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FINANCING THE WAR

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I

SINCE no one can foretell where any war may lead or foresee how long it may last, the military and financial policies of the United States should contemplate a long contest of the first magnitude. The war which has convulsed Europe for nearly three years may be nearer its end than we suppose; but we have no right to take anything for granted, and should prepare for a contest that may demand the complete mobilization of the material and human resources of the country. In finance this means that we need a program. Intelligent foresight and comprehensive grasp of the situation should from

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the very outset control, and shortsighted or temporizing measures should be carefully avoided. Mistakes can be made during the next six months that will disorganize our currency, injure our credit, and enormously increase the cost of the war. Upon the other hand, by adopting a sound financial program now, we can, with a minimum of friction and waste, raise all the funds that may be needed to finance even this greatest of wars.

In such a program the first requisite is obviously economy in all expenditures, public as well as private. For the time being the chief business of the country must be to divert enormous sums from other objects and to devote them to the maintenance of armaments. This means that we shall have to go without many things that we might otherwise have, which is to say that we must practice economy. The citizen must be prepared to retrench in his private expenditures in order that the extraordinary needs of the government may be supplied, and the government should do its part by husbanding its resources with the utmost care. Heavy taxation of luxuries will give the citizen an extra inducement to perform his duty; nothing but rigid economy and efficiency will enable the government to do its part. At such a time private luxury and pork barrel legislation fall under the same condemnation. New undertakings not related directly or indirectly to military operations should be confined within the narrowest possible limits. And finally, if we are ever to have a rational budget system, the present is obviously the time for its introduction. This Congress should not adjourn without providing for a complete reorganization of future budgetary procedure.

So far there can be little disagreement, but concerning the next point there may be difference of opinion. In financing a great war, revenue from taxa-

tion must be supplemented by loans, but neither in theory nor in practice is there universal agreement concerning the proportions in which the two expedients should be employed. Since this is the most fundamental question connected with a program of war finance, it requires most careful consideration.

II

The first theory of war financing is that upon which most wars have been conducted ever since the invention of national debts. According to it, the extraordinary outlay of a war should be financed by loans in order to avoid the inconvenience and disturbance occasioned by a heavy increase of taxation. Such a policy is deemed to be fair because it throws at least a part of the burden upon future generations, and is ordinarily adopted in full confidence that it will suffice for all probable needs. In short wars that make no serious demands upon a nation's resources it has often worked well enough, but in every protracted struggle it has spelled disaster. Of this our own history affords most striking and conclusive demonstration.

During the Revolutionary War our government possessed no effective power of taxation, and its experience affords no fair test of the financial policies which it adopted. In 1812, however, it possessed authority to levy taxes ample for all needs, and the wisdom of its financial measures may be tested fairly by their results. As early as 1807, when war was thought to be inevitable, Secretary Gallatin had outlined the policy which the United States subsequently followed, proposing that war expenditures should be defrayed by loans, and that taxes should be levied only in the amount necessary to provide for the expenses of government on a peace

establishment and for interest on any new loans that might be created.¹ This plan of financing a war received a perfectly fair trial during the next three years because, out of a total extraordinary expenditure of \$70,000,000, nearly 10 per cent was financed by taxation, so that somewhat less reliance was placed upon loans than Gallatin's theory strictly called for.² The result was failure, complete and decisive, leading to something very near a financial breakdown. It soon became difficult to float interest-bearing loans because investors saw the government's liabilities rapidly increasing without any material increase in its revenues, by which alone, of course, its ability or willingness to provide for its obligations could be safely judged. Treasury notes had to be issued in increasing amounts which tended to inflate the currency and therefore to increase the cost of the war. After the government's credit had been impaired additional taxes were at length imposed, but they yielded little revenue until the very end of the war when the mischief had already been done. In sum, impaired credit, currency inflation, and threatened collapse were the unmistakable results of this attempt to finance war expenditures exclusively by loans.

