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CHAPTER 6

Desirable Amounts of Taxation and Borrowing

As WE HAVE SEEN, the immediate practical task of war financing consists largely in reducing civilian use of resources needed for the military program and in preventing the inflation that might develop because civilians have more money to spend on fewer goods. The general role of financial measures was outlined in Chapter 4, and the progressively important role of direct controls, in Chapter 5. We now examine the principal considerations bearing upon the choice of financial methods, especially the relative reliance to be placed upon taxation and borrowing.

Financial methods play a dual role in war. First, to the extent that we continue to employ competitive prices, the profit system, and private initiative, financial methods serve in the ways outlined in Chapter 4 to stimulate output and to facilitate the diversion of economic activity to the war effort. Second, the specific financial methods we use influence profoundly the ultimate distribution of the economic costs of the war among the population; and this second function remains even when direct and detailed governmental prescription—by rationing, production restrictions, price-fixing, etc. —is partly or largely substituted for finance in the first function. Thus, even if a universal rationing system imposed an approximately uniform level of consumption upon all citizens during the war, the ultimate distribution of the economic costs of the war among them would vary according to the manner and extent to which the government promised to reimburse them in the future for their unequal sacrifices and services in the present.

In practice, important areas of economic activity will continue to exist even in 'total war' within which the influence of financial incentives and financial guides to production and consumption cannot wisely be ignored. Further, the very effectiveness of the direct controls will be conditioned in some fields by the government's financial policies. If, for example, the government's fiscal methods do not succeed in mopping up private money incomes sufficiently, its rationing and price restrictions will become more difficult to enforce. Surplus money incomes that cannot be spent in the lawful markets will tend to overflow into 'black' or illegal markets, driving up prices in the latter and, even worse, providing large rewards for the diversion of resources from military to civilian uses.

We shall find that our choice among the combinations of financial methods open to us will be properly influenced by several considerations of both immediate and longer-run character. The possible combinations of methods differ in the way they distribute the immediate economic sacrifices of war among the population; in the degree to which they preserve or modify inequalities in the distribution of wealth; in their psychological effects upon the public, and in the private economic incentives they offer for extra wartime effort; and in their postwar effects upon our monetary system. These and similar considerations will enter into our analysis in this chapter and will receive further attention later in the book.

1 THE SPENDING BALANCE

To avoid inflation and otherwise to promote the war program, one objective of financial methods and direct controls alike should be to achieve what may be termed a 'spending balance'. Aggregate spending, public and private, should approximate that needed to take up the total output of goods without substantial change in the price level. However prodigious the increase in the government's spending, a spending balance can be achieved and maintained if this increase is offset by the combination of a reduction in private spending and an expansion in the output of real goods and services. A spending balance for our war economy as a whole is possible even if the federal budget remains heavily unbalanced and the public debt increases enormously. These developments might create difficulties in the long run, but to the extent that they are accompanied by increases in output and reductions in current civilian spending—as by the use of civilian incomes to purchase government bonds instead of goods—they are compatible with the maintenance of a spending balance in the short run.

During the first year or so following the inauguration of the defense program in May 1940, the increase in government spending was more than matched by the accompanying increase in the national output. Consequently, the expansion in private spending did not raise prices much. During the fiscal year 1942, however, the sharp increase in the government's spending was not fully offset by the accompanying increase in output or by a curtailment of private spending, and prices rose significantly. During the fiscal year 1943 government spending is scheduled to leap to the huge sum of $76 billion, while only modest further increases can be expected in the national output. In consequence, a close approach to a spending balance will require that civilians forego the private spending of an amount of current money income equal roughly to total government expenditures; and they must also forego, on net balance, the private spending of accumulated liquid balances.

To some extent, the total of the government's projected outlays overstates the net curtailment that will be required in private spending to maintain a spending balance. Several important outlays of the federal government, such as those for interest on the accumulated public debt, pensions, and relief payments, are not 'exhaustive'; that is, they do not represent the current use of manpower, materials, etc., and so do not reduce the real resources available for private consumption. The like is true of expenditures for the purchase of land and other previously accumulated resources, prepayments for goods to be produced in the future, and purchases in other countries. In addition, civilian spending may draw upon the exceedingly large stocks of goods with which we started the war.

While the gross total of government outlays therefore overstates the net curtailment required in private spending, the aggregate overstatement on these accounts, which we estimate roughly at $5 billion for the fiscal year 1943, is not large in relation to the projected total outlays. For this reason and because the gross national product during the fiscal year 1943 is likely to be at its immediately realizable maximum, we may conclude that the government must absorb or otherwise immobilize a gross amount of private money income roughly approximating its own total outlays if a close approach to a spending balance is to be achieved and maintained.

2 CHIEF METHODS OF LIMITING PRIVATE SPENDING

The principal methods by which private money incomes can be absorbed or immobilized are four: The government may

1) rely in part upon the normal tendency of civilians to save but may greatly reduce the private use of such savings by priorities, allocations, and other direct limitations upon the purchase of construction materials, machinery, transportation, etc.;
2) induce additional private saving by vigorous publicity campaigns to sell its securities and by limiting the purchase of various consumer goods through rationing and similar procedures, and by sales, excise, and other taxes designed primarily to discourage spending rather than to raise revenue;
3) directly reduce the spendable income of civilians by more taxation;

4) reduce the spendable income of civilians by forced loans.

The first two, in practice, involve government borrowing from voluntary lenders. The fourth also involves government borrowing, but on a compulsory basis. Only the third avoids an increase in the public debt.

3 'VOLUNTARY' RESTRICTION ON PRIVATE SPENDING WILL BE SUBSTANTIAL

We know from experience that, so far as consumers are concerned, a substantial part of the necessary restriction of private spending is likely to be voluntary because consumers tend to save a sizeable portion of their money incomes, particularly when these incomes are increasing.[1] We saw in Chapter 3 that if national income payments rose from $81 billion to $109 billion under certain peacetime conditions, consumers would be likely to increase their expenditures by less than 60 per cent of the increases in their incomes.[2] Some of the remainder would be spent on gifts and direct taxes, but most of it would be saved. The altered distribution of income in favor of the lower income groups during the war will tend to reduce the expected proportion of savings. On the other hand, unusual encouragements to saving will also be operative. Well planned, vigorous, and continuous 'selling campaigns' may induce large numbers of wage earners and others to buy government securities with a portion of every pay check. The wartime impact of priorities, allocations, and rationing in reducing or eliminating the availability of numerous important consumer goods, such as automobiles and electric refrigerators, may be counted on to exert an even more powerful influence toward saving. A man who is prevented from buying an automobile because his job does not entitle him to a preferential status is not likely to spend the entire purchase money for other goods: he is likely to save some of it.

The private use of these savings and of the gross savings of business enterprises for non-military purposes is made difficult by governmental restrictions upon the purchase of construction materials, plant equipment, and inventories, and it may be further limited by restrictions upon granting bank credit and upon the issue of new corporate and other securities. Even outlays intended merely to replace the wear and tear of industrial plant and equipment and of residential and commercial property are obstructed. Thus, through its priorities, allocations, and rationing, the government not only influences consumers to spend less, but it also greatly restricts or completely blocks many of the most important private investment outlets for their savings and for the gross savings of business enterprises. The purchase of shares in building and loan associations, the payment of life insurance premiums, and additions to savings bank accounts will formally continue to absorb some of the savings, but the receiving institutions will find relatively few new mortgages or new corporate securities to buy with these funds. They may buy 'old' securities; but this merely transfers the problem of investment to the sellers of the latter. The accumulation of liquid balances in the form of currency and bank deposits, and the direct purchase of government securities are left as the principal outlets for private savings.

