4. Taxes and Controls

THE WINTER and spring of disasters on the fighting front following Pearl Harbor seemed to be duplicated in part on the domestic front. Here, too, there was drift. By the first part of 1942 all the signs of inflation were clearly visible, yet an integrated program to deal with them had not yet been formed.

The President was taxed to the limit of human endurance in attending to the immediate military tasks that faced the nation. The Congress had its attention drawn to the elections in November. The various parts of the economic community felt the heady wine of "prosperity" for the first time in thirteen years. Each group in its own way—businessmen, laborers, and farmers—was strongly tempted to drink more of the stuff that had been denied it for so long. Each group was prepared to have prohibitive rules clamped down on other groups, but not on itself. All that could be done to stem the inflationary tide was a series of stopgap measures that were splintered almost as soon as they were put in place.

Shorthand notes of the record up to this point would read something like this:

September 1939 to July 1941, attempt made to hold prices down by getting voluntary co-operation of business. Result: failure. July 1941 to December 1941, attempt made to get selective control of commodities. Bill introduced in Congress in July embodied this principle. Passed by House of Representatives on eve of Pearl Harbor. By end of January 1942, the Emergency Price Control Act of 1942 passed by Congress and signed by the President. Limited to selective controls and ignoring pleas for full controls made by Leon Henderson. In meantime, from September 1939 to December 1941, the price of 28 basic commodities affecting production and living-costs increased by almost one fourth. Of approximately $67 billion authorized for munitions and armaments as of December 1941, it was estimated $13 billion would be absorbed by price increases. No wage stabilization. No control of farm prices.

January–February 1942, decision made to hold farm prices at levels then current. By executive order, issued January 12, President establishes National War Labor Board. No statement of national wage policy to guide settlement of wage disagreements. Despite formal steps indicated above, from December 1941 to March 1942 food costs rise 4.9 per cent and clothing costs 7.7 per cent. By March, prices of these commodities approximately 20 per cent higher than one year earlier.

On February 12, 1942, in an address before America's Town Meeting of the Air, I offered a skeleton outline of what I felt needed to be done on the fiscal front to curtail the volume of purchasing power that had been created through government expenditures on goods that were not available to the public. I proposed the following:

Reductions of personal exemptions and increase in individual income-tax rates; steep increases in corporation taxes, especially excess-profits levies, addition of a withholding tax to collect part of the individual income taxes at the source, or from pay envelopes (this idea was carried out by Congress as a part of what later was known as the Ruml Plan); extension of selective excise taxes on an increasing number of articles, particularly those in short supply; closing of glaring loopholes in the tax laws; and an increase in government borrowing from the current income of individuals and corporations, through the sale to them of savings bonds and other types of government securities.

This entails *making*—not just *talking* about—sacrifices [I said]. So far our standard of living is at the highest peak of all time. It must be drastically reduced in order to make the supreme effort that alone will assure victory. The time to make the supreme effort is now. The time to reduce our individual expenditures is now, not after inflation has taken hold. The time for business to accept smaller profits, the time for labor to forego wage increases and for farmers to forego price advances, is now. This is the time when we must all contribute our utmost to the common effort and not squabble among ourselves to see who can get the most out of it.

When those of us on the home front wake up to the fact that we are fighting for our very lives, we will stop talking about the profits, the wages, the prices we can get out of the war. Only then will we really begin to fight. And just one thing is going to win this war—and that is fighting.

In an approving comment on this address Nicholas P. Gregory, a financial writer, observed at the time: "There is one—and it is a big one—sour note in the whole . . . Eccles tax program. This is, will it get Congressional approval? It is doubtful."

As events were to prove, the sour note was sustained for several more years of the war.

While there were many of us in Washington who were deeply involved in this question, I believe it was a series of conferences Harold Smith, the Director of the Budget, had with Leon Henderson and myself that brought matters to a head. With Smith acting as our friend at court, the President on March 17, 1942 was at last induced to order basic staff and command work on the problem of inflation. On that day he directed Vice President Henry Wallace, Secretary of the Treasury Henry Morgenthau, Price Administrator Leon Henderson, Secretary of Agriculture Claude Wickard, and myself to draft a coordinated anti-inflationary program.

The vicious circle with which we had to deal was aptly described in a Bureau of the Budget memorandum sent to the President on March 26. It pointed out that inflation could not be stopped as long as wage increases as well as rising governmental expenditures created additional purchasing power. Wage increases could not be stopped as long as prices rose.

Price rises could not be stopped unless part of the rapidly increasing purchasing power was absorbed by fiscal measures. Fiscal measures could not be effective as long as businessmen, wage-earners, and farmers could make up for taxes by increasing their incomes.