By 1846, when the Mexican War began, the lesson of 1812 appears to have been forgotten, and the same financial policy was adopted which had failed so signally a generation before. But the resources of the country had greatly increased, and the war proved a comparatively small affair which lasted less than two years and

¹ It should be said for Gallatin, however, that he advocated this policy because he thought that the war would so injure the commerce of the United States as to decrease the resources available for taxation, and that he recognized that under different conditions it might be "practicable and wise to raise by taxes the greater part, at least, of the annual supplies"

² Data upon this point, as well as upon the entire subject of the finances of the War of 1812, may be found conveniently in H C Adams's *Public Debts*, pp 116-26, and D R Dewey's *Financial History of the United States*, pp 128-42

occasioned no strain upon our finances. Without levying internal taxes, the government contrived to meet some \$14,600,000 of war expenditures out of ordinary revenues, while incurring a net indebtedness of some \$49,000,000.¹ This time the loan policy had worked well enough, yet its success was due, not to its inherent strength, but to the short duration and comparatively trifling magnitude of the strain to which it was subjected. Under different conditions there is no reason for supposing that it would have worked any better than it did in 1812.

When the Civil War broke upon the country, it was natural that the government should revert to the policy followed in the war with Mexico. Secretary Chase recommended² that taxation should be confined to the amount needed for the ordinary expenses of the government and for interest upon loans, and that extraordinary expenses should be met by borrowing, estimating that this plan would require \$80,000,000 to be raised by taxes and \$240,000,000 to be procured by loans. Congress acted upon the secretary's advice, imposing such new taxation as appeared to be called for and authorizing a loan of \$250,000,000. Thus the country entered upon a conflict which lasted four years and required unprecedented outlays, with a plan of finance that might have sufficed for another Mexican war but was certain to fail in a conflict of greater duration and magnitude.

The situation was complicated by a variety of circumstances, chiefly the unsatisfactory state banking system, which would have caused much embarrassment in any event; but after all allowance is made it is clear that Chase's plan received a fair trial, and that it failed as signally as Gallatin's plan in 1812. Difficulty was

¹ Dewey, *op. cit.*, pp. 255-56

² Report on the Finances, July 4, 1861

encountered at the very outset in floating bonds, and \$60,000,000 of demand notes were authorized in 1861. These were followed in 1862 and 1863 by a much larger amount of legal tender notes, the so-called greenbacks, and by a variety of other short term obligations. Not until the third year of the war did long term loans begin to preponderate, and even in the fourth year interest-bearing notes actually exceeded the bond issues of the government. The inevitable result was currency inflation, by which the cost of the war was enhanced some hundreds of millions, and credit impairment which seriously hampered the government's financial operations.

After much mischief had been done, but in time to save the situation, Congress, which in this matter showed more wisdom than the secretary, imposed heavy taxes to which the country loyally responded. Indeed, after the first year, the people seemed frequently wiser than their rulers, and the action of Congress in increasing taxation was partly in response to a widespread popular demand. This fact greatly impressed foreign observers, one of whom remarked to Mr. Seward: "I was not surprised to see your young men rushing enthusiastically to fight for their flag. I have seen that in other countries. But I have never before seen a country where the people were clamorous for taxation." And von Hock, the Austrian economist, has left on record the fact that he was attracted to the study of American financial history by the "wonderful spectacle" of a people who after being free from internal taxation for nearly half a century, "through love of country and zeal for the rights of humanity," willingly submitted to the heaviest taxation and assumed the burden of an enormous debt.¹

¹ C F von Hock, *Die Finanzen und die Finanzgeschichte der Vereinigten Staaten von Amerika*, Vorrede

But time was required to devise a new system of internal taxation and get it into successful operation, so that not until the end of the war did the revenue from taxes attain its due proportion to the government's loans. In the first year taxes brought in \$50,851,000, while loans and notes produced \$433,663,000, the ratio of taxes to loans and notes being 1: 8.5. In the second year taxes yielded \$108,185,000, and loans and notes \$596,203,000, the ratio being 1: 5.5. The third year the tax revenue was \$212,532,000, and the loans and notes amounted to \$719,476,000, the ratio standing at 1: 3.4. And finally, in 1864-65, taxes supplied \$295,593,000, while the loans stood at \$872,574,000, the ratio being 1: 2.9.¹

By 1863, Secretary Chase was convinced of the unsoundness of the theory upon which the war up to that time had been financed, and in his annual report called attention to "the great importance of providing, beyond all contingency, for ordinary expenditures and interest on debt, and for the largest possible amount of extraordinary expenditures, by taxation." And he added: "It is hardly too much—perhaps hardly enough—to say that every dollar raised for extraordinary expenditures or reduction of debt is worth two in the increased value of national securities, and increased facilities for the negotiation of indispensable loans."² Hindsight is always easier than foresight, but it is usually more expensive; and the dear experience which brought Secretary Chase to the correct position which he took in 1863 ought not to be necessary in 1917. Since no internal revenue system existed in 1861, six months or a year would have elapsed inevitably before increased