To the extent that consumers and business enterprises buy government securities directly with portions of their current money incomes, a corresponding amount of their funds is, of course, transferred to the government. But to the extent that they keep their current savings in the form of idle currency and commercial bank deposits, the government may borrow (and spend) an equivalent amount from commercial banks without causing a net increase in total spending. In the latter case, aggregate currency and bank deposits in the country will be nominally increased, and this may be objectionable for reasons that will be noted presently; but the increase will not upset the current spending balance if it represents only an offset to amounts of current money incomes that individuals and business enterprises have decided to hold as idle cash.

Whether government borrowing is from individuals or from commercial banks is of considerable moment, especially for the future, but it is not the decisive question in connection with the maintenance of the spending balance. The real question is whether the amount of government borrowing (and taxing) represents an equal curtailment of private spending.

Borrowing Reinforced by Direct Controls

In contra-distinction to the compulsory restriction of total private spending the government can accomplish by taxation and compulsory loans, we have termed 'voluntary' the restriction reflected by the accumulation of idle cash balances and the unforced purchase of government securities from current money incomes. In point of fact, however, the distinction between 'voluntary' and 'compulsory' is often blurred. If 90 per cent of the workers in a plant have 'signed up' to have a given proportion of each pay check deducted for the purchase of war bonds and savings stamps, a strong degree of coercion is inevitably exerted upon the remaining 10 per cent of the employees to do likewise. Similarly, if rationing restrictions prevent a man from buying more than a limited (if any) amount of each of a long list of popular consumer goods, and his desire for other goods is already fairly well satisfied, he is likely to add to his bank balance or his holdings of war bonds. Although the government has not specifically compelled him to save more of his money income, his additional savings can scarcely be said to be purely voluntary. On the other hand, an increase in taxes may fail to produce a commensurate reduction in private spending because the higher taxes may be paid with funds which would have been saved in any event—the effect of the compulsory restriction being offset by a reduction in voluntary saving.

In past wars extensive reliance upon voluntary lending has commonly led to substantial price inflation because it has not usually been accompanied by a sufficient restriction of private spending. In this war this weakness of voluntary loans has been overcome or offset in large degree by the enormous and effective use of non-fiscal limitations upon private spending; that is, by priorities, production restrictions, allocations, and rationing. As just indicated, when the governmental authorities place rigid limits upon the physical quantities of many of the necessaries and common luxuries an individual may purchase, establish effective controls over the prices at which these goods are sold, and bar nearly all important avenues of private investment, a substantial curtailment of private spending is brought about even in the absence of additional taxation. Cash balances pile up and government securities are purchased because the competing uses for funds are restricted. Thus, in England and Germany the kinds of goods controlled by direct rationing restrictions have become so numerous and inclusive that the effective power of money to command goods has been greatly impaired. In consequence, judged by the accumulation of idle cash balances and individual and business subscriptions to government war loans, 'voluntary' saving has increased tremendously; and, despite large amounts of government borrowing from commercial banks, the rise of prices during 1941 and the first six months of 1942 was kept within narrow limits.

The greater readiness and ability of all governments to adopt direct controls in this war can be attributed in part to greater recognition of the limitations of the price system in an emergency (see Chapter 5); and in further part to a new appreciation that modern war makes comprehensive demands upon a nation's entire economy. But fundamental to this development has been the great technological progress in recent decades in manufacturing, transportation, and communication. This progress has strikingly furthered centralized control by government.

The restriction of consumption and investment brought about by rationing possesses some distinct advantages over that effected by purely fiscal measures; that is, by taxation or by borrowing unsupplemented by direct controls. By rationing the government can better control the directions and amounts of physical curtailment than by taxation or ordinary borrowing. Restrictions upon consumption become more acceptable to the public generally because inequalities due to differences in wealth or income are eliminated or minimized. The well-to-do, who might otherwise maintain their level of consumption, despite higher taxes, by saving less currently and drawing upon their accumulated savings, are forced to curtail. And when the curtailment that rationing accomplishes is accompanied by an increase in the individual's cash balance or in his holdings of government securities, he has the satisfaction of being compensated for his current sacrifice.

Rationing Total Spending Power

An interesting, suggestive, and logical extension of the rationing device to restrict private consumption and prevent inflation during wartime was projected by Michael Kalecki of Oxford University in an article in the (London) *Banker* of October 1941.[3] Mr. Kalecki proposed that a limit be placed on the sum any individual or family might spend at retail during each week, month, or quarter. The limit could be uniform for all, as Mr. Kalecki originally suggested, or it could be made to vary with the size of income, thereby preserving some degree of inequality in current consumption. Regardless of the amount of his total liquid resources or of his current income, the retail spending of the individual (or family) would be limited to the amount stipulated for his income class. Coupons to the value of the weekly, monthly, or quarterly spending ration would be distributed to all individuals or families and all retail purchases would require payment in these coupons, as well as in money for the full amount of the purchases. Shopkeepers would be able to replenish their stocks from wholesalers and manufacturers only by surrendering coupons to the amount of the retail value of the goods ordered. Mr. Kalecki suggested in addition that his plan could be made the instrument for ensuring minimum family allowances: those whose money incomes were not enough to enable them to use the entire minimum allotment of coupons would be permitted to sell one-half of the remainder to the government. The proceeds of such sale and the rest of their coupons could then be spent on further purchases.

When fairly general and stringent curtailment of consumption is required, limitations upon total spending, in addition to rationing certain goods, might prove a powerful and otherwise valuable instrument for enforcing and distributing restrictions upon consumption, provided its administrative feasibility could be established. It would not eliminate the need for rationing scarce necessities, but it would tend to reduce the number of goods that required rationing. It would prevent an inflationary spilling over of money demand from rationed goods to those free from specific restrictions; and, by narrowing the area within which specific rationing was needed, it would make consumers' choice freer. In all these ways it would reduce the administrative task of specific rationing. It would, in effect, solve the problem that excessive money incomes bring by suspending for the duration the power of money, unsupplemented by rationing coupons, to command goods in general; and it would provide a method for an equitable distribution of the necessary immediate sacrifices.

It would leave other problems unsolved. Unless the unspent incomes were absorbed by taxation, they would accumulate in the form of currency and bank deposits or be invested in government securities. In either form, they would remain as claims upon the future and could easily become great enough to create serious monetary and fiscal problems after the war, as we shall note again presently. To keep these problems within manageable proportions, restriction by this as by other forms of rationing would have to be supplemented by extensive taxation or, as a partial alternative, by compulsory lending.

Spendings Tax

A different proposal with a similar objective calls for a graduated tax on the expended portion of incomes, with certain exemptions. Outlays for life insurance premiums, debt repayments, and capital assets, including bank deposits, government bonds, etc., would not be taxed; but graduated rates would be imposed upon all other expenditures, after a small personal exemption, with possible exceptions for limited amounts paid for medical services, charitable contributions, etc.

Such a tax would differ from ordinary sales and excise taxes: it would be deliberately designed to restrict spending rather than to raise revenue, its rates would be graduated to vary directly with total expenditures, and personal exemptions and similar allowances would be easily possible. It would differ from the personal income tax because only the expênded portions of incomes (and of receipts from sales of property, gifts, etc.) would be taxed, the saved portion being completely exempt. If the rate schedule were severe enough —rising, for example, to several hundred per cent on all expenditures in excess of a stated annual sum—it might accomplish many of the same purposes as the rationing of total spending power. The measure of its success would lie rather in the amount of spending it prevented than in the amount of revenue it raised.

