BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date November 5, 1945

To Chairman Eccles

Subject: Interim Tax Bill

From Richard A. Musgrave

The Interim Tax Bill has been passed by both Houses, just thirty days after the presentation of the Treasury recommendations. The President's signature is expected to follow promptly.

Reduction in Yield

The changes provided for in the Interim Bill are estimated to reduce liabilities for the calendar year 1946 by nearly $6 billion, more than half of which will accrue to corporations. A breakdown of the reduction in liabilities by tax sources is shown in Table I.

The effects on the 1946 collections will fall far short of the effects on liabilities, because the cut in corporation taxes applicable to 1946 profits will not affect collections until 1947. Also, the reduction in personal income tax liabilities will not be fully reflected in collections until 1947. Whereas liabilities for 1946 will drop by nearly $6 billion, the decline in collections will fall short of $2 billion. Collections for the fiscal year 1946 will be affected by less than $1 billion. The immediate inflationary impact of the tax reduction for the transition period is thus less than the over-all cut in liabilities would suggest.

The effects of the Bill on the Federal deficit for 1946 and 1947 are shown in Table II. The deficit for the first half of 1946 is estimated at $8 billion instead of $6.6 billion under the present revenue act; the surplus for the second half of 1946 is estimated at $200 million as against $1.6 million without rate changes. The corresponding figures for the first half of 1947 are surpluses of $2 billion and $6 billion respectively. These figures, particularly for 1947, are, of course, tentative since they depend greatly upon the level of income which will be realized. Considering the period from now to the middle of 1947, during which time the gross national product might decline by about $30 billion, the decline in the level of economic activity is likely to produce an even sharper contraction in yield than would be caused by the current rate changes.

Major Provisions

(1) The most important item is the repeal of the excess profits tax as of January 1, 1946. The provision for the carryback of unused excess profits credits and losses against the tax liabilities of earlier years will continue to apply for 1946 incomes. There was some uneasiness in the Committees that the continued carryback provision may lead to some abuse but no legislative provision was made to curtail them.

(2) Under the corporation tax, the surtax rate for large corporations is reduced by 2 percentage points, lowering the combined rate for corporations with net incomes in excess of $50,000 from the present 40 to 38 per cent. For small corporations with net incomes under $25,000, the reduction in the combined normal and surtax rate equals 4 percentage points. Also, the capital stock and declared value excess profits taxes are repealed, effective June 30, 1946.

(3) Under the personal income tax, adjustments are in three parts:

(a) Normal tax exemptions, now $500 per person independent of dependency status, are made equal to surtax exemptions. The rate applicable to each surtax bracket is reduced by 3 percentage points. The result is almost identical with that of simply repealing the normal tax.

(b) The total personal income tax liability, as computed after these adjustments, is reduced by 5 per cent. The new income tax liabilities at selected income levels are shown in Table III.

(c) Tax liabilities and service pay of enlisted men are forgiven and the time period for the payment of deferred taxes by veterans is extended to 3 years.

(4) The automobile use tax is repealed.

(5) The rate increase in the pay roll tax, scheduled for January 1, 1946 is postponed for one year.

Legislative History

There was general agreement between the Treasury and Congress that this should be an interim bill and that major issues should be avoided. Hence, difficulties were relatively minor and could be easily dissolved. As far as the total loss of yield (1946 liabilities) is concerned, the Bill as passed exceeds the original Treasury proposal by $900 million.

The one major difference was in the treatment of the excess profits tax. The Treasury had recommended repeal and the Senate Finance Committee supported the Treasury recommendation, whereas, the Ways and Means Committee wanted to retain the tax for one year. However, the Ways and Means Committee showed little insistence on its point of view in Conference Committee.

There was no serious Treasury objection to lowering corporation tax rates for small corporations but the Treasury did oppose a flat cut in the corporation surtax rate. Both Congressional committees favored some such reduction. The 2 point reduction which has been passed is a compromise between the Treasury position and the House proposal to reduce rates by 4 points.

With respect to the normal tax, there is little or no difference between the Treasury recommendation for repeal and the provision of the Bill which substitutes surtax for normal tax exemptions and lowers surtax rates by 3 points. The additional 5 per cent reduction in income tax liabilities provided for by the Bill was opposed by the Treasury.