¹ For these figures and other data about the Civil War finances see Dewey, *op cit.*, pp 298-330, Adams, *Public Debts*, pp 126-33

² *House Ex Docs*, vol vi, no 3, pp 10-12, 38th Cong, 1st Sess

tax revenue could have been procured, but there was no reason why in 1862 and 1863 the treasury might not have been as amply supplied as it was in 1864 and 1865. As Professor Henry C. Adams, to whom we owe the first scientific criticism of our Civil War finances, has so justly observed, it is not easy to overestimate the financial benefits that would have accrued if the receipts from internal revenue could have been moved forward by two years.¹

In the Spanish War for the first time in its history the United States followed the correct theory of emergency financing. The act of June 13, 1898, which authorized a loan of \$200,000,000, also levied new internal taxes which, since the machinery of collection was already in existence, almost immediately increased the tax receipts and were presently furnishing an additional annual revenue of some \$100,000,000. The war was of such limited scope and duration that the older theories of Gallatin and Chase could have been followed without causing disaster. But the sounder policy which actually prevailed has established a safer and better precedent which should be followed in the present great emergency. It cannot be doubted that, in the words of Professor Adams, "an adequate policy for the management of war finances is a tax policy assisted by credits rather than a credit policy assisted by taxes."²

The same lesson is taught by the experience of Great Britain and Germany in the present war. German theory and practice have long inclined unduly to favor public loans. This is probably due in some measure to the influence of Karl Dietzel, who taught that the State is a part of the capital of a country, and that outlays for the extension and strengthening of the State may be

¹ Adams, *op. cit.*, p. 132

² H. C. Adams, *Science of Finance*, p. 542

safely financed by borrowing.¹ It is due also to the successful financing of former wars by loans and indemnities. It was natural, therefore, that the German government should undertake to finance the present war by public loans which, according to report, have been utilized even for the purpose of paying interest. Only recently has taxation been materially increased, and a recent outgiving of the Kaiser indicates that he finds ground for satisfaction in the fact that taxes have now been levied to provide for interest upon war loans. The result is that one of the greatest of Germany's problems today is the state of her finances, and that serious doubt is expressed concerning the success of the next loans. Upon the other hand, Great Britain, altho compelled to borrow huge sums, has steadily increased her revenue from taxation, and is at present financing from this source no small part of her war expenditures. So far as the outcome of the war depends upon possession of the longer purse, there is no doubt as to which antagonist has the advantage at the present time.

There are three main reasons why the exclusive loan policy has always failed under a severe and protracted test. Public credit depends primarily upon the ability and willingness of a government to support loans by substantial revenues from taxation; and when the latter are not provided, an impairment of credit inevitably follows. In the second place, if taxation is not increased in time of war, private expenditures are not curtailed, and the government must bid against its citizens when it purchases supplies, with the result that prices rise and inflation naturally ensues. Finally the security of public loans varies inversely as their volume, so that, as debts accumulate, a government's obligations at last become

¹ *Das System der Staatsanleihen* (1855)

unattractive to investors. Ordinary prudence, therefore, dictates that a war should be financed as far as practicable by increased taxation, and that loans should be employed as sparingly as possible.

III

The failure of the exclusive loan policy under any severe strain and the evils resulting from the swollen national debts which it entails have led not unnaturally to a second theory of emergency financiering which goes to the opposite extreme. Early in the nineteenth century David Ricardo, impressed by the condition in which Great Britain found itself in 1815, contended that wars should be financed wholly by taxation; and this theory now finds numerous advocates in the United States who would have the government avoid all loans, except such as may be necessary during the first few months, and finance the war wholly by taxes levied principally upon income and war profits. Since the practical difficulties of the plan are tolerably obvious, and it seems evident that for the present, at least, the government is unlikely to venture upon such a rash experiment, I will not undertake to consider it in this paper.

A sound program of war finance must avoid the extremes of exclusive reliance upon loans and exclusive reliance upon taxation. It will draw upon the supply of loanable capital in the hands of investors, and will also employ taxation to as great an extent as may be consistent with the welfare of industry. It must, except in direst need, avoid unnecessary strain upon any part of our industrial organization. We should tax heavily in order to minimize the strain upon national credit; but we must permit industry to prosper, and allow time for

the readjustments which are going to be necessary. This means that at the outset we must rely rather more upon loans than upon taxation, and that, as the war proceeds, taxation should be increased as rapidly as experience shows this to be practicable. It is to be hoped that this is what President Wilson had in mind when he recommended that the war outlays be financed, "so far as they can equitably be sustained by the present generation, by well-conceived taxation."

