BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date September 17, 1947

To Chairman Eccles

Subject: Tax Reduction in 1948

From Richard A. Musgrave RAM

File Papers

We hope the attached memorandum will serve as the basis for further work on your tax ideas for the next year.

Of course, this manuscript is still preliminary and the economic outlook is such that the 5 billion dollar tax reduction which the memorandum discusses is indeed of doubtful wisdom as a matter of economic policy. Quite possibly the inflation problem will continue such as to make tax reduction at least in the early part of 1948 as inadvisable economically as it was this year. Since politics in the election year will require that something be done, there are two alternatives: One may be to propose a detailed program in the January 1 message but not to be specific as to when the reductions are to become effective. It might even be possible that this legislation be enacted in early spring, the date of its becoming effective to be decided later. Another and perhaps more feasible alternative would be to recommend the enactment of legislation to become effective on January 1, 1949. This line of thinking -- which was mentioned to me by Louis Shere (now Acting Director of Tax Research) might meet the political needs and at least postpone the economic issue.

As you may have read, the Secretary of the Treasury has appointed a Committee to work out a tax program which includes Carl Shoup, William C. Warren and Harold V. Amberg. Prof. Shoup who is also Tax Advisor to the Economic Council has of course worked with the Treasury for a long time and may be expected to produce a reasonable if conservative program. The other members of the group I do not know. Mr. Knutson has also appointed an Advisory Committee including Mr. Magill and Mr. Hanes. This Committee may be expected to take a piecemeal approach beginning with sharp reductions in the corporation tax.

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TAX PROGRAM FOR 1948

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I. The Outlook for Tax Reduction in 1948

Substantial tax reduction and tax reform should be undertaken as soon as general economic conditions and curtailment of Government expenditures will permit. It is still too early, however, to decide how much, if any, tax reduction can safely be made in the calendar year 1948. The program here presented must therefore be regarded as tentative and subject to revision or deferment should economic conditions and budget developments differ substantially from those assumed.

Economic Outlook

(1) Continued inflationary pressures in 1947 prove that tax reduction this year would have been a mistake. The period since the end of the war has been characterized by a sucession of booms, first in non-durables, then in durables, inventories and now in net exports. Demand for durables is expected to remain strong with further expansion of consumer credit and construction activity has not yet reached anticipated levels. On the other hand, the inventory boom has run its course and demand for soft goods is beginning to weaken. Also, the level of net exports is likely to decline, in the near future, perhaps very sharply. Moreover, there is serious question whether consumers may be able to keep up with rising prices. The annual rate of profits before tax is currently at 29 billion dollars and profits after tax are at 17.4 billion. To date, the extraordinarily high level of corporate profits and savings has been more than offset by an unusually high level of investment and consumer demand, based upon backlog needs and accumulated saving. After these factors have leveled off, the rate of savings will tend to increase and the present rate of profits will tend to create a shortage of consumer demand, which may well contribute to a downward

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Table I

ESTIMATED BUDGET FOR 1948-49

(In billions of dollars)

	1947-48	1948-49
National Defense	$10.8	$ 9.0
International Finance	3.6	3.5
Veterans' Benefits	7.5	7.8
Interest on Public Debt	5.1	5.2
Tax Refunds	2.1	1.5
Other	8.1	8.0
Checking Accounts of Gov. Corporations	- 0.2	--
Total	37.0	35.0

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movement. Finally, the large cash surplus of the Government which is expected for the first quarter of 1948 will be a substantial deflationary factor.

In short, inflationary pressures are still strong and may well continue strong for another year or so. At the same time, enough weaknesses are evident to create possibility that the calendar year 1948 (and more likely the fiscal year 1948-49) may bring a recession sufficiently severe to call for tax reduction. Whatever the precise timing of its application, a tax reduction program should be developed now to meet this contingency. A more detailed discussion of the outlook for the next fiscal year is given in Exhibit I.

Budget Outlook

While the case for tax reduction should depend primarily on the trend of economic conditions, the level of Government spending will also have to be taken into account. In the political setting of 1948 the scope for tax reduction without incurring deficits will be a major factor.

It appears fairly certain at this time that the 1948-49 budget will be at least 35 billion dollars, or not more than 2 billion dollars below this year's budget. To come down to this level of 35 billion dollars, as shown in Table I, national defense expenditures would have to be reduced to 9.0 billion or 1.8 billion below this year's level. International finance and relief expenditures (Marshall Program) have been placed at 3.5 billion dollars or at about this year's level. Veterans' benefits most likely will be somewhat higher in the coming year. Tax refunds will be lower and other expenditures including interest on the public debt should, in the aggregate, remain at about this year's level. The more detailed discussion of the budget outlook as given in Exhibit II indicates

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Table II

ESTIMATED SURPLUS WITH 35 BILLION DOLLAR BUDGET

(In billions of dollars)

Income of 180 Billion	Present Law	Proposed Law
Yield	$38.3	$33.0
Budget Surplus	3.3	- 2.0
Cash Surplus	5.3	--
Income of 185 Billion		
Yield	39.0	34.0
Budget Surplus	4.0	- 1.0
Cash Surplus	6.0	1.0
Income of 195 Billion		
Yield	42.0	36.0
Budget Surplus	7.0	1.0
Cash Surplus	9.0	3.0

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that the estimate of 35 billion dollars is on the low rather than on the high side.