With regard to excises, the Treasury and the House had agreed that the wartime excises should be repealed by the middle of 1946 but the Senate was willing to agree to such repeal only if further adjustments in other excise rates were made. As a compromise, the entire excise reduction was omitted, with the exception of the repeal of the automobile use tax.

Appraisal

In appraising the Bill, it should be clear that some tax reduction at this time was inevitable. As far as the total reduction in liabilities is concerned, there is hardly a major difference between the $5 billion as proposed by the Treasury and the $5.9 billion as passed by Congress, particularly if one allows for the fact that immediate effects on collections will be much less than on liabilities. If the Treasury had proposed a smaller reduction, Congress would have followed suit. There was a general feeling in the committees that the actual cuts were more than necessary.

The major issue is, of course, whether it would not have been better to retain the excess profits tax for 1946. In view of the position of the Ways and Means Committee, it now appears likely that the tax might have been retained if the Treasury had thus recommended. Most likely, the effects of immediate repeal will do considerable damage to the stabilization program without substantially speeding up the flow of goods. As far as the remainder of 1945 is concerned, the provision to repeal the tax as of January 1, 1946 may in fact considerably retard production and distribution of goods. It might have been better in this respect to terminate the tax as of November 1.

The elimination of the normal tax on personal incomes was a proper first step in the downward adjustment of income tax rates. The additional 5 per cent reduction similarly does not seem objectionable as far as its effects on rate structure are concerned, although perhaps it might have been better to make the reduction somewhat more progressive.

Considering the effects on this revenue bill upon additional revenue changes next year, its two most important aspects are the 2 point reduction in the corporation surtax rate and the failure to cut down excises. However, it is interesting to note in this connection that Congressional opinion (including Senator Taft and Representative Knutson) suggests that no further reduction in corporation tax rate can be expected for the next two years, and that major emphasis will have to be given to further cuts in the personal income tax and to excise reduction. For next year's revenue legislation, the present discussion seems to bring out these points:

(1) Congress feels that the corporation tax rates should stay "fairly high" or at least that they must look fairly high. Congress will thus not be willing to adopt the CED or Ruml schemes which will virtually eliminate the corporation income tax. From the point of view of the general tax structure, I think this is a healthy attitude.

(2) The general approach to tax reduction seems to be to "make the gravy go around" -- tax reductions should be spread, rather than used for a revision of the tax structure on broader economic principles.

(3) There seems to be no strong inclination or hurry to bring about a reduction in excises. If the choice will be between further reductions in income taxes or in excises, Congressional preference will be for income tax reductions. This is unfortunate but hardly surprising.

Attachments 3

TABLE I

REDUCTION IN TAX LIABILITIES FOR CALENDAR YEAR 1946

(In Millions of Dollars)

	million dollars
Corporation Taxes	
Repeal of excess profits tax	2,555
Corporate surtax reduction	347
Repeal of capital stock tax	234
	3,136
Individual Income Tax	
Increase in normal tax exemptions	782
Reduction in surtax rates	1,303
5% over-all cut	559
	2,644
Automobile Use Tax, Repeal	140
Total Reduction	5,920

TABLE II

TREASURY RECEIPTS, EXPENDITURES AND DEFICIT *

(In Billions of Dollars)

	1945	1946		1947
	2nd Half	1st Half	2nd Half	1st Half
G.N.P. (Annual Rate)	186.1	168.1	173.5	166.6
Total Expenditures 1/	40.4	26.8	16.4	14.2
Net Receipts:				
Present Law	19.1	20.2	18.0	20.2
New Bill	19.1	18.8	16.2	16.2
Total Deficit:				
Present Law	21.1	6.6	+ 1.6	+ 6.0
New Bill	21.1	8.0	.2	+ 2.0

1/ Including net of trust account.

* The estimates have been made in conjunction with Miss Coffee.

TABLE III

PERSONAL INCOME TAX LIABILITIES

(Married Person, No Dependents)

Net Income Before Exemptions	Present Law	Interim Bill	Reduction In $	Reduction In %
$ 600	$ 3	---	3	100
1,000	15	---	15	100
2,000	245	190	55	22.4
3,000	475	380	95	20.0
5,000	975	798	177	18.2
10,000	2,585	2,185	400	15.5
15,000	4,695	4,047	648	13.8
25,000	10,295	9,082	1,213	11.8
50,000	27,585	24,795	2,790	10.1
100,000	69,435	63,127.50	6,307.50	9.1
1,000,000	900,000	839,714.50	60,285.50	6.7