4 BORROWING VERSUS TAXATION

To the extent that the government relies upon voluntary savings and rationing to curtail private spending, it usually obtains the funds for its own spending by borrowing.[4] To the extent that it employs compulsion through fiscal methods to restrict private spending, taxation is the usual weapon, with compulsory lending a supplementary possibility. Traditionally, the principal controversy of war finance has centered on the extent to which resort should be had to borrowing as against taxation, as alternative sources of government funds and as alternative means of restricting private spending.

Despite its many disadvantages, the principal of which will be noted below, borrowing from voluntary lenders may play a highly useful role in war finance. It is capable of diverting large amounts of current savings to the use of the government, and of doing it more quickly and more effectively than is usually possible by taxation. It taps depreciation, depletion, and replacement funds that cannot be reached easily or equitably by taxation. It is more flexible as between individuals and as between enterprises than taxation, avoiding hardship for those with heavy responsibilities or urgent business needs for funds, and yet permitting those who can spare most to make their maximum current contributions to the government. This flexibility and the absence or smaller degree of compulsion permit the transfer to the government of sizeable amounts of purchasing power with minimum disturbance to the financial programs of individuals and enterprises. Further, borrowing interferes far less than taxation with the financial incentives to production, and is far less apt to impair public morale. When a man or a firm receives Treasury bonds or notes in exchange for his money, the subjective effect is very different than if he were to receive a tax receipt. In the latter case, the lender's private wealth is reduced; in the former, it is not.

But, while borrowing from voluntary lenders offers many advantages for reaching funds that would be saved in any event, it is a weak instrument for inducing large *increases* in private saving. In general, taxation is apt to be far more effective for actually curtailing private consumption. Additional taxes not only reduce the current funds of the taxpayer—the purchase of government bonds will do that; they also make him *feel* poorer, and so disposes him to extra economies. When an individual *lends* money to the government on the other hand, he is apt to obtain more of the funds by reducing his other forms of savings, such as a larger bank balance, life insurance, savings accounts, than by curtailing his current consumption. The desire to serve one's country can far more easily lead people to single acts of great energy and courage than to a long series of small self-denials.

Taxation an Aid to Rationing

It is true, as we have seen, that the weak restrictive influence of voluntary lending upon private spending may be reinforced by direct controls—by priorities, allocations, and rationing; but extreme dependence upon such controls, unsupported by fiscal compulsion, accentuates the administrative difficulties and policing problems they involve. The effectiveness of rationing is enhanced when taxation rather than voluntary lending is used to absorb surplus money incomes. When the funds are not taken by taxes, they can spill over into unrestricted avenues of expenditure. To the extent that the productive resources engaged in the unrestricted lines are underemployed and are unsuitable for military production, this is an advantage. Such a condition may well exist in connection with amusement and recreation facilities. But to the extent that the unrestricted lines are only somewhat less vital to the war effort than the restricted, or are already operating at capacity, the diversion of spending to them will necessitate the extension of direct controls to them. Likewise, the policing needed to prevent the development of 'black' markets for the purchase and sale of rationed goods and to prevent the bidding up of prices is likely to be much less if the greater part of the surplus money incomes that tempt people to evasion is taxed away.

In brief, although the curtailment which may be brought about through direct controls possesses some real advantages over that possible by purely fiscal methods, these advantages must not be interpreted as favoring borrowing over taxation. The extensive adoption of direct controls is no less compatible with an enlarged use of taxation than with an enlarged use of borrowing to mop up the resulting surpluses of money incomes. The rationing procedures that make borrowing easier and safer also make heavy taxation more practicable. And when borrowing rather than taxation is used to absorb the private funds dammed up by rationing and price fixing, monetary and fiscal problems are created for the future.

5 DISADVANTAGES OF UNNECESSARY INCREASES IN PUBLIC DEBT

Extensive reliance upon borrowing, compulsory or voluntary, regardless of how strongly the latter is reinforced by direct controls, has several distinct disadvantages. Borrowing leaves a debt, the interest and principal payments on which remain a burden on the fiscal system long after the war is over. Taxation, in contrast, has the enormous advantage of absorbing excess money incomes without creating a troublesome legacy for the future.

As noted in Chapter 1, the war must be mainly paid for as it is fought. If we finance it by borrowing instead of by taxing, the additions to private property we create in the form of Treasury bonds do not represent equal additions to the country's real wealth: the goods which purchase of these bonds enables the government to buy are being mainly shot away or otherwise used up. In consequence, the future burden of the debt will be a 'deadweight'.

Further, financing by borrowing tends to make future inequalities in the distribution of income greater than if the financing were by taxation. A well-to-do person is naturally able both to pay heavier taxes and to buy more bonds than a poor person. To the extent that the financing is by taxation, the heavier contributions of the rich are evidenced by tax receipts which have no claim on the future. But to the extent that the financing is by borrowing, the heavier purchase of bonds by the rich gives them a greater claim on the future income of the country. To pay interest and principal on these bonds, the children and grandchildren of today's poor would have to pay over part of their incomes through the government to the children and grandchildren of the rich. This tendency could be counteracted by imposing heavier taxes on the well-to-do in the future. But this possibility exists whether the debt is increased or not. Hence, except to the extent that the heavier debt itself may be relied on to cause future increases in the relative tax burden upon the rich, borrowing tends to make the future distribution of income more unequal than if taxation were used.[5]

The fiscal problem involved in raising large additional sums annually for debt service is difficult, although virtually all the taxes paid by Americans to service the debt will also be received by Americans (foreigners will hold a negligible proportion of the debt), and these receipts will be subject to taxation in the hands of the recipients. A special tax of 100 per cent on all receipts of interest on the government's war debt would be obviously inequitable. Since taxpayers are not likely to be holders of the government's bonds in amounts nicely proportional to their incomes from other sources, no mechanical adjustment of the income tax rates could be depended upon to make the bondholders pay their own interest. In short, from the standpoint of its demands upon the tax system, an advance in interest charges presents much the same problem of new revenues or reductions in other expenditures as any other new outlays by the government. An increase in debt charges is therefore often a threat to the continuance or expansion of federal outlays for various desirable social services and other governmental activities. And, because interest charges constitute an inflexible item in the budget, they become especially burdensome in bad times when the national income and tax receipts decline. According to the revised budget estimates, issued April 24, 1942, a public debt of $125 billion is expected by June 30, 1943. If the average interest rate on this debt is limited to 2 per cent, government annual interest requirements of $2.5 billion on that date will be more than double those of any preceding year in our history and will be greater than the total yield of the tax on individual incomes in any year between 1917 and 1941.

These well known disadvantages of a larger public debt are not decisive, of course, under all circumstances. They compete with other considerations in both wartime and peacetime. But they are especially pertinent in wartime because the amounts involved dwarf those commonly involved in peacetime borrowing, and because huge wartime increases in the public debt may make future peacetime borrowing more difficult. The contemplated net addition of approximately $76 billion to the interest-bearing public debt during the two years ending June 30, 1943, as forecast in the revised budget estimates, is more than two and a half times the entire increase in the direct and guaranteed debt of the federal government during the entire eight years ended June 30, 1940.