Morgenthau, who knew the trend of our thinking, held himself aloof from the joint effort. He was, I believe, somewhat piqued that as Secretary of the Treasury he was not made head of the committee, but was placed on an equal footing with others, and particularly with Harold Smith. But the rest of us met off and on for a month to do what the President directed. With the help of Dr. Alvin H. Hansen and Dr. Gerard Colm, who were brought in for technical assistance, the draft program was completed and then submitted to the President on April 18. Morgenthau did not sign it. He was against any lowering of income-tax exemptions and a freezing of wages, both of which were basic to any inflationary-control program.

The remainder of the committee reported to the President that we had examined the possibilities of a partial program to check inflation under an all-out war effort, but we had come to the conclusion "that partial programs will not work and that only a simultaneous attack on prices, rents, wages, profits, and mass purchasing power will suffice. Every element is essential to the effectiveness of every other element. Any lesser program must fail." Such a comprehensive program, we added, not only was economically and politically sound, but would be strongly backed by the public.

As for *price control:* we urged that rents should be stabilized within the limits of the Emergency Price Control Act; that a ceiling be placed immediately on all prices—retail, wholesale, and manufacturing. The proposed general ceiling would include most foods and all clothing at retail. To do this, the Emergency Price Control Act would have to be stretched. If the cost of living was to be fully stabilized, the 110-per-cent parity limitation had to be stricken from the price law. At the same time we recommended that the existing restrictions on the sale of government-held commodities be removed.

As for the *wage control:* we proposed the proclamation of a policy of stabilizing wage rates except those below forty cents per hour. The hope had often been expressed that stabilization of the cost of living would be enough and that the stabilization of wage rates would be unnecessary, but this hope was unfounded. Wage *income* was certain to rise even if wage *rates* were stabilized. The number of employed workers in a family of workers would continue to rise. Furthermore, employees would work more hours per week at overtime premiums and they would move up continually from lower- to higher-paid jobs. "Stabilization of wage rates," we said, "eliminates only one important inflationary factor. It reduces the excess of purchasing power over shortened supply so that the remainder of the problem can be managed through fiscal and price-control measures. Unless wage rates are controlled, we believe that increased labor costs and increased consumer demand will shatter the price ceiling and thereby discredit price administration and Government in general."

We asked that a standard work week of forty-eight hours should be proclaimed with time-and-a-half paid for overtime above forty hours, that double time for Sundays and holidays should be abandoned, and that restrictive labor practices should be eliminated.

As for *profits:* we noted that some salaries and bonuses of management had been raised out of all reason. These instances were well known to labor and farmers and incited demands for higher wages and higher farm prices. While the proposals for profit taxation in a Treasury bill then pending would reduce 1942 profits at the disposal of corporations below the 1941 level, even these stiff tax proposals would permit some corporations and some individuals to retain unreasonable gains.

To remedy this we proposed three steps: that excess-profits tax provisions of pending Treasury proposals should be tightened;

that unreasonable salaries and bonuses, and salaries and bonuses that had been increased to avoid corporate taxation, should be eliminated by strict application of the internal-revenue laws that prohibit deductions of "unreasonable" salaries in computing net income; that a ceiling of fifty thousand dollars after taxes should be placed on individual incomes, thereby dramatizing the equality of sacrifice implicit in the proposed over-all program.

As for *mass purchasing power:* we informed the President that price and wage stabilization was doomed to failure unless the explosive pressure of excess purchasing power was reduced through appropriate tax and savings measures.

The pending tax bill of the Treasury, we said, fell far short of that requirement, for even if wage rates were stabilized and the complete Treasury tax program was enacted immediately, excess purchasing power in 1942 would amount to more than $10 billion. Furthermore, much of the excess would be in the hands of the people who typically spend almost all of their income—an income not materially affected by the income tax. What we needed was a tax system that would absorb purchasing power at the annual rate of $6 billion during the first half of the fiscal year 1943, and above $10 billion for the second half.

As for the Treasury's voluntary-savings program, that too was hopelessly inadequate. Less than ten per cent of all savings bonds had been bought by individuals in the lower-income bracket. Over ninety per cent of the bonds sold merely represented the normal savings of middle- and higher-income groups. Thus a voluntary-savings program would not sufficiently curtail the consumption of the lower-income groups. To do the job, we strongly recommended that some type of compulsory universal saving should be adopted.