Scope for Tax Reductions

Assuming a 35 billion dollar budget for 1948-49, the question is at what level of income this budget should be balanced. The present tax structure would yield 35billion dollars at an income level of about 170 billion dollars. (Reference is to the level of "personal" income, which is the new Department of Commerce term for income payments.) At current levels of income (195 billion dollars) the yield would be 42 billion dollars. That is, the 35 billion dollar budget could be balanced after a yield reduction of 7 billion dollars. If the balancing requirement is applied to the cash budget which includes the net receipts of trust funds rather than the conventional budget, the permissable yield reduction would be about 2 billion dollars higher or 9 billion dollars. It does not seem likely, however, that conditions during fiscal 1948-49 and especially during the calendar year 1948 will be sufficiently deflationary to make it desirable to devote this entire surplus to tax reduction. To maintain stability and to provide for debt retirement, it would be better to retain some surplus at present levels of income and to plan for balancing the budget at some lower income level such as 180 billion dollars. This level, which is about 8 per cent below the current annual rate of 195 billion dollars might be thought of as a more "normal" prosperity level, to be established after some downward adjustment of prices.

The present tax structure at the 180 billion dollar income level provides for a yield of 38.3 billion dollars. With a budget of 35 billion dollars this would permit a tax reduction of 3.3 billion dollars while

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Table III

TAX YIELD UNDER PRESENT AND PROPOSED LAW
PERSONAL INCOME LEVEL OF 180 BILLION DOLLARS

(In billions of dollars)

	Present Law	Proposed Law	Reduction
Personal Income Tax 1/	$19.0	$15.3	$-3.7
Corporation Income Tax 2/	9.0	8.6	-0.4
Miscellaneous Internal Revenue	8.1	6.9	-1.2
Customs, Etc.	3/ 2.2	2.2	--
Total	38.3	33.0	-5.3
Net Receipts of Trust funds, etc.	2.0	2.0	
Total Tax Receipts	40.3	35.3	

1/ Includes back taxes and current overwithholding. Refunds from overwithholding are accounted for under budget expenditures. On a liabilities basis, income tax yield would be about 2 billion dollars less.

2/ Including back taxes.

3/ Excludes 2.5 billion dollars of surplus property receipts and 1 billion dollars of other nonrecurring miscellaneous receipts.

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Table IV

PROPOSED CHANGES IN YIELD 1/

(In billions of dollars)

Personal Income Tax	
Increase in per capita exemption from $500 to $600	$-1.6
Optional income splitting between husband and wife	-0.7
Decrease in tentative surtax rates by two points	-1.4
Corporation Income Tax	
Increase in basic rate from 38 to 40 per cent	+0.5
Decrease in rate on dividends paid from 38 to 25 per cent	-0.9
Excises	
Elimination of gasoline tax	-0.5
Miscellaneous excise adjustments	-0.7
Total	-5.3

1/ Note: These estimates of change in yield were based on a personal income level of 180 billion dollars, but should not differ significantly at other levels of income around 180 billion except at very high levels of income, see Table II.

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maintaining the budget in balance. Our recommendation, however, is for a reduction of 5.3 billion dollars. At the 180 billion dollar income level this will result in a budget deficit in the conventional sense of 2 billion dollars, but the cash budget -- which is the significant factor with respect to income flow and debt retirement -- will still be in balance. At the present level of income (195 billion dollars) the recommended tax reduction will still leave a budget surplus of 1 billion dollars and a cash surplus of 3 billion dollars. These figures are summarized in Table II.