During the great depression of the 'thirties, government borrowing and spending were on a considerable scale in this and several other countries in order to mitigate the economic waste and the human suffering entailed by widespread unemployment. It is to be hoped that we shall some day devise other means than the creation of interest-bearing public debt to maintain a high level of employment and national income in the face of recurring shrinkages in private spending. Meanwhile, however, it is clearly desirable to avoid the creation of any unnecessary obstacles to the peacetime use of deficit spending in times of need.

Postwar Inflation

A grave danger of relying too largely upon voluntary lending, however reinforced by rationing, is postwar inflation. The more serious inflations of the first World War period occurred after rather than during the war. When the government relies heavily upon voluntary loans, the liquid assets of the public, cash and securities, expand by roughly the same amount. If the borrowing is from commercial banks, it is the public's cash that is increased, for as the government spends its newly created deposits, they get into the possession of the public. If the borrowing is from individuals and business enterprises, the latter come into the possession of easily marketable or redeemable securities.

These additions to the total supply of the public's liquid assets may be harmless during the war, especially if the direct restrictions upon private spending are extensive. But at the close of the war, such restrictions are likely to be removed rapidly, and, even if the attempt is made to continue them, their effectiveness is likely to become greatly impaired because of diminished support by public opinion. At such a time, huge idle cash balances and marketable or redeemable government securities in the hands of the public will be accompanied by accumulated shortages in housing, in consumer durable goods, and in plant and equipment for the manufacture of civilian products. Under these conditions, even an extremely rapid conversion of industry to the production of civilian goods might not suffice to prevent disorderly price rises and boom conditions.

The danger of deferred inflationary influences arising from large government borrowing is doubtless greater if the borrowing is from banks than if it is from individuals and business enterprises, for additions to the public's cash are likely to stimulate more spending than equal additions to its holdings of securities. Nevertheless, the difference is often exaggerated. Some persons mistakenly contend that any amount of borrowing will have no inflationary consequences if only it comes from the genuine savings of individuals and enterprises, and that even a small amount of borrowing from commercial banks is necessarily inflationary because it leads to an increase in bank deposits. We have several times called attention to the error involved in the latter belief, for borrowing from commercial banks may merely offset hoarded money. As respects the former, the point is ignored that the possession of marketable government securities may greatly speed up private spending under favorable conditions by inducing people to spend their cash more actively. Such securities serve as a good substitute for cash reserves, and may even serve as money itself. Liberty Bonds were accepted in payment for all manner of goods for some years after the first World War. Unless and until the Treasury securities issued during the war get into the hands of investors who intend to hold them indefinitely as investments, they may, under favoring circumstances, produce many of the same effects as an excessive volume of money.

There are some who, fearing that the greater postwar danger is unemployment and business collapse, regard the accumulation by the public of large cash balances and enormous amounts of marketable securities as a wholesome antidote to this contingency. As against this view, it may be argued that the possibility of an immediate postwar boom is at least as real as that of a slump; and that whereas a present policy of minimizing an increase in the public debt and in money will leave the government's hands free with respect to any volume of public spending which may be needed in the event of a threatened slump, the opposite policy in the present may well leave the government powerless to control a postwar inflation, should the latter threaten. The maintenance of, or actual increases beyond, the wartime rates of taxation, together with a drastic reduction in federal expenditures, would be needed in the latter case to offset the expansion of private spending. But the end of a war and the resumption of peace are apt to make increases in wartime tax rates, or even their maintenance, extremely difficult politically.

6 UNDESIRABLE EFFECTS OF OPPRESSIVE TAXATION

The foregoing considerations create a powerful presumption in favor of financing the war by a minimum of borrowing and a maximum of taxation. But other considerations exert a coercive influence in the opposite direction. One is the usefulness of retaining the strength and reliability of private gain as a motive force in organizing and maximizing production. Extreme rates of taxation, particularly when applied to the marginal or last additions to income, entail serious risk of impairing this force. If, for example, a tax of 100 per cent were imposed upon all business profits in excess of the prewar average, or upon those exceeding 6 per cent on the invested capital, enterprises which were already earning more would be deprived of all private economic incentive for further improvements in efficiency and further reductions in cost, and even for the full maintenance of former standards of efficiency. The usual restraints upon wasteful expenditures would be greatly weakened because such expenditures would be paid for, in effect, by the government. Advertising outlays to build up a long-run goodwill would become exceptionally attractive, and it would become much less worth while than previously to resist rises in prices charged by suppliers, demands for higher wage rates, and the development of small wastes. Similarly, if all increases in individual incomes during the war were to be taxed away, the private incentive for extra effort would be snuffed out. The danger is much less if any part of the increase in income is left to the individual or to the business enterprise; nevertheless it remains grave whenever the marginal rates are high. A worker who receives a dollar an hour for an eight-hour day might well be willing to work an additional two or three hours at an overtime rate of $1.50 an hour, and in some cases even at the regular rate; but if his overtime compensation is subject to an income tax rate of 50 per cent, whereas his regular compensation, because of personal exemption, etc., largely escapes taxation or is taxed at very low rates, the financial incentive for overtime work is greatly weakened.

In partial qualification of the foregoing, it should be noted that heavy taxation may also stimulate effort. Many men may work harder in order to maintain their customary standard of living in the face of higher taxes. Similarly, many business managements will be stimulated to seek extra economies and extra improvements in efficiency in order to maintain their established levels of dividend payments. This tendency of individuals and business enterprises to exert extra effort to overcome the effects of bigger total taxes is most conspicuous, however, when the taxes are determined substantially without regard to current increases in income, or when the increase in taxes takes merely a small share of the increase in income. In the short run, this tends to be true of property taxes, of taxes levied as a percentage of invested capital, and, in less degree, of the normal and first bracket rates of the individual and corporate income tax. Large increases in these types of tax may be compatible with the maintenance of adequate private financial incentives, for they bear relatively lightly if at all upon the *extra* amounts of income resulting from *extra* effort or efficiency. Thus, from the standpoint of direct incentives (though not from other standpoints to be noted presently), it would be preferable to place extra heavy taxes on prewar or normal individual incomes and prewar or normal business profits than on the wartime increases. Although other objectives of tax policies would make it unwise to formulate a tax program with reference solely to the maintenance of private economic incentives, this objective cannot prudently be ignored altogether.

The incentive force of private gain would be of small importance if, at the outbreak of war, the government could quickly and efficiently introduce detailed rules for the complete regulation of economic activity. Compulsion would largely take its place. But in point of fact, a detailed and comprehensive plan has never existed even on paper, and the enormous organization that would be needed to execute and administer it could not be improvised in a few months. Many persons are inclined to exaggerate the extent and character of governmental control of economic activity in wartime America, as in wartime Britain.[6] Direct examination of the powers actually exercised will reveal that the control is not nearly as thoroughgoing as it seems to be. It takes the form of prohibition and limitation primarily, rather than of positive commands. Nearly all internal management and a large part of the external business relations of firms and individuals have remained free from interference. A considerable latitude for initiative and discretion is left for capital, management, and labor. In guiding the exercise of such initiative and discretion, economic incentives may play a highly useful role in wartime, leading management to watch costs and avoid wastes, leading labor to work longer and harder than otherwise and voluntarily to enter the occupations most in demand, and stimulating capital to exercise ingenuity and speed in diverting facilities to military work. Although outright compulsion offers definite advantages in various areas, it is always purchased at the cost of considerable administrative effort; and although patriotism alone is a powerful force and highly effective in some spheres, it is less reliable for guiding daily humdrum activities than for inducing acts of concentrated sacrifice. By supplementing compulsion and patriotism with private economic incentives, we harness to wartime needs a force that economizes administrative burdens and operates steadily through fluctuations in moral fervor. Unless and until direct governmental compulsion can usefully be made detailed and comprehensive enough to provide an adequate substitute, we must be wary of an excessive impairment of the private economic incentives upon which our peacetime economic system is mainly organized.