To further the same purpose behind a universal-savings plan, we suggested that Congress be requested to make a reduction of exemptions under the individual income tax. The exemptions suggested would be reduced to $500 for a single person, $1,000 for married people, and $250 for each dependent, with a moderate rate for the lowest-income bracket. This reduction, based on the then cost of living, we felt, would not add too great a burden on the individual brought under the income tax for the first time.

The President's committee considered at some length the role of consumption taxes in a war period, but decided against recommending them at that time. We believed that such measures as low-bracket income taxes, increased universal savings, and social security were superior to general sales taxes. We suggested, however, that the President might announce to the country and to Congress that he was determined to recommend a war consumption tax if the fiscal program we had suggested did not prove equal to absorbing the excess purchasing power. "The stabilization program," we said, "must be executed under all circumstances—if necessary by resort to regressive forms of taxation, which are normally undesirable but more desirable than an inflationary price rise."

We recognized that Congress was likely to enact a sales tax with or without the President's request. But we suggested that if the President indicated that a war consumption tax might be necessary for future use, it might deter Congress at that time from enacting such a tax as a substitute for a portion of the income and profits taxes included in the Treasury bill then before Congress.

Finally, as an essential supplement to the balance of the program, we urged that credit expansion of all kinds had to be prevented or controlled.

This in broad outline was our plan of action.

When the plan was completed, but before it was submitted to the President, I left for Utah to tend to some private matters. While there, I received word that Roosevelt was prepared to send to Congress the whole of what we had urged. Then a few days later I was told he had changed his mind. I do not know whether the change was due to Morgenthau's influence, or whether Morgenthau merely reflected the President's own attitude at that time. In any case, while Morgenthau was prepared to control every other kind of price, as I've said, he balked at clamping a ceiling on wages. He observed at the time: "Labor is not a commodity."

This is true when viewed in human terms, but in economic terms it ignored the fact that more than two thirds of the overall costs of production is represented by wages and salaries. Any program to control a price inflation would clearly be doomed to failure if the cost or price of labor was left uncontrolled.

When I heard that the President was wavering, I sent him the following telegram on April 25:

> After ten days spent in this rapidly growing defense area talking to numerous people, I am more than ever convinced that the public desire and are prepared for a drastic anti-inflationary program of enforced savings, withholding income taxes, ceilings on wages and salaries, lower income exemptions, and higher income and excess-profit taxes, as well as freezing all prices and rents. The standard of living must be greatly reduced through curtailing mass purchasing power by the methods indicated if war production is to succeed without bringing on inflation.

I assume that pleas of a similar nature poured in on the President from many other sources, but they were of no avail. In his message to Congress on April 27, and in a subsequent Fireside Chat, the President did take notice of the imminence of inflation and called for action in seven areas. The ones he enumerated were drawn from the document we had submitted to him on April 18. Still, despite the eloquence of his chat, it was vague and general in its substance. In essence his program called on Congress to build a strong basement for prices, but gave no specific instructions on how the roof was to be tied down. Through this gap Congress looked up at the elements, saw the elections of November in the distance, and accordingly did very little. And so the inflationary spiral continued.

Leon Henderson did his energetic best to hold prices in check despite the weak instrument he had to use for that purpose, and despite the very considerable problem he faced in assembling a nation-wide staff to administer and interpret the regulatory orders that were issued from time to time. As I've said before, in the absence of a vigorous fiscal and credit program, which should have been the primary stabilizer of our war economy, it was the price-control and rationing mechanism that had to bear the major burden for economic stability. And if at times Leon Henderson issued flamboyant orders, it is important to remember that he understood better than most people what fragile economic stabilizers had been placed in his hands. His so-called "crack-down" telegrams were a deliberate bluff, to which he had to resort in the absence of a more effective way of keeping the economy in balance.

So long as the banks were required to finance a substantial part of the government's large deficit, it was impossible to restrain the growth of bank credit, and hence stop the growth in the supply of money. To assure the successful financing of these deficits, it was necessary to maintain a stable government security market at a fixed pattern of rates. The increase in the supply of money brought about in the above manner, when disbursed by the government, increased the supply of money owned by the public. There was, therefore, little growth in private bank credit because it was not needed. Nor, for this reason, was there any need to restrain it. As a matter of fact, the over-all growth in all nongovernment debt in the years 1941–5 was less than $1 billion, while the government debt at the same time increased by $196.4 billion.

In the ensuing months of congressional inactivity, we debated whether a further effort should be made by the President to bestir the Congress or whether he should stabilize prices by means of an executive order issued under his emergency powers.