II. Summary of Program

The yield under the present and proposed revenue structures is shown in Table III and yield costs of the proposed provisions for tax reduction are shown in Table IV. When the time for tax reduction arrives, the major need will be for strengthening consumers' buying power. To meet this need, the benefits of the proposed tax reduction program should be made to accrue primarily to the middle and lower income groups which spend a large share of their income for consumption. This means that priority for rate reductions goes to low bracket income taxes and excises and our program accordingly provides for income tax reduction of 3.7 billion dollars, two-thirds of which goes to incomes under $5,800, and an excise cut of 1.2 billion dollars also accruing mainly to these groups. Corporation tax yield is reduced by 400 million dollars only. This small reduction reflects the simple fact that within the limitations of a 5 billion dollar program a substantial reduction in income tax rates is possible only if the corporation tax yield is maintained at a fairly high level. This can be done without imposing a severe deterrent to investment if at the same time certain

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Table V

PRESENT AND PROPOSED INCOME TAX LIABILITY

(Married person, no dependent)

Net Income before Exemptions	Present Law 1/	Reduction due to			Total Reduction	Proposed Liability
		Higher Exemptions	Lower Rates	Income Splitting		
$ 1,200	$ 38	$ 38	--	--	$ 38	--
1,500	95	38	$ 6	--	44	$ 51
2,000	190	38	15	--	53	137
3,000	380	38	34	--	72	308
5,000	798	42	72	$ 34	148	650
10,000	2,185	65	167	127	559	1,626
20,000	6,394	101	347	1,674	2,122	4,271
50,000	24,795	137	927	6,046	7,110	17,685
100,000	63,128	165	1,877	12,826	14,868	48,260
250,000	191,340	170	4,727	22,001	26,898	164,441
500,000	407,465	170	9,477	23,925	33,572	373,893

1/ Assumes one spouse has all the income.

Source: Senate Finance Committee Hearings on H. R. 1, pp. 512-518.

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Table VI

COMPARISON OF TAX BURDENS UNDER PRESENT LAW, PROPOSED CHANGES
AND THE REVENUE ACT OF 1940

(Married person, no dependents)

Net Income	Present Law 1/	Proposed Law 1/	Revenue Act of 1940
$ 1,200	$ 38	--	--
1,500	95	$ 51	--
2,000	190	137	--
3,000	380	308	$ 31
5,000	798	650	110
10,000	2,185	1,626	528
20,000	6,394	4,271	2,336
50,000	24,795	17,685	14,128
100,000	13,128	48,260	43,476
500,000	407,465	373,893	330,156

1/ Assumes one spouse has all the income.

Source: Senate Finance Committee Hearings on H. R. 1 and Treasury Bulletin, February 1947.

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technical changes are made in the way in which corporation profits are taxed.

Personal Income Tax

The two proposals considered by Congress in the last session were H. R. 1 and the Lucas Bill. The former provided for a flat 20 per cent cut in liabilities over most of the income range which results in a distribution of tax relief excessively favorable to the very top income groups and inadequate for the very lowest income groups (under $1,000 of net income). The Lucas Bill, whose provisions had been given tacit Administration support, (even though the Administration opposed its enactment at the time) gives a more equitable and progressive pattern of adjustments for about the same yield cost. It is adopted as part of this program since it has already been extensively discussed and could therefore probably be enacted with greater speed than an entirely new program.1/

The Lucas Bill provides for an increase in per capita exemptions by $100; a two percentage point reduction in surtax rates and an option to split family incomes. The burden distribution under the present law, the relief obtained from these three provisions and the burden distribution under the proposed law are shown in Table V. A comparison with the prewar burden level of 1940 is shown in Table VI.

The three income tax revisions contained in the Lucas Bill supplement each other and result in a fair distribution of tax relief. The increase in exemptions is desirable because it is the most effective way of giving relief to the lowest income brackets. The proposed increase of $100 involves a yield cost of 1.6 billion dollars and is estimated to lower the number of taxpayers from 48.5 to 43.8 million. A more drastic

1/ Some minor variations of the bill are under study.

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increase in exemptions is not recommended. Since the personal income tax must remain the major tax source, it is necessary, in view of continued high yield requirements, to retain a broad income tax base. If some further reduction in income tax burden for the lower income brackets should become possible later on, it might be preferable to provide such relief by splitting the present first surtax bracket of $2,000 into two brackets and reducing the rate on the new first bracket.

The two point reduction in surtax rates all along the scale is estimated to cost 1.4 billion dollars.1/ If a yield reduction in excess of 5 billion dollars were possible, some further cut in, say, the first three surtax bracket rates should be given a high priority since these middle income groups are not benefited as decisively by the increase in exemptions or reduction in excises as are the lower groups nor do they gain as decisively from the income splitting device as do the upper groups.

The present scale of surtax rates over the upper ranges of the income scale is very steep indeed, and it is reduced but slightly by the two point cut here recommended. However, the upper part of the surtax scale must not be taken at its face value. The effective rates actually paid, if related to a proper definition of income, are considerably less in most cases because of (1) the tax exemption of interest on State and local bonds; (2) the privilege of a preferential rate for capital gains; and (3) the use of income splitting devices. The economic case for discontinuing tax exemption

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1/ In the Lucas Bill the 5 per cent reduction in liabilities under the Revenue Act of 1945 is retained. It is suggested that the surtax schedule be revised to consolidate the 5 per cent liability reduction and the proposed two point rate reduction into a single schedule.

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on State and local securities is overwhelming and recommendations for removal of the privilege should again be made at least as far as new securities are concerned. Complete repeal of the exemption privilege would increase yield by about 200 million dollars but this item is not here allowed for because there is little chance that Congress would adopt such a provision. Some proposals for adjustment in capital gains taxation are considered below.

With respect to income splitting, it is proposed that the problem be met head-on by giving taxpayers the option to split income equally between husband and wife. This relief which is estimated to cost 700 million dollars is significant especially in the $20,000 to $100,000 income range and is designed to take the place of further rate reductions in the upper surtax brackets. Under this provision, a married taxpayer with no dependents and with an income of $50,000 who pays $24,795 under present law will find his tax liability reduced to $18,724. The reduction will of course be less where splitting already occurs. The income splitting option here proposed makes the best of a bad situation. With respect to capital income, various devices such as trusts and inter-family gifts of property already make for widespread income splitting. In the 10 community property states splitting of earned income is possible as well and there is prospect for early community property legislation in other states. Technically, this problem of income splitting could be met by providing for compulsory joint returns or by applying different rate schedules to single and married taxpayers, but such proposals would meet with insurmountable opposition in Congress. In the absence of a more satisfactory solution the general option of income splitting would be preferable to the present situation. However, it should be made clear

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that this option in effect corresponds to a substantial reduction from present surtax rates and that this provision is in lieu of a sharper reduction in upper bracket rates.1/ Given the income splitting option -- and keeping in mind the lower capital gains rate and the tax exempt interest -- the actually effective level of rates is not too severe under present circumstances.

The combined effect of the three provisions is shown in Table IV. The table shows a quite substantial reduction in liabilities for the very low incomes up to, say, $2,500 and a more moderate reduction of approximately 20 per cent in the $3,000 to $6,000 range. Above this level, the magnitude of reduction depends greatly upon the extent of income splitting which already exists. Assuming that there has been no income splitting previously and that all income is received by one spouse, the reduction for incomes from $20,000 to $50,000 is in the 30 per cent range. Above this level, the reduction rate falls off sharply, but it should be recognized that this is the income range where the bulk of income is in the form of capital income which is taxed at rates substantially below the nominal surtax rates.2/

As shown in Table V, the proposed reduction will leave liabilities throughout the income range (except for the group excluded by the increase in exemptions) much above prewar levels. This, of course, is an inevitable result of the greatly increased yield requirements of the postwar budget. Thus, the yield of the 1940 income tax at an income level of 180 billion

1/ One serious objection to this plan is that it discriminates severely against single taxpayers who cannot split their incomes. However, these taxpayers receive somewhat less than 15 per cent of the income in the $20,000 to $100,000 range, which is the range primarily benefitted by splitting.

2/ This, however, leaves the question whether it might not be desirable to provide for a surtax limitation of, say, 60 per cent on earned (as distinct from capital) income. Such a provision would involve a yield cost of less than 100 million dollars.

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dollars would be in the neighborhood of 8 billion dollars, whereas the tax here retained is to yield 15.3 billion.

Corporation Income Tax

In view of the limited scope for tax reduction and the priority of other adjustments, no substantial reduction in corporation tax yield will be possible. Corporation profits after tax are now at an annual rate of 17.4 billion dollars or nearly twice the highest wartime year. Over two-thirds of profits after tax are retained by the corporations. In view of these facts no convincing case for reducing the corporation rate can be made at this time.1/ Given a proper handling of the corporation tax structure a rate of, say, 40 per cent will not result in a serious impairment of corporate investment as long as there is adequate consumer demand to take the goods off the market.

Certain changes may be made in the corporation tax, however, which will not involve a substantial loss of yield but which will reduce possible deterring effects upon investment. Such effects are most likely to result because of the double tax burden on dividend income. Dividend income, under present procedure, is taxed first under the corporation income tax and, after distribution of dividends has been made again under the personal income tax. While these two rates are by no means fully additive, especially for dividend recipients in the high surtax brackets, this double taxation in certain cases results in excessively heavy taxation of dividend income.

1/ A case could be made if it was argued that the corporation tax was shifted -- largely or wholly -- to consumer or wage earners. Our argument is based on the assumption, which seems more reasonable although it is difficult to prove, that the bulk of the tax is not shifted.

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To provide some relief, it is proposed that the corporation rate payable on distributed earnings be reduced from 38 to 25 per cent. This adjustment which will involve a yield cost of approximately 900 million dollars[1/] will further supplement the personal income tax reduction previously proposed. It is recommended advisedly that the dividend relief be given in the form of a preferential corporate rate on distributed earnings rather than as an income credit under the personal income tax as in the United Kingdom. While both approaches may be fashioned so as to be formally similar, the first approach is preferable: (1) It avoids the need for refunds which is likely to arise under the other approach; (2) It exerts some pressure for distribution of earnings; (3) To the extent that the corporation tax is shifted, it is better not to collect from the corporation in the first place.

In order to recoup part of the 900 million dollar loss of revenue due to the dividend credit, it is proposed to raise the basic corporation tax rate from 38 to 40 per cent. This is estimated to provide a yield gain of about 500 million dollars. Some technical changes in the corporation tax structure are also recommended and will be considered below.

Excises

The program allows only for a reduction in excises by 1.2 billion dollars. This leaves excises at a multiple of the prewar level but the limiting factor is the permissable amount of total tax reduction and the fact that some income tax reduction is to be given priority.

It is recommended that the Federal gasoline tax be eliminated and this field be left to the States. This will involve a revenue loss

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1/ Without regard to its effects on dividend policy or to the higher level of individual income taxes under higher dividend payments.

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of 400 million dollars. It is also suggested that the tax upon the transprotation of property and of persons be eliminated. These taxes, which now provide a yield of 440 million dollars, are reflected directly in increased cost of production and tend to be pyramided. The remainder of 350 million should be applied to the elimination of certain other excises which are pyramided or regressive such as the electrical energy tax.1/

III. Timing and Flexibility

In presenting the tax program for 1948, there should be frank recognition that public policy for income stabilization must be flexible. Present techniques do not permit income forecasting for a 12 or 18-months period with sufficient accuracy to make it possible for the Government to commit its fiscal policy in advance for such a period. The idea that admission of uncertainty in a public policy statement (such as the State of the Nation message or the Economic Report) is a sign of weakness and therefore not permissable is foolish. Thus, it will be desirable for the Administration to develop a tax program for 1948 but it is quite unlikely that the outlook will permit recommendation of a tax reduction program for the entire fiscal year in terms which will be completely definitive as to timing and amount.

With respect to timing, it now seems quite unlikely that a substantial tax reduction will be in order for January 1, 1948. Whether the outlook by the end of this year will permit a definite recommendation for June 30, 1948 remains to be seen. If there is insufficient certainty, even as to the direction of economic development, it may still be desirable to

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1/ The excises recommended for removal and/or reduction are: (1) taxes on electrical energy, (2) taxes on telephone service, telegraph, etc., and (3) taxes on light bulbs.

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come forth with a concrete reduction program but the timing should then be left open.1/

Changes in the economic outlook by the end of the year may make it desirable to recommend either a smaller or a larger program than the one here discussed. If the scope for yield reduction is less, the proposed revisions should be considered in the following sequence: (1) increase in income tax exemptions;2/ (2) reduction in excises; (3) reduction in rates; (4) income splitting; (5) dividend relief. If a more extensive reduction program is possible, these additional revisions should be considered: (1) splitting of first surtax bracket and 50 per cent reduction in first bracket rate; (2) reduction of surtax rates in $4,000 to $12,000 range and possibly on earned income at the top end of the income scale; (3) further excise reduction.

IV. Technical Recommendations

The effect of a corporation income tax on the level of corporate investment depends to a very large degree on the extent to which losses incurred can be offset against profits in computing the tax base. Present law, which allows a two-year carry-back and a two-year carry-forward of losses, represents a substantial improvement over the prewar situation, but even further liberalization is desirable. The carry-forward period should be increased to at least five years. A two-year period is seriously inadequate for most new businesses which typically suffer losses in the

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1/ If fiscal policy is to become an effective control instrument, authority as to the timing of tax and expenditure adjustments will have to be delegated to the executive branch. However, this is hardly the time to recommend such legislation.

2/ It may be advisable to recommend such an exemption increase even with continued inflationary pressures as a "cost-of-living" adjustment for the lowest income groups.

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first few years of their existence and which, of course, cannot avail themselves of the additional relief provided for established businesses by the carry-back. Moreover, it is doubtful whether the present carry-overs cover a period long enough for the offsetting of losses over a major business cycle. The two-year carry-back, despite its administrative complication, should be retained (along with the speeded-up refund provisions) in view of its contribution to business liquidity at the onset of a depression. The proposed lengthening of the carry-over period will not result in any considerable reduction in yield for the coming fiscal year as such revenue loss will occur only after a period of extensive losses.

Reexamination of Exemptions from the Corporation Income Tax

Taxpayers cannot be expected to bear the extremely high tax burdens necessary for many years to come without assurance that no class of profit-making business is being allowed to escape its fair share of these burdens. At the present time, there are many types of business enterprise earning substantial profits but making no contributions or disproportionately small contributions to the cost of Government. Most of these are being allowed to escape tax liability because they can claim a specific exemption under one subsection or another of Section 101, Internal Revenue Code. This Section dates from the very beginnings of the income tax and has never been overhauled despite the fact that the problems which gave rise to it, the level of taxation and the character of the exempt organizations themselves have changed drastically over the past thirty years. Continuance of these old exemptions at the present time is not only undermining taxpayer morale, but preventing, by the revenue loss they produce, desirable tax reductions elsewhere in the system.

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Foremost among the necessary changes should be a repeal of the exemption now extended to about half of the farmers' marketing and purchasing cooperatives under Section 101 (12). This section exempts from corporation tax income which is added to certain reserves or paid in dividends to stockholders. Both these privileges are not available to corporations or non-exempt cooperatives. Farmers' cooperatives now have an annual business volume in excess of 5 billion dollars of gross income. Many are engaged not primarily in buying and selling but in manufacturing and even petroleum production and refining on a large scale. Several organizations are known to have sales of more than 100 million dollars each and their tax advantages can be presumed to account for a significant part of their growth to this size. Clearly these organizations no longer merit special privilege and it is recommended that it be removed. The resulting gain in yield will hardly exceed 25 million dollars.

Also, it must be recognized that the repeal of this special privilege still leaves the taxation of cooperatives in a rather unsatisfactory condition. Under present law, patronage dividends are deductible from the corporation income tax; while this provision is available to all corporations, it is of use only to cooperatives and in certain cases may tend to give cooperatives competitive advantages. These arise primarily because patronage dividends are frequently paid in the form of stock rather than cash or reinvestment is required on a compulsory basis. While it is not recommended that patronage dividends as such be made taxable to the cooperative, it will be necessary to tighten up the provisions of the law with regard to non-cash distribution. If no satisfactory solution is found, a special tax on cooperatives based on invested capital may be preferable.

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This tax could then be adjusted to equalize their taxes over the long run with those of their corporate competitors. Such a more extensive change in the tax status of cooperatives might be expected to increase revenues by as much as 100 million dollars.

A change should also be made in the status of those schools, charities and similar organizations exempt under Section 101 (6) which are deriving all or part of their funds from the operation of business enterprises in competition with taxable firms. Profits earned from such ventures should be segregated from contributions and ordinary investment income and taxed in full under the corporation income tax. Steps should also be taken to discourage the use of educational and charitable foundations for the purpose of avoiding estate and income taxes and for maintaining family control over business enterprises. As a minimum, such foundations should be required to disburse annually for educational or charitable purposes all their net income or forfeit the right to exemption on amounts retained.

Modification of the Treatment of Capital Gains and Losses

The treatment of capital gains and losses represents one of the most unsatisfactory features of present income taxation. The main defect, of course, is the fact that the flat rate maximum tax of 25 per cent on long-term gains is far too low in comparison with the burdens on other sources of income. As a matter of principle, it would be desirable to subject all capital gains to the regular surtax schedule and allow full deduction for all net losses but to do so it will also be necessary to apply some averaging device for capital gains and losses. Such an averaging provision might well be introduced before averaging for income in general is considered. To close a further loophole of tax avoidance, it will also be desirable to consider the death of the taxpayer as constituting a realization

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of his gains and losses for income tax purposes.

It seems unlikely, however, that such an ambitious program of reform in capital gains taxation is politically feasible in the near future and more modest recommendations might therefore be preferable. For 1948, an effort should be made to raise either the maximum rate or the percentage of long-term gain taken into account. The holding period should be raised from the present six months to one year. This is the minimum period consistent with the idea that long-term gains should be taxed at a rate more nearly compatible with the time distribution of their accrual. Finally, the loss provisions should be modified to require the offsetting of a net short-term capital loss against a net long-term gain before rather than after the gain is reduced by the statutory percentage. The present treatment has the effect of allowing one dollar of short-term loss to wipe out two dollars of taxable long-term gains. While these provisions would bring the taxation of capital gains more in line with the taxation of other income, it is almost impossible to estimate their precise yield effect but in any case, it will not be substantial.

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EXHIBIT I

Income Outlook for the Fiscal Year Ending June 30, 1949 1/

The Gross National Product for the second quarter of 1947 was the largest in history, measured at current prices. Its further upward movement from the very high level reached at the end of 1946 has been accounted for primarily by two factors: (1) an increase in net foreign investment from an annual rate of $5.2 billion in the last quarter of 1946 to $10.6 billion in the second quarter of 1947, and (2) an increase in personal consumption expenditures from an annual rate of $154.0 billion to $159.0 billion. Thus consumption expenditures continued the advance that began in mid-1945, but at a considerably reduced rate. Likewise, business inventories, which had expanded rapidly, especially toward the end of 1946, are now increasing very slowly.

The Outlook for the Remainder of 1947

At the moment the critical factors in determining the level of activity for the balance of 1947 appear to be exports and the cashing of veterans' leave bonds. It is estimated that net foreign investment (in the absence of action by Congress) will probably decline sharply from the second quarter rate of $10.6 billion to a fourth quarter rate of $7.0 billion. Data released by the Department of Commerce indicate that exports for June and July of this year were down from preceding months. This deflationary factor, however, will

1/ Prepared by Kenneth B. Williams

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probably be largely offset by the cashing of veterans' leave bonds, which we have estimated as contributing to personal income at an annual rate of about $2 billion in the third quarter and $3 billion in the fourth quarter of this year. It should be pointed out, however, that the magnitude of net foreign investment is at present particularly difficult to predict, since the urgency of the need in Europe may force action under the Marshall Plan at an earlier date than was contemplated in the estimates. In any event, it appears likely that for the balance of this year, activity will remain fairly close to the second quarter level.

Although the two factors mentioned above now seem to be most critical for the next few months, changes in other variables may exert considerable influence.

(1) The removal of the remaining credit curbs on November 1 may not have much effect at this time, but such effect as it does have will be on the expansionary side.

(2) Prices are likely to remain close to current levels if expenditures are maintained. A decline in exports might have some effect on farm prices, but could hardly do more than stem the present upward trend during the remainder of 1947. A reduction in exports of capital goods would probably not affect prices in this country materially, because of the continued pressures here on the available supply of such goods.

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(3) The rate of inventory accumulation is another unknown factor. As mentioned above, business inventories are now increasing very slowly. The ratio of stocks to sales in department stores is still low, however, in comparison with prewar relationships. Consequently, the possibility of further expansion in this area must be considered.

(4) The dollar volume of construction has held up well this year despite high costs. New industrial construction, however, has been sliding down.

The Outlook for the First Half of 1948

The critical factors for the first half of 1948 appear to be the same as those operating for the last half of 1947. It has been estimated that net foreign investment will have dropped to an annual rate of $5.0 billion for the second quarter of 1948. At the same time, the stimulus to business resulting from the cashing of veterans' leave bonds will be considerably reduced--we have estimated that the increase in personal income from this source will amount to only $1.0 billion each in the first two quarters of 1948. In the absence of any offsetting factors, there may well be a mild dip in activity for the first half of next year. We need not elaborate again, however, the uncertainties associated with our foreign aid program and the possibility that such aid may be forthcoming fairly early in 1948. Unless this decline in business activity is sharper than now appears likely, it is doubtful whether it will have very

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much effect on prices. Prices of farm products and foods will depend in large part on the extent to which such commodities are shipped abroad. If exports of such commodities are sharply reduced, we may well have some reduction in farm prices. It is unlikely, however, that commodity prices other than for farm products and foods would decrease much in these circumstances.

Many important labor-management contracts expire in the first half of 1948. Demand for additional wage increases will be strong if living costs continue to advance. No attempt will be made to predict the outcome of the bargaining, but the nature of the final agreements may have a considerable effect on the course of business for the next year.

We assume that construction activity will continue high in the first half of 1948 as it has in 1947, in spite of high costs. Costs may be reduced somewhat, but this--if it should happen--seems likely to influence the duration of the construction boom more than the level of activity in the immediate future.

Personal consumption expenditures on nondurable goods and services have been fairly stable since the fourth quarter of 1946. Consumption of durables has not shown a much greater relative increase, largely because of the limited availability of such commodities, particularly automobiles. Nonetheless, the volume of deferred demand will have been considerably reduced by 1948, and it is unlikely that expenditures on consumer durables will increase appreciably unless we have an increase in the production of automobiles.

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In summary, it appears that there may be a minor recession during the first half of 1948 but its occurrence is largely contingent upon the timing of aid abroad. It is unlikely that any major price readjustments will occur during this period unless the recession is very much sharper than now appears likely.

Outlook for the Fiscal Year Ending June 30, 1949

The chief additional influence that we can now see operating in fiscal 1949 is the probability that taxes may be reduced somewhat. We assume that personal taxes in fiscal 1949 will be about $3.5 billion below the 1948 level and that excise taxes will be reduced about $1.0 billion a year. It also seems very likely that regardless of the timing of foreign aid, net foreign investment will be forthcoming at a fairly high level in the last half of calendar year 1948. These two factors of themselves will exert a considerable influence on the economy. It is possible that the stimulus will be strong enough to lead to fairly rapid inventory accumulation in contrast to the present situation. If these possibilities are realized and if the volume of construction remains high, we are likely to have high levels of business activity in fiscal 1949. Under such circumstances, Gross National Product of about $215 billion, personal income of about $185 billion, and disposable income of about $166 billion are quite reasonable possibilities. These would compare with a Gross National Product at the annual rate of $226 billion, personal income at $191 billion, and disposable income at $170 billion in the second quarter of 1947.

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Exhibit II

BUDGET OUTLOOK FOR FISCAL 1949
by
Walter F. Stettner

Outlook

The attached table shows a tentative estimate of the expenditure budget for fiscal 1949. The 35 billion dollar total is two billion below the revised budget estimates for 1948 due primarily to a lower estimate of expenditures for national defense and a reduction in tax refunds. Like in the budget for 1948, four items, national defense, veterans' services and benefits, international affairs and finance, and interest on the public debt account for more than 70 per cent of total budget expenditures. Any significant drop in the future budgets is therefore dependent primarily on reductions in these four items.

The estimate of 35 billion for fiscal 1949 in general assumes the continuation of present programs and with the exception of foreign aid does not make allowance for any new programs which Congress might vote for. The main assumption is that expenditures under the Marshall Plan will keep the outlays for international affairs at current levels but that there will be a substantial reduction in national defense outlays. It is quite doubtful, however, whether these reductions will materialize. Accordingly, the table also shows a higher budget estimate of 40 billion. In addition to a somewhat higher allowance for foreign aid, this budget holds national defense expenditures at this year's level and assumes also that some of the expenditure programs now under active consideration by Congress will be enacted in time to allow a modest start in fiscal 1949.

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Both the 35 billion and the 40 billion dollar budgets assume continued prosperity, a high national income and substantially full employment. They do not include any outlays designed primarily to cope with unemployment. The higher estimate also assumes that both the labor and material situation will have eased sufficiently to permit the carrying out of construction and certain other projects at a somewhat higher rate, yet still substantially within the limits of the present program.

The 35 billion dollar budget, although not a rockbottom budget, appears to be the minimum that can be expected. Aside from further cuts in national defense expenditures (which are wholly unlikely) other expenditures could hardly be reduced by more than a half or at the most by one billion dollars. The assumptions underlying the estimates for 1949 are discussed in some detail below.

1. National Defense

The higher figure of 11 billion assumes a slight reduction in the occupation forces and some administrative economies due to the consolidation of the War and Navy Departments into a single department of national defense. The slight increase over the current rate of expenditures reflects increased cost under universal military training legislation which is likely to be adopted. The lower figure of 9.0 billion is not an estimate but merely reflects the level to which these expenditures have to be reduced if the budget is to be kept at 35 billion. As far as can be learned from available sources, there are no major items in this year's armed forces budget which will be nonrecurring.

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2. Veterans' Services and Benefits

The slight increase (300 million dollars) in veterans' expenditures for 1949 is the net result of a change in various parts of the program as compared to the present year. The estimate assumes an increase in pensions which will continue for several years. With regard to readjustment benefits a decrease in unemployment benefits is assumed which, however, will be offset by greater expenditures for educational and training benefits. Also included in the estimate is a slight increase in expenditures for hospital construction and administration due to the larger number of hospitals which will be in operation. The veterans' program is sufficiently predictable to say that out estimate is not far off the mark.

3. International Affairs and Finance

The estimate of 3.5 billion dollars for international affairs is of course a mere assumption since no definite proposals for submission to Congress have been formulated as yet. Some of the figures which have been mentioned for implementing the Marshall Plan are considerably above the 2.5 billion which are here assumed. It is assumed that 2.5 billion dollars is the minimum which Congress could appropriate within the framework of the Marshall Plan. It is also assumed that the cost of the Marshall Plan will appear as an expenditure item in the budget but consideration might be given to various techniques by which this item might be kept out of the formal budget.

The remaining expenditure of one billion dollars assumes some reduction in the cost of occupation of Germany and Japan and the continuation of relief to the extent of about 200 million dollars to a few countries such as Austria, Italy and Greece. The higher estimate of 4.5 billion

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assumes an increase in the occupation cost of Germany due to a change in the present arrangement with Great Britain, and a somewhat larger expenditure under the Marshall Plan.

4. Interest on the Public Debt

The estimate for interest payments for 1949 is slightly higher than for the current fiscal year despite a possible small reduction in the total public debt. The increase is due primarily to a larger accrual of interest on savings bonds and a possible slight further increase in short-term rates.

5. Social Welfare, Health and Security

The lower estimate of 2 billion dollars under this heading assumes no change from the present fiscal year; however, it is somewhat larger than the original January budget estimate due primarily to increased payments for public assistance grants to the states. These expenditures reflect present contractual obligations and could not be reduced without legislation for retrenchment of the social security and assistance programs. The higher estimate of