The advantage of borrowing over taxation in this connection is that the former enables us to utilize the incentive of private gain to a greater degree, yet avoid offering this incentive in the form of present goods. Instead of taxing away extra wages and extra profits, we borrow them away. Individuals and enterprises accumulate bank balances and government securities which will be cashed and spent mainly in the future, or only the interest on which will be spent for a long time to come; yet these claims upon the future may for a considerable period constitute adequately effective rewards for extra economic effort. Undoubtedly some part of the extra wages and extra profits is likely in individual cases to be spent for present goods and services, and this is unfortunate; though it may be offset by extra saving on the part of others.

Civilian Morale

A second, though related, consideration that restrains resort to drastic taxation is the possible damage to civilian morale. There can be little doubt that a feeling of financial wellbeing and of financial progress on the part of individuals and business enterprises can contribute significantly to morale. A box containing $1,000 in government bonds may represent just as great a sacrifice of current spending as a box containing $1,000 of receipted tax bills, but most persons would feel better in possession of the former. The feeling of enhanced financial security born with the acquisition of the bonds would be a strong stimulant to morale. In contrast, taxation so drastic as to compel large numbers of wage and salaried workers to allow their life insurance policies to lapse in default of funds for the payment of premiums, or to force them to discontinue or to trench upon their other forms of individual and family savings, such as savings bank accounts and mortgage payments on residences, could seriously depress the morale of the general public. The same can be said of such stringent taxation of business profits as would prevent the accumulation of customary reserves and of additional reserves against the uncertainties of postwar adjustments.

No competition with the war effort is entailed by permitting individuals and business enterprises to continue such private savings programs, provided the savings are directly or indirectly siphoned off for the use of the government. Life insurance premiums, savings bank accounts, installments on mortgages, etc., do not impinge appreciably upon productive resources. So long as the creditors or other institutions that receive them are prevented from investing them in other ways, if only by the absence of competing investments, the bulk of the funds will become available for investment in Treasury securities. The fact that a greater resort to borrowing as against taxation makes for less disruption of private programs for individual, family, and business security, and may positively aid these programs, exerts a potent influence in favor of borrowing.

Resort to drastic taxation is impeded in the early part of the war because the tolerance of the public for a given scale of rates is closely related to the scale in force. Rates which would require violent adjustments by the public would tend to be regarded as oppressive even if they were high merely *relatively* to those previously in force. The public might tolerate a doubling of its federal income tax payments in each of several succeeding years, whereas a sudden rise of several hundred per cent in a single year might be regarded as intolerable. For this reason, resort to relatively heavier borrowing may be necessary in the early period of the war than later.

In practice, large increases in taxation commonly make for immediate changes in the relative distribution of income and hence are almost certain to produce heated political controversy. Since the incomes of the middle and upper income groups allow a greater margin above subsistence requirements than those of the lower, the former must expect to bear a disproportionately large share of increases in taxes, just as they must expect to buy a disproportionately large share of bonds to the extent that the financing takes place by borrowing. It is natural that they should resist heavily disproportionate advances in taxes. On the other hand, some representatives of the lower income groups will contend that levies on the well-to-do do not go far enough if they leave the latter at all significantly better off than members of the lower income groups. Such controversies may conceivably become so acute as to jeopardize the moral unity of the country and its concentration upon the war effort. Financing by borrowing reduces the area and heat of such controversies because it entails no immediate change in the relative distribution of incomes: members of the upper income groups will retain their relative advantage in money incomes, but they will invest a disproportionately large part of their incomes in government securities. The question of the future distribution of the burden of debt remains: who shall pay the additional taxes needed to service and retire the debt? Thus, borrowing does not finally avoid or solve the problem of distributing the costs of the war. But by postponing that problem, it removes a potent source of domestic controversy during the war. Further, even the future problem may be indefinitely postponed in large part if reductions in the public debt are avoided except when convenient or desirable for special reasons. Such a policy would restrict the need for additional taxes to the amounts required to pay interest alone on the war debt. Various objections may be raised to prolonging such a policy indefinitely, but its obvious political advantages have doubtless been responsible, in some measure, at least, for its traditional use by Great Britain and France.

The requirements of civilian morale do not all run in one direction, however, and they are in partial opposition to the desirability of avoiding types of taxation which impair private financial incentives. The considerations we have noted call for relatively lighter taxation and greater resort to borrowing than would otherwise be indicated; but they apply most clearly to the lower and middle income groups. The situation with respect to large incomes is different. Gross inequalities in income are important sources of discontent even in ordinary times, and especially so in wartime. The spectacle or even the suspicion of large profits being garnered in the munitions and other war industries provokes widespread dissatisfaction; and unusual increases in profits and salaries in civilian industries are little less resented. When sacrifice is universal, equitable considerations are greatly enhanced; and the heavy taxation of all large incomes and unusual profits may well be essential to the maintenance of a high state of morale and a spirit of national unity. The unfavorable practical effects of the impairment of private financial incentives tend to be modified in the short run by several factors: (1) A considerable proportion of very large individual incomes and high rates of business profits is attributable to investments and decisions made in the past, and to this extent their unusual gains depend little upon the current decisions of the recipients. A large income from investments reported by the heir to a large estate may be cited as one of the many examples of this factor. (2) The training and experience of most salaried executives of large corporations is such that they are likely to discharge their duties with the same competence and energy as when their incomes were not heavily taxed. (3) The desire to maintain 'goodwill' stimulates efficient administration. (4) In part, as we have noted, effective and sometimes superior substitutes for private financial incentives may be provided by sentiments of patriotism, on the one hand, and by outright government compulsion and supervision, on the other.

Despite the welter of complex and often contradictory influences, it is clear that taxation may in fact be so heavy and take such forms as to reduce the aggregate national output through its impairment of private financial incentives and of civilian morale in general; and that considerations of this character cannot wisely be ignored in the formulation of wartime fiscal policy.

7 TAXATION AND THE INFLATIONARY GAP

Earlier in this chapter we indicated that our economy as a whole could achieve and maintain a spending balance, thereby avoiding inflation for the time being, even if the public debt increased enormously. The spending balance would be maintained if only the increase in government outlays was matched by a combination of larger total output and curtailed private spending, regardless whether the latter is achieved by taxation or by borrowing. Subsequently, however, we showed that the method is not a matter of indifference, and that, with the important qualifications just discussed which will receive further attention presently, a powerful presumption exists in favor of taxation. Nevertheless, we have also just seen that several considerations point to the desirability of substantial borrowing.

A competing view that has received considerable support is that only so much taxation is desirable as is needed to supplement voluntary curtailment in achieving a spending balance. It stresses that people tend to consume progressively smaller shares of additions to their incomes and to save progressively larger shares. In the language of John Maynard Keynes, the marginal propensity to consume diminishes and the marginal propensity to save increases. The fear is that taxation greater than that needed to supplement voluntary saving in order to achieve a spending balance would lead to a disproportionate reduction in consumption expenditures and, thereby, to a contraction of the national income and a wastage of productive capacity.