By July 1942 the President's seven-point program issued in April was a complete shambles. All elements in the land were straining to free themselves from the seeming disadvantages they suffered in contrast with their neighbors. The "little-steel formula" invited some farm leaders to ask for bigger farm prices. A rise in the cost of living led some labor leaders to seek further wage increases—all this at a time when Congress wanted to get out of Washington and start campaigning.

It seemed for a time that Roosevelt would deal with the rising cost of living by means of an executive order. Robert Sherwood has related that the President's Labor Day address dealing with the problem of inflation was first written as a proclamation and explanation of such an order. The final decision was a compromise. Roosevelt sent Congress a demand for action by October 1, 1942, and coupled it with a clear warning that if Congress did not act, he would.

The message resulted in the enactment by Congress of the Stabilization Act, which Roosevelt signed on October 2. Among other things, it established an Office of Economic Stabilization, and Justice Byrnes stepped down from the Supreme Court to become the Director of that office. The powers given him to stabilize farm and wage prices were broad ones and represented a major step forward in providing the grappling-hooks with which prices could be bound to the earth. But the grant of these powers left open a wide area of disagreement on how they should be used and, in particular, how they should be used in regard to wage stabilization. The bulges and strains in the economy continued to disfigure the national scene.

In November 1942 I tried to point this out to the advisory committee that assisted Byrnes in his work. As I recall, the committee was formed of eight men, two each representing labor, agriculture, business, and the general public. At a meeting with this committee on November 13, I argued that if we were to control excess purchasing power and preserve reasonable economic stability, we had to resort to far more drastic measures to curtail civilian spending power than those adopted up to that time. At that time the expendable income had reached a point where it exceeded by $40 billion the value of the goods available for sale. Given the character of American saving and spending habits, we faced a prospect of a rise in the cost of living by at least a third, brought on by the pressure of the excess purchasing power on hand.

The extent to which we are failing to meet the problem on the domestic front, I continued, was illustrated by a comparison with the British and Canadian experience at that time. They were financing about one half of their expenditures by taxation and one half out of borrowing in contrast with our one quarter from taxation and three quarters from borrowing. Of the half they borrowed, about two thirds came from the general public and only one third from the inflationary process of bank borrowing. In contrast, of the part we borrowed, one third came from the general public and nearly two thirds from the banking system. How could we change this trend?

> We all recognize the limitation on what price control and rationing can do by themselves [I said to the Advisory Committee]. The strongest administrative machinery would crumble under the pressure of the excessive purchasing power now flowing into the hands of the American public. A hard-boiled fiscal policy is our only hope of reducing the pressure enough to permit rationing to function.

On the fiscal front, I urged on the committee that the ratio of taxation to borrowing, as well as the ratio between nonbank and bank borrowing, should be of the British and Canadian variety. While decreasing purchasing power in this way, there was the offsetting need to increase the supply of goods. There, too, we could learn much from our English friends. In Great Britain the average working week was about 54 hours for nonagricultural workers. In the United States it was only 43 hours. We needed to increase the work week to 48 hours. "Organized labor won the 40-hour week after many years of painful effort and struggle," I said. "It should be made unmistakably clear that the government does not propose to abolish but merely to suspend the legislation guaranteeing this achievement." In addition, federal action should be coupled with further action that would impose a blanket prohibition on working more than 60 hours a week except in grave emergencies.

Finally, I argued that we could release resources for essential use by employing existing training facilities in the colleges for the armed forces rather than to build new facilities destined for the scrap heap after the war. In this way we could economize the use of scarce building materials and labor. We could also release resources for essential use by cutting down on advertising. It seemed contradictory to me that at a time when it was the government's declared policy to curb civilian demand, advertising of all kinds continued to whet the public's appetite to buy. The government not only permitted this, but by various means actually encouraged this misuse of resources. First, in our tax laws we allowed generous deductions for advertising expenses, and thereby not only virtually paid for advertising out of the public treasury, but encouraged it when a company was subject to excess-profit taxes. Second, we continued to encourage appeals to the public that were wholly inconsistent with the government program of conserving civilian goods and making the most efficient use of our resources. A great deal of labor and scarce materials were thus squandered, to say nothing of the additional burdens on transportation and postal facilities, which were already strained.

When I had finished this statement, Byrnes commended it as being "courageous and interesting." Then he went around the table and called on each of the eight Board members to criticize or to associate himself with it. Not a person present spoke up for the program.

I admit it was a tough program and had no political appeal. Still, while others may have had good personal reasons for remaining silent, I could not do so.

I repeated this same argument before the Senate Banking and Currency Committee on February 17, 1943, and there declared that the government "was doing a very bad" job of war financing compared with other countries; that we needed higher taxes and less borrowing from the banks if we were to control inflation. Almost a month later, on March 30, before the Central States group of the Investment Bankers Association meeting in Chicago, I repeated this same argument and placed on Congress the responsibility for the inadequacy of our war financing.