There can be no doubt that the tax revenues of the government can be, and should be, increased immediately by not less than \$1,000,000,000. Only the most careful investigation can show how far beyond that figure taxation can prudently be carried this year. Much depends upon our forecast of business conditions. If these can be expected to remain as favorable as they were in 1916, taxation can obviously be carried further than if we must look forward to a year of less prosperity. I venture in the most tentative way to offer the following suggestions.

The income tax should be increased as much as can be done without forcing too severe or abrupt readjustments. This will require numerous amendments to the present law, which will be considered in the concluding pages of this article.

The recently established tax upon excess profits, however objectionable in ordinary times, can be somewhat increased, but ought not to be made retroactive if that can possibly be avoided. The large profits of the last two years are not wholly disposable income. In many cases they must go to pay for new plants, or are needed for working capital. While war contracts have proved bonanzas in some cases, they have involved very large commitments for which full payment has not yet been made, and serious results

might follow if taxation of excess profits should be carried too far.

By the act of March 3, 1917, the rates of the federal estate tax were raised to very high figures, which ought not to be increased. Beginning with a rate of $1\frac{1}{2}$ per cent upon estates having a net value not in excess of \$50,000, they reach the figure of 6 per cent upon the excess of any estate above \$250,000, 9 per cent upon the excess of any estate above \$1,000,000, and 15 per cent upon the excess of any estate above \$5,000,000. Taken in connection with the inheritance taxes levied by the states, these rates are probably excessive. Since an estate or an inheritance tax does not fall equally upon all property in any year, but only upon property transferred in a particular way, its rate should be stable, in order that the amount of tax paid shall depend upon the size of a man's estate and not upon the year in which he dies. It is, therefore, not fit to be used as an emergency tax, and increase of the present rates should be avoided. After the war is over, some understanding and adjustment must be reached in state and federal taxation of inheritances. The claims of the states cannot be considered now, but the federal government should at least avoid making a bad situation worse. It is to be hoped also that Congress will not omit to make some adjustment for those who may lose their lives at the front.

The taxes upon tobacco, beer, and spirits should be immediately increased. That on spirits could probably be raised to \$1.50 per proof gallon without making it difficult to enforce, and if the Bureau of Internal Revenue so advises, should be increased to \$2.00 per proof gallon. That upon beer ought to be raised to at least \$2.00, the rate which prevailed during the Spanish War, and unless administrative reasons forbid, should be increased to \$2.50 or \$3.00. The tax upon tobacco

is much lower than is imposed by many other countries, and I see no reason why it should not be advanced to twenty cents per pound upon smoking and chewing tobacco, with a corresponding increase in the rate upon cigars and cigarettes. From these three duties an additional annual revenue of \$150,000,000 and upward can probably be obtained.

Stamp taxes, such as were levied during the Spanish War, should at once be reimposed, and with such rates as would be justified in the present emergency might readily be made to yield from \$80,000,000 to \$100,000,000. To these should certainly be added taxes upon theatre tickets and tickets of admission to moving picture exhibitions, while advertisements of all descriptions might well be laid under contribution.

A heavy tax ought to be levied upon gasoline, since the government will have to purchase large amounts of this commodity for its own use and ought to discourage consumption by automobiles and motor boats.

Finally, import duties should be imposed upon tea, coffee, and cocoa, which are now untaxed and could readily yield \$60,000,000 per annum. There are doubtless other imported luxuries upon which duties can be increased. It would seem also that the present emergency calls for the restoration of the sugar duty to the point of maximum revenue.

All these suggestions, with the exception of that relating to sugar, are premised on the theory that it is practicable and desirable to raise somewhat more than \$1,000,000,000 from taxes that will not tend to increase the cost of articles necessary for subsistence. More detailed investigation, such as I have not had opportunity to make, might show that very much more revenue can be raised without undesirable results; and if so, taxation ought to be carried further than I have

ventured to suggest. But, whatever plan of finance may be adopted, we can hardly avoid an upward tendency of prices during the coming year, and such a tendency ought not to be accentuated by a general excise system such as was introduced during the Civil War. If later on more revenue is needed than can be obtained from other taxes, it will be possible to make a more extensive use of customs and excises, but for the present this should be avoided. It is obvious, therefore, that the suggestions here made leave untapped vast resources of indirect taxation upon which the government can draw in case of need.