Many students have found the Keynesian concepts of the 'marginal propensity to consume' and the 'multiplier' highly illuminating in analyzing peacetime fluctuations in business activity, employment, and the national income. The application of this approach to problems of public policy calls for deliberate deficit spending by the government during depressions, with the objective of raising the national income by compensating for deficiencies in private spending and by stimulating increases in the latter, the deficit being achieved mainly by increasing government expenditures, but also by reducing taxes, or, at any rate, by refraining from raising the latter to cover the increased expenditures.

But however useful this approach may be for problems of public policy at other times, its usefulness in financing an 'all-out' war seems questionable. When government spending is limited almost solely by the availability of productive resources, we do not need to be greatly concerned over the danger of reducing the national income by an excessive contraction of private spending, induced by increased taxation, despite a substantial propensity to save. To the extent that taxation forces civilians to release productive resources through curtailing their private spending, increased resources tend to be made available for the military effort. Government spending can be relied upon to be sufficient to force the national income to its realizable maximum almost regardless of reductions in private spending, for it will absorb the resources released.

The only important qualification is that reductions in private spending may release some resources that are not useful for military purposes. If a theatrical performance is going to be presented, vacant seats do not add directly or indirectly to our resources for fighting. The possibility of such wastes is real, and every effort should be made to minimize them, even by subsidizing goods and services which do not compete with the war program, as has been done in Germany. But some wastage of resources and some unemployment of men and capital facilities operate powerfully to induce the transfer of resources to industries serving the war. Moreover, the danger that taxtion will cause needless curtailment of private spending is greater in the degree that the war calls mainly for highly specialized goods and skills. In the last analysis, however, there are relatively few skills, factories, materials, and other resources that cannot be harnessed, directly or indirectly, to an 'all-out' war. Given the organizing ability and the time required to put them where they can serve best, a very great proportion of our total resources can contribute to the war. A federal budget that calls for military expenditures of $70 billion in a single year, which approaches one-half of the nation's expected gross product, must obviously draw upon a very wide array of resources. The useful expenditure of anything like this sum will itself be possible only if curtailment in private spending is widespread. In view of the mounting demands of the war in midsummer 1942, and the rapidly maturing technical organization for their satisfaction, we may conclude that the practical danger of wasting productive resources by an excessive reduction in private spending, brought about by severe taxation, had by then become remote.

The concept of an inflationary gap is nevertheless useful.[7] Several varieties of this concept may be distinguished, but for our present purpose it is best regarded as the amount by which the dollar volume of spending must be curtailed to avoid an inflationary rise in prices. In other words, it is useful because it focuses attention upon the size of one of the most important, though not the sole, of the tasks of wartime fiscal policy—to avoid inflation. But the tendency of many persons to identify the estimated inflationary gap with the desirable additional tax revenues is objectionable on several grounds. In the first place, a given inflationary gap may be closed by other methods than taxation, in whole or in part, such as further rationing or greater coercion or outright compulsion in lending. In the second place, apart from the objective of preventing inflation, the growth in the public debt should be minimized. Taxation greater than the minimum amounts needed to close the inflationary gap may be desirable for the latter reason. In the third place, different types of tax exert varying degrees of restrictive effect upon private spending, so that the additional tax revenues required to close a given inflationary gap, assuming that taxation alone were to be used, might be larger or smaller, depending upon the types of taxation contemplated. Heavy taxes on business profits and on large personal incomes do not powerfully curtail private consumption, since they are paid at the expense of savings, in considerable degree. Hence a disproportionately large increase in tax revenues would be required if increases in these taxes were being relied upon to effect the needed curtailment; though the extra revenues would serve the highly useful purpose of retarding the growth of the public debt. We conclude that the estimated size of the inflationary gap at any time is of great significance for the determination of taxation and other aspects of wartime fiscal policy; but that it is a mistake to regard the gap as an appropriate measure, by itself, of the desirable amount of taxation, or to regard taxation as the one possible method of closing the gap.

8 DESIRABLE AMOUNTS OF BORROWING

On the basis of all the different issues, is it possible to arrive at an ideal combination of taxation and borrowing—the proportions or amounts that would be universally most desirable?

The answer is clearly no. There is no one combination of taxation and borrowing that would be ideal under all conditions. The relative importance of the various factors which should influence our choice is not always the same. At one time, greater weight may be given to minimizing postwar fiscal and monetary burdens by more vigorous taxation in lieu of borrowing; at another time, maintaining public morale may justly exert greater influence, and may warrant a relatively larger resort to borrowing. No single criterion is decisive under all circumstances. Even the urgent desirability of avoiding inflation is not by itself a sufficient test: on the one hand, a moderate rise in prices might be preferable to the dislocations and impairment of incentives that might ensue from a violent increase in taxes; and on the other hand, inflation may be fought with other weapons, including borrowing itself, particularly when compulsory or reinforced by rationing. The determination of the most suitable amounts and proportions of taxation and borrowing under any given circumstances is a matter of art as much as of science.

Are there any grounds, nevertheless, on which we can approach an estimate of the desirable amounts of borrowing in the present circumstances? Some rough indications have already been suggested. *First,* we would like to avoid so large a volume of voluntary borrowing that a substantial degree of inflation would be stimulated. Very great reliance upon borrowing would tend toward inflation because the accompanying curtailment of private spending would be inadequate. *Second,* we do not wish to borrow even as much as might be non-inflationary, if we can avoid it, because of the fiscal and monetary difficulties created for the future. *Third,* we noted some positive reasons for preferring certain amounts of borrowing in lieu of taxation. We noted the desirability of minimizing disruption to programs for personal and family security, and for maintaining the financial strength of private business organizations; likewise, the desirability of fostering morale and maintaining private economic incentives. To these might be added certain equitable considerations, such as the merit of providing future compensation for those from whom extraordinary sacrifices are now being exacted. All these purposes may be furthered by issuing government securities instead of tax receipts in exchange for a portion of the private funds the government absorbs. Rough estimates of the borrowing, rather than taxation, that would be desirable to take care of these types of needs can be made:

1) The net excess of receipts over disbursements of life insurance companies approximates $1.5 billion annually. It would be desirable to borrow these funds from the insurance companies, rather than to tax them away in the hands of the policyholders. The life insurance companies themselves may not directly invest the entire $1.5 billion in government securities; but, assuming the absence of new issues of non-government securities and the unavailability of mortgages on new construction, all their additional investments would have to consist of either government obligations or old securities previously owned by others. To the extent that they buy old securities, the sellers come into possession of funds for which no important avenues of investment will be open other than government obligations.
2) Additions to individual savings in the form of currency and bank deposits have been exceeding $3.5 billion a year.[8] The mere fact that the volume of money and bank deposits in the country has been increasing would tend to add to the liquid balances of individuals, because

they, rather than business concerns, commonly hold the bulk of such balances. Nevertheless, the growth in recent years, until 1940, was not accompanied by lasting price increases and seemed to reflect a stronger desire to hold wealth in liquid form. If individuals, in response to an urge for liquidity, continue to make additions of this size to their savings in this form, more securities can properly be sold to commercial banks. Indeed, the one way in which the demand for additional cash balances can be met is by creating new money.

3) Most individuals will be prevented by priorities from making extensive repairs and from building or buying new houses. Some $1.5 billion may be allowed as additional gross savings for satisfying these needs later. Doubtless many individuals who would ordinarily have bought houses will not save in cash or in government bonds the full amount they would have invested in the houses, but will use some of it in other ways. Many other potential home-buyers, however, will accumulate such funds, particularly because several important competing uses, such as automobiles, will not be available, and because of the bond-selling campaigns.