Again this theme was repeated in a nation-wide broadcast on April 14 while the Treasury's second war-loan drive was on to raise $13 billion through the sale of war bonds. I said at that time:

> The question is not whether the goal of this campaign will be reached, but how it is reached. The government can always raise the money it needs. What is of vital importance to every man, woman, and child in the country is that the money needed to wage this war is raised in a way that will not result in a disastrous rise in the cost of living. This means it must be financed out of savings and not by additional bank money.

The heavy oversubscription in the drive induced many people to argue that there was no further need for stiffer taxes. What they ignored was the way Treasury offerings found their way ultimately into the banks, with inflationary consequences that have been detailed already. They also ignored the fact that the Treasury's offering absorbed only a fraction of the $55-billion purchasing power that was then on hand in excess of the amount of consumer goods available.

In the course of testimony before the House Banking and Currency Committee on May 13, 1943, I argued for a separation of individual and bank borrowing when the special drives for bond sales are put on: the effort, I said, should be centered on getting individuals to buy. If this was done, then an estimated $15 to $20 billion more bonds might be purchased by individuals in the new loan drives. But, even so, this would leave upwards of $25 billion in excess purchasing power that had to be absorbed by taxes. More taxes and still more taxes were the only solution if we were to curb inflation. I flatly denied that the success of the Treasury's drive in any way reduced the necessity for a comprehensive tax program.

The whole of this testimony, added to what had gone before it, resulted in an increase in tension between Secretary Morgenthau and me. It was heightened by Morgenthau's "take-it-or-leave-it" speech to the Board of Governors and Reserve Bank presidents which he made at that time. But, like all other differences, this one was also composed, and it was agreed that in the future the offerings to the public would be separated from offerings to the banks; that the emphasis be put on individual purchases as a means of curbing inflation. Still, this agreement did not end the need for additional tax revenues to siphon off the excess purchasing power over and above that would be absorbed by increasing individual purchases of securities.

Accordingly I continued to press for additional taxes and a compulsory savings program. In October 1943 the House Ways and Means Committee was considering a new tax bill recommended by the Treasury calling for $10.5 billion in additional revenues. When I appeared before the committee in connection with this bill, I urged an even higher tax figure of $13 billion. Not only was the proposal I made promptly rejected, but even the Treasury proposal was largely scrapped. Indicative of congressional attitudes at that time relative to increasing taxes, Chairman Robert L. Doughton of the House Ways and Means Committee had this to say about my suggested revision of the tax bill:

"Amazing, fantastic, and visionary. I don't like it at all. If possible, it is worse than the Treasury program."

In his budget message of 1944 President Roosevelt asked that taxes be stepped up to get an additional $10 billion; the request was based on the fact that despite earlier tax hikes the public was still left with a considerable sum of money with which it could increase inflationary pressures. Harold W. Smith, Leon Henderson, and I strongly urged the President to take the course of action reflected in his message. Had the Congress been of a similar mind, there is no question that subsequent inflation might have been mitigated. Congress, however, remained committed to easy financial devices and in the election year of 1944 prepared to have the war financed by bank credit rather than by stiffer taxes. The result was a tax bill that Roosevelt vetoed in language so sharp that it provoked Senator Barkley to resign as majority leader of the Senate. He was induced, however, to resume his post and Congress promptly proceeded to override the President's veto. The action may have satisfied those who saw in it a reassertion of legislative leadership by Congress in the face of attempted encroachments by the executive. But, to be truly praiseworthy, the independence of the legislature should have been asserted on behalf of sound public policy. In this case, the legislature was wrong and the executive was right, and we all were to suffer because the legislature's point of view prevailed.

Ultimately a good part of the legislation that was required to fight an all-out war finally was written into law. Cumulative figures on the fiscal front showed that of $380 billion raised by the government between June 30, 1940 and the end of 1945, $153 billion came from taxes, or about 40 per cent. The remainder, $228 billion, or about 60 per cent, was raised by borrowing. Of the total borrowed, $133 billion, or about 60 per cent, came from selling government securities to investors other than commercial banks and the Federal Reserve banks. Approximately $95 billion, or 40 per cent, of the amount borrowed was raised by selling government securities to the commercial banking system. By the end of the war the percentage figures of taxes in relation to borrowing, and of borrowing from banks and nonbank investors, had improved considerably over what they were when I appeared before the Byrnes committee in November 1942, but the improvement was not enough to spare us from a postwar hangover.