm and H. Tarasov, Who Pays the Taxes?, Monograph No. 3, Temporary National Economic Committee, p.6.

The hardships involved in such a program are more apparent to the general public in advance, but, as we have already seen, they are less severe than the hardships involved in any other type of program which diverts an equally large share of the total national income to the defense effort. Opposition of the middle-income and upper-income groups to higher taxes, therefore, in my opinion, is misguided and short-sighted. If adequate taxes are not adopted, and inflation is prevented by wide-spread adoption of price control and rationing, the rations allotted to these groups will certainly restrict their consumption more narrowly than the highest conceivable taxes. In fact, this is considered by advocates of rationing to be one of its major virtues. More important, in the long run, by opposing adequate taxes the middle and upper income groups will be helping to destroy the very kind of economic system of which they are the prime beneficiaries.

Not only should the middle-income groups bear very much heavier tax burdens, if the defense effort is in any substantial measure to be financed by taxation, but those of us whose incomes have increased little or not at all, in my opinion, must be subject to the same tax rates as those whose incomes have increased as a direct or indirect result of the defense program. We with fixed (or relatively fixed) incomes are inclined to think that only those whose incomes have benefited from the defense effort should be subject to taxation to pay for it. Many of us, I fear, cannot understand why we whose incomes are not increasing should be required to reduce our consumption except when civilian production is declining and then only in proportion to the total reduction in civilian consumption.

The answer is that to feed, clothe, and otherwise maintain the newly employed or more effectively employed producers, we must grant them consumption goods greater in amount than the increased production of such goods. We cannot expect the newly employed and the more effectively employed to produce all the military goods plus all their increased consumption. They may be able for a time to provide all of the military output and part of their consumption, but the rest of their consumption must come from a reduction of consumption on the part of those whose income status has not changed. It is a curious idea that the burden of the war should be borne by those who were badly off before the war while those who were well off both before and during the war should be treated very gently. Finally, unless we propose to supplant the free enterprise system of incentives with a system of state slavery, persons must be allowed to retain a portion of the gains which they receive from accepting employment, working harder or longer, or changing jobs.

The idea of taxing in such a manner that no one would benefit from preparation for war is defensible only in terms of the widely circulated doctrine of earlier years that it was a method of avoiding preparation for war. But if it is now public policy to prepare for war, this reason for removing benefits from war has disappeared. Indeed, on the basis of incentive considerations there is now reason for taxing the defense increments of income less intensively rather than more intensively. Insofar as the benefit doctrine deserves any consideration in this connection, surely the man with a consistently higher income has more to gain from preserving our way of life than one who receives this income for the first time.

In the last war the fallacy was prevalent that the burden of the war could be avoided by borrowing. In this war the prevailing fallacy is that sacrifice

can be avoided by taxing primarily those whose incomes benefit from the increase in total national production. The fact that the military effort in its initial steps has been accompanied by an increase in total national production, however, has little bearing on the extent of the sacrifices required of the fixed income groups. If we had started the defense program at a time of full employment, there would not have been much question of the inevitability of immediate sacrifices. Since we started with unemployment, there seems to have been a feeling that until full employment was reached, no one needed to make any sacrifices and that then the sacrifices need be only to the extent of any decline in the production of civilian goods. Actually, it is necessary that the group whose employment status is not changed must bear nearly as great a burden from the beginning as though full employment had prevailed throughout the military effort. The increased production of the country must go largely to military ends. The increased consumption of those who have received additional or better paid employment must come largely from reduction of consumption by the fixed income groups.

Conclusion

In summary I have tried to make the following points.

1. Inadequate taxes will cause a great and possibly permanent revolution in our economic structure.
2. It is to the selfish interest of the middle and fixed income groups to pay greatly increased taxes now before total production of civilian goods declines and to pay even heavier taxes which will leave them little more than a mere subsistence when we achieve an all-out effort.
3. The form in which government obligations are issued, the purchasers who acquire them, and whether or not such obligations are acquired by the banks are of little significance.