As this is written, the Treasury Department has just given out a comprehensive plan for the first war loans. Since this may be subject to change, I will not consider it in detail but will confine myself to some general observations concerning public borrowing in time of war.

It is to be hoped that the government, whatever else it does, will minimize its use of transferable certificates or obligations. Such evidences of indebtedness, even tho issued in large denominations, can serve to some extent as a medium of exchange, and therefore are very dangerous. One of the great evils of Civil War finance was the large resort to short term notes and certificates which more or less contributed to the inflation of the period. If money is needed during the next few months in anticipation of taxes or permanent loans, the government ought to borrow from the banks in the ordinary way, and avoid, if possible, the issue of transferable notes or certificates. Any temporary obligations issued should be in large denominations, should run for short periods, and should be transferable only by registration. This may require a somewhat higher rate of interest, but that is a small consideration compared with the danger of inflation.

The important thing, to which other considerations for the time being should be subordinated, is to issue long term loans that will be attractive as permanent investments. This requires first of all that such loans shall be convertible into any others that may subsequently be issued at higher rates of interest, and very wisely the Treasury Department has provided for this in the bill recently submitted to Congress. All investors should be treated alike, and the first issues will certainly not be as well received if subscribers face the possibility that the value of bonds may subsequently fall as a result of the issue of new loans at higher rates of interest.

It is further important that the Treasury should be authorized to deposit in any banks the money raised by loans. The huge sums needed ought not to be withdrawn from the ordinary commercial banks and accumulated either in the federal treasury or to an undue extent in the Federal Reserve Banks. They should be kept as nearly as possible in their accustomed places in order to minimize the disturbance occasioned by the loans. This arrangement will obviously give to all banks greater ability to encourage and assist their depositors to subscribe to the loans.

Another leading consideration is that controllability is more important than the rate of interest which the government pays during the duration of the war. For emergency financing it is probable that no better security can be devised than a 5-20 or 5-25 bond, redeemable at the option of the government after five years, and payable at the end of twenty or twenty-five years. Experience with our federal sinking fund has been so unsatisfactory that it ought to be provided that, after the war, the present loans should be payable on the serial plan in equal annual instalments. Provision should be made, however, that, in case of a future war,

the government should be permitted to suspend redemption in order that it may never be in a position where it will be obliged to pay off instalments of old debt while contracting new loans at a higher rate of interest. War loans of the United States should first of all be controllable so that they may be refunded upon more favorable terms, if that becomes possible after the war; and provision should then be made to insure their repayment within a reasonable number of years.

It would be a great mistake at this juncture to regard the rate of interest paid during the war as the primary consideration. Rapid absorption of loans by permanent investors is vastly more important. In proposing to borrow \$5,000,000,000 at $3\frac{1}{2}$ per cent the government is stressing the wrong factor in the problem; and in order to do this, is making a bad bargain by exempting the bonds from the income tax, as will be pointed out later. Unusual conditions may enable the United States to float, in instalments, \$5,000,000,000 of bonds at $3\frac{1}{2}$ per cent, but nothing except a bad bargain with income taxpayers will make that possible. The moment that subscriptions lag, it is very important that the rate of interest should be permanently increased. At such a time there will be temptation to resort to temporary financing which may injure the credit of the government and easily take a form that will cause inflation. This was one of the principal errors committed during the Civil War, and it ought not to be repeated today. If provision is made by which bonds may be refunded at the end of five years, it will be far cheaper for the government to offer a higher rate of interest and avoid temporary expedients that are likely to increase greatly the cost of the war.

Another thing to be avoided, if possible, is commandeering the resources of the Federal Reserve Banks and

the other banks that are members of the reserve system. Financial institutions must, indeed, do their utmost to facilitate the floating of loans, and they should also make such temporary loans to the government as their condition will permit. But if serious trouble is to be avoided, the resources of all banks should be kept as liquid as possible, and they should not be expected to absorb a large part of the permanent loans. We are entering upon a period of readjustment, and the banks should be permitted to function as nearly as possible in a normal manner. Every dollar taken from the liquid resources of the banks may diminish by three or four their ability to assist in placing permanent loans.

IV

Whatever plan of finance may be adopted, it is certain that the income tax must be materially increased; and I shall conclude this paper with some observations concerning that tax.

The exemptions now granted under the normal tax are much too high, and should be reduced. In 1913 liberal exemptions were justified on purely administrative grounds, if upon no other, but today the tax is in successful operation and such considerations no longer control. I venture to suggest that the exemption to a single individual be reduced to \$1000, and that an exemption of \$2000 be granted to husband and wife. An additional exemption of \$200 might then be made for each minor child up to the number of five, with the result that for a family of seven persons the total exemption would be \$3000. Such an arrangement would yield a substantial amount of revenue from incomes that now contribute nothing, and would still allow a generous scale of exemptions.

In the next place, specific and effective provision should be made for including in a person's taxable income the fair rental value of a dwelling-house occupied by the owner and the fair value of produce consumed on a farm. The exemption of these items introduces into the present law a serious inequality, since it exempts an important part of the real income of certain classes of taxpayers while other classes are taxed upon money incomes expended for house rent and household supplies.

The ordinary tax upon corporations will be difficult to increase without changes in the provisions relating to collection at source. At present the average corporation is obliged to assume payment of the ordinary tax upon bond interest and upon that part of the profits distributed to holders of preferred stock. It therefore comes about, if the tax is not shifted, that the holders of common stock may be taxed at two or three times the ordinary rate. Further than this, the present law, by refusing to grant a deduction for taxes paid by subsidiary corporations, imposes a multiple tax upon some portions of the income of many companies; with the result that, if the ordinary tax is increased, the burden of such multiple taxation may become very serious. With a rate of 5 per cent, which might not otherwise be excessive, some corporations would be compelled to pay taxes amounting to 10 or even 15 per cent of the income available for distribution to holders of common stock. This difficulty may not have been great when the rate of taxation was one per cent, but it cannot be left out of account if the rate is to be increased to meet the present emergency.

I have discussed in another place¹ the problems arising from the attempt to collect the ordinary tax at

¹ Proceedings of the National Tax Association, vol VIII, pp. 264-79

the source, and will not dwell upon the subject in this paper. But it is clear that the present law, in its application to corporations, has given us in effect a business tax which exempts large numbers of investors and falls with very unequal weight upon holders of common stock. In the case of public service companies, the present tax imposes a burden which must be taken into account in the adjustment of rates, and is bound to be shifted in the long run either in the form of higher charges or poorer service. Regulating commissions may, indeed, proceed upon the theory that taxes should be disregarded in determining reasonable rates; but recurring charges cannot be met indefinitely out of surplus account, and in some cases surpluses have already fallen below the point where they should be maintained in order to protect the credit of the companies. Collection at the source, when it was adopted, seemed to offer important advantages in administration, but it has produced other results which must now be taken into account if the rate of the ordinary tax is to be increased.

By the introduction of a system of information at the source, the difficulties now attending the operation of the ordinary tax could be wholly removed, and the burden of that tax would be placed upon investors where it really belongs. Such a system would be quite as effective in preventing evasion of the ordinary tax, and it would give the government a great deal of valuable information it does not now possess concerning incomes subject to the additional tax. The experience of Wisconsin and, more recently, that of Massachusetts have shown that, with just and effective administration, a system of personal returns, supplemented by information at source, will insure collection of the tax; so that there is now no reason to suppose that the federal government cannot tax incomes unless it employs the

method of collection at source. During the present year under the Massachusetts income tax more than 180,000 returns have been received, and it is already evident that the tax has been a success. The state now has a large body of information which would be useful to the federal collectors, and if the United States would adopt the principle of information at source, provision could then be made for most helpful coöperation between federal and state authorities in taxing incomes.

The additional tax levied by the federal government is now imposed upon investors, as the ordinary tax ought to be. It has therefore avoided the difficulties to which I have just referred, but unfortunately encounters another difficulty. Since it is a progressive tax, it ought to be imposed upon the whole income of the taxpayer, because it proceeds upon the theory that ability to contribute increases with the size of a man's income. But the present law exempts income from United States bonds, from the obligations of a state or any political subdivision thereof, and from securities issued under the provisions of the Federal Farm Loan Act of 1916. The result is that the scale of progression is in practice governed not by the amount of a taxpayer's income, but by the character of his investments. Even with its present rates, the additional tax has created an artificial demand for tax-exempt securities; and if the rates are increased, this demand will be greatly intensified.

Assuming that the interest on outstanding bonds of the United States must in any case be exempt, it is all the more important that a correct policy should be followed in respect to new loans. If the government were levying only a proportional tax, it could reasonably expect that exemption of the bonds would lead to a corresponding enhancement of their prices. But the additional tax gives to large investors a much greater

inducement to purchase government bonds than the ordinary tax gives to the small investor, and it is certain that the price of the bonds will not be enhanced to a degree commensurate with the exemption secured by persons having large incomes. To this point attention has already been called by Professor T. S. Adams.¹ It is true, of course, that if people with the largest incomes could, or would, absorb the whole of the new loans, the price of bonds would be increased to an extent commensurate with the advantage of exemption from the additional tax. But a great part of the loans must be taken by persons with smaller incomes who will not pay so great a premium for them, and the price will be fixed by this class of marginal investors. If, therefore, the bonds are exempted, it is clear that the government will not receive in the form of a higher price an equivalent of the exemption from the additional tax, which exemption, be it noted, not only relieves large taxpayers from taxation upon interest received from the government, but also reduces the rate of the additional tax upon the rest of their income. This difficulty may not at the present moment offset the advantage derived from a rapid absorption of the war loans, which is manifestly the great desideratum. But it is an additional reason for providing that the loans shall be redeemable at the expiration of five years.

In any event, it is clear that the exemption of state and municipal bonds and the exemption of securities hereafter issued under the Farm Loan Act ought not to be continued. The latter exemption may be small today, but it will steadily increase in importance, and will vitiate the operation of the progressive tax as long as it continues. The former is already important, and should receive immediate consideration. State and

¹ *The New Republic*, April 7, 1917.

municipal bonds for two or three years past have been in unusual demand because they are free from the federal income tax. As the rate of the additional tax is increased, it is obvious that there will be a greater artificial demand for such securities, which would be undesirable under any circumstances and is positively dangerous now. This is not a time when states and municipalities should compete with the United States for loans, so that the situation calls imperatively for taxation of state and municipal obligations. It is true that in the case of *Pollock v. the Farmers' Loan and Trust Company*, in 1895, the Supreme Court of the United States held that the federal government had no power to tax state and municipal bonds. But this decision has been overruled by the adoption of the sixteenth amendment, which expressly authorizes Congress to levy taxes on incomes "from whatever source derived." Upon other grounds it would be desirable to bring to an end the policy of exempting any class of securities from the income tax, since such exemption creates a large class of investors who, to the extent that they hold "non-taxables," have no interest in governmental expenditures. With the adoption of highly progressive rates, the policy of exemption becomes a rank absurdity, and the present is certainly the time to bring it to an end.

Readjustment of the rates of the income tax will, of course, be necessary. If the normal tax could be reorganized so as to place the burden upon the right shoulders, its rate could be increased to 5 per cent. If such reorganization is not effected, the rate of the ordinary tax should probably be left at about its present figure, and the additional tax should be imposed upon incomes in excess of \$4000 or \$5000. For the year 1917 the maximum rate on incomes subject to the additional tax should not exceed 25 per cent. Since revenue is

immediately needed, perhaps the best course would be to make a surcharge of 50 per cent upon all income taxes levied this spring under the act of September 8, 1916. This would give a maximum rate of $19\frac{1}{2}$ per cent for the additional tax upon increments of income in excess of \$2,000,000, to which would be added 2 per cent more on account of the normal tax. For the taxes levied in 1918 in respect of incomes received or accrued during the year 1917, higher rates will be desirable; and if the war should continue for three years, still higher rates must be imposed. It is probable that for 1918 the additional tax, without injury to industry, can be raised to 40 per cent upon increments of income subject to the highest rate and that the following year it can be increased to 50 per cent. In this matter, however, Congress should be guided by the conditions of business at the time decision is made, and it would be rash to try to determine at the present moment precisely what the ultimate limits of income taxation ought to be.

The general principle to be followed is that of charging what industry will bear. For the year 1917 commitments have been made, and only a certain amount of readjustment is desirable or possible. In 1918, however, many readjustments will have been effected, and the income tax can be increased to a figure which would not be justified at the present moment. It is not a question of duty or willingness to contribute, but one of changing industries and investment markets from a peace to a war footing. The purpose of Congress should be to effect this transition in such a manner as not to decrease the amount of taxable income, and therefore the source of revenue, available in the second and third years of what may prove to be a protracted war.

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