4) Business enterprises, in order that their financial integrity may be maintained, should obtain assets, cash or securities mainly, corresponding to the unreplaced depreciation and depletion of their capital assets and the net liquidation of their inventories, the aggregate of which for the fiscal year 1943 may be about $5.5 billion. An additional $1 billion may be allowed for reinvested profits.

5) Private assets needed to offset the unreplaced depreciation of farm machinery and buildings would amount to about $1 billion. Actual depreciation accounting is not common, and the limitations imposed by priorities upon the replacement expenditures would merely release such funds for other uses. Nevertheless, substantial amounts

will at least mentally be ear-marked for future replacements.

6) To all these provisions for maintaining the financial security of individuals and business enterprises, the government might add perhaps $6.5 billion of borrowing in lieu of taxation in order to foster and sustain a high state of public morale. Some $4.5 billion of securities could be considered an offset against the unreplaced depreciation of private passenger automobiles and other consumer durable goods, replacement of which will be impossible for most people during the war; and the other $2 billion could be viewed as a provision for stimulating and rewarding extra exertions.

The figures summarized in Table 12 are estimates of the borrowing that can be justified on various specific grounds apart from the question of inflation. Were there a conflict between the borrowing deemed desirable on these positive grounds and the limitations imposed by the threat of inflation, a powerful reason would exist for less borrowing. But in the present situation, it is probable that significantly more borrowing than the total indicated could be undertaken without inflationary consequences. The greater part of the amounts listed in Table 12 represents funds that would be saved in any event, the normal investment outlets for which will be temporarily unavailable. In the absence of heavier taxation than that officially proposed, it is likely that 'voluntary' savings would substantially exceed $20 billion, particularly if the rapid extension of direct governmental restrictions upon private spending continues.

Nevertheless, were borrowing limited to roughly the total in Table 12 and the remainder of the potential savings taxed away, the private capital assets of individuals and enterprises in the United States would be increased during the fiscal year 1943 by a net amount of some $12 billion, a greater sum than the aggregate capital formation in this country in any preceding year.[9] Even after deducting from this net gain the sums representing the unreplaced depreciation of consumer durable goods, the net increase in private wealth would be substantially greater than that of any recent year. Such borrowing would seem ample for maintaining morale and

TABLE 12

Estimated Government Borrowing * Sufficient in the Fiscal Year 1943 to provide Private Offsets to Unreplaced Depreciation and to make greater Net Additions to Private Capital Assets than in any Preceding Year.

To provide offsets against unreplaced depreciation of capital goods

	BILLIONS OF CURRENT DOLLARS
Business plant & equipment	3.0
Net liquidation of business inventories	2.5
Farm machinery & buildings	1.0
Residential housing	1.5
Sub-Total	8.0

To provide net additions to private capital assets & to offset unreplaced depreciation of consumer durable goods

Additions to:	
life insurance equities	1.5
cash balances of individuals	3.5
Extra savings of individuals	2.5
To offset depreciation of:	
passenger automobiles	2.5
other consumer durable goods	2.0
Sub-Total	12.0
Total Borrowing	20.0

* Other than that arising from the issue of Treasury securities to the Social Security and other government trust funds.

economic incentives. Yet, if public borrowing were to be limited to $20 billion, tax revenues and trust fund receipts for the fiscal year 1943 would have to approximate $56 billion, as compared with $14 billion in the year ended June 30, 1942.

United States Budget for 1943 Relies Largely upon Voluntary Restriction of Private Spending

Major reliance upon the voluntary restriction of private spending was implicit in President Roosevelt's Budget Message of January 7, 1942. By rearranging certain of the budget figures (Table 13) we see that tax revenues and the net re-

TABLE 13

Dependence upon Voluntary Curtailment of Private Spending Implied in Federal Budgets for 1942 and 1943
(billions of current dollars)

	FISCAL YEAR	
	1942 [a]	*1943* [b]
Total federal expenditures excl. debt retirement and non-cash outlays but incl. net outlays of government corporations [c] (roughly equals the amount of private money income to be immobilized or absorbed, assuming the national income to be at its immediately realizable maximum) [d]	34	76
Less: Total federal tax collections, incl. net receipts of governmental trust funds, and miscellaneous receipts, assuming enactment of new laws to raise $7 billion in 1943 in additional ordinary revenues and $2 billion in additions to the social security trust funds	14	28
Remainder: Dependence upon voluntary restrictions of private spending, represented by sales of government obligations to savers and banks [d]	20	48

[a] Based on Daily Treasury Statement figures.
[b] Based upon the President's budget message of January 7, 1942, and revised budget estimates issued April 24, 1942.
[c] Does not include amounts advanced by federal government to government corporations for debt redemption nor federal securities transferred to Old Age and other government trust funds in payment of congressional appropriations and of interest on their holdings of government securities.
[d] The needed amount of private curtailment is somewhat overstated because some federal expenditures, roughly estimated at $5 billion in 1943, do not represent commensurate drafts upon the country's current productive capacity. Such outlays include so-called transfer expenditures, such as relief and interest payments, purchases of land, pre-payments for goods to be produced in the future, and expenditures outside of continental United States.

Private spending here covers all non-federal spending, including that of state and local governments, and private money income refers to the gross money incomes of all recipients other than the federal government.

ceipts of governmental trust funds provided for only 40 per cent of the government's total outlays in the fiscal year 1942; and that these sources, after allowance for additional receipts of $7 billion from proposed new tax legislation and $2 billion from proposed increases in the levies made for the Social Security trust funds, were expected to provide for only 37 per cent in the fiscal year 1943. The remainder was to be borrowed from the public and the banks, presumably on a voluntary basis. As we have indicated, part of the funds might be lent the government directly by the savers; part, by the savings banks, life insurance companies, and other institutions through which individuals are wont to invest their savings; and funds equal to the portion of the voluntary savings the savers prefer to hold in the form of currency and commercial bank deposits might properly be borrowed from commercial banks.

Unless our estimates of the practicable increase in the output of real goods and services should prove substantially too low, nearly all this borrowing would have to represent a commensurate curtailment in the spending of private money incomes if a very marked rise in the price level is to be avoided. In other words, the government's program at the beginning of the fiscal year 1943 implicitly contemplated that not much less than $48 billion of private money incomes would be 'voluntarily' saved. But such enormous reliance upon voluntary saving is exceedingly dangerous. On the one hand, drastically greater resort to rationing and other direct restrictions upon private spending would doubtless be essential to realize any such amount of 'voluntary' saving. On the other hand, the very retention by consumers and enterprises of any such amount of surplus money income would itself undermine the price and rationing restrictions.

The budget for the fiscal year 1943 contemplates an increase of approximately $14 billion, or 100 per cent, in tax and trust fund receipts over those of 1942; although the increases contemplated by the President in the social security and other levies were still not enacted by the opening of that year on July 1, 1942. A further increase in taxes of anything like $28 billion, which would be necessary to reduce the year's public borrowing to about $20 billion, may well be impracticable, nor is it essential to prevent inflation. Nevertheless, the situation at the close of the fiscal year 1942 urgently called for substantial steps in this direction. Without further steps, the government would be relying upon some two and one-third times as much voluntary abstention from the spending of private money incomes as it had in the preceding year, during which the price level rose materially. Such great reliance upon voluntary saving seems dangerously excessive. During most of the fiscal year 1942, our economy had the benefit of a high rate of production of consumer goods and of large accumulated stocks. Long before the close of the fiscal year 1943, in contrast, the output of these goods will have been reduced and great inroads will have been made upon the accumulated stocks. Under these conditions, consumers will be under strong pressure to increase the dollar volume of their spending in a foredoomed attempt more nearly to maintain their former standards of consumption. This pressure will constitute a serious threat to our rationing and price controls and to the stability of the price level. In July 1942 the fiscal outlook was such that even if psychological and other obstacles barred adequate resort to enlarged taxation, consideration of alternative and supplementary means to ensure a sufficient absorption of money incomes seemed urgent.

9 COMPULSORY LOANS

One advantage of compulsory over voluntary fiscal methods—taxation and forced loans over voluntary lending—is the greater equity achieved in the sharing of current sacrifices. Compulsion involves less regard for the finer differences in individual needs than does voluntary lending, but it removes differences in character and patriotism as sources of differences in current sacrifice. The ignorant, weak, or selfish man who does not voluntarily curtail his private spending in order to respond more generously to appeals for voluntary loans is forced to do his share when he is taxed and lending is compulsory.

The most outstanding advantage of compulsory fiscal methods is that they leave lighter burdens for the future. Doubtless the government could obtain a substantial sum from the public during wartime solely by an appeal to patriotism, by a voluntary loan without interest and with highly restricted negotiability. But if the public is to be induced to lend great sums every month for months on end on a voluntary basis, the terms must be such as will appeal to the private interests of the investors. This means that the loans must bear substantial rates of interest and be either freely transferable or redeemable by the holder on short notice. In contrast to such loans, a compulsory loan may bear little or no interest, may be repayable only at times and under conditions the government deems favorable, and may not be transferable. The extreme form of fiscal compulsion is represented by the tax receipt, which is merely evidence of a closed transaction.

As between taxation and compulsory lending, the former is greatly to be preferred for all except unusual purposes. A compulsory loan possesses much of the odium and inflexibility of a tax without the latter's clear-cut advantage of avoiding a debt. It is less effective than taxation in curtailing private spending because it provides securities which serve some of the same private purposes as other forms of saving, thereby causing a reduction in the latter.

Nevertheless, compulsory loans may be used to great advantage for special purposes:

1) When taxation has been carried so far that further increases would seriously impair the economic incentives to exertion and output, compulsory loans offer the stimulus of a reward without increasing private purchasing

power in the present, and they do so on terms more favorable to the government than could be obtained through a voluntary loan. A current example is to be found in Great Britain's treatment of excess profits: although a tax of 100 per cent is imposed during the war on all profits in excess of the prewar average, 20 per cent of this tax will be remitted after the war.

2) Compulsory loans are useful in that they bring deferred rewards to those who, because of unusual present exertion coupled with unavoidable and otherwise unrewarded present hardship, deserve additional compensation as a matter of equity. When Great Britain lowered the personal exemptions and allowances for dependents under her individual income tax of 1941, with a resulting increase in hardship for members of the lower income groups, who, at the same time, were being asked to work more hours, provision was made for the return of 90 per cent of the tax at the end of the war. Time and one-half or other overtime rates of pay may well be needed to stimulate extra exertion among workers in various industries in the United States, but if such overtime pay took the form of non-negotiable government obligations payable after the close of the war, the maintenance of extra incentives would not be accompanied by greater current spending power.

3) When further increases in taxes would cause dangerous controversy concerning the distribution of the additional burdens, compulsory loans may be a palatable compromise. Compared with additional taxation, they may serve to postpone the distribution of the burden. And, because compulsory loans may conceivably be interest-free or bear a very low rate, and because the times and methods of repayment may be arranged to favor the government, they may be so devised as to create much smaller future fiscal and monetary problems than a similar volume of voluntary borrowing.

A danger, as well as an advantage, of compulsory loans is that all classes would prefer them to taxes, i.e., they may be used to excess, at the expense of taxation. Many members of the upper income groups may naturally be expected to favor almost any kind of borrowing over taxation, unless inflation were acutely feared, because increased taxation threatens their relative economic position, whereas borrowing tends to preserve it. The lower income groups are also apt to favor compulsory loans because they can hope through them to improve their future economic position without appreciably worsening their present position. That is, members of the lower income groups can hope to obtain government securities or restricted Postal Savings or social security deposits in return for funds they would otherwise have had to pay in taxes anyhow. In addition, they would doubtless seek to have the whole scheme of compulsory loans placed on a kind of reversed graduated basis: As in Great Britain today, the loan portion of each taxpayer's total compulsory payments to the government would vary inversely with the individual income, a greater part of the poor man's combined tax and loan liability being represented by the loan than of the wealthy man's.

When compulsory loans are viewed primarily as alternatives to voluntary loans rather than as alternatives to taxation, the case for them becomes especially strong; and in this light they offer very interesting possibilities. Caution in their use is indicated, however, by our small experience and by the ease with which they could be used to excess. A portion of all income payments to individuals could conceivably be required to be paid in a special type of government security, which employers and other disbursers of incomes could purchase from the Treasury, the self-employed being required to purchase commensurate amounts from their net incomes. These special government securities might be non-interest bearing or might bear a very low rate. To mitigate the additional burden upon those who are already saving substantial proportions of their incomes, and to avoid undue hardship on taxpayers with unusual responsibilities, special allowances might be made. For example, the new securities might be made receivable, within limits, for the purchase of ordinary government bonds and for the payment of life insurance and annuity premiums, the insurance companies to have the privilege of exchanging them at the Treasury for ordinary government bonds or a combination of such bonds and cash. Somewhat similar provision could be made for the use of the securities by taxpayers to meet other types of contractual obligation, such as mortgage installments on residences, and other debts. Reductions in the compulsory loan liability could be made for extraordinary medical expenses, burial expenses, etc.

10 REDUCTION IN FEDERAL NON-MILITARY EXPENDITURES

Our borrowing and tax revenue requirements could be reduced if federal non-military expenditures were further curtailed. In the President's budget message a reduction of approximately $1 billion was contemplated for all non-military outlays for the fiscal year 1943, except interest on the public debt. The possibilities of further reductions are examined in the Appendix.

NOTES

1 See Simon Kuznets, *National Income and Its Composition, 1919–1938*, Ch. 7; R. W. Goldsmith and Walter Salant, The Volume and Components of Saving in the United States, 1933–1937, in *Studies in Income and Wealth, Vol. Three* (National Bureau of Economic Research, 1939); National Resources Committee, *Consumer Expenditures in the United States, 1935–36* (Government Printing Office, 1939).

2 Similar to those assumed in the National Resources Committee study of consumer incomes and expenditures.

3 A similar though not identical proposal is made by J. J. Polak in *Economica*, Aug. 1941: Rationing of Purchasing Power to Restrict Consumption.

4 It might conceivably obtain part or all the funds by printing or minting new money.

[5] See, however, Inflation, Menace or Bogey, by Jacob Viner, *Yale Review*, Summer 1942.

[6] Cf. J. R. and U. K. Hicks and Laszlo Rostas, *Taxation of War Wealth* (Clarendon Press, Oxford, England, 1941), p. 4.

[7] See The Inflationary Gap, by Walter S. Salant, *American Economic Review*, June 1942.

[8] Securities and Exchange Commission, *Volume and Components of Saving in the U. S.*, Special Studies No. 11 and supplements. Several of the other estimates used were based on these studies.

[9] See Kuznets, *op. cit.*, p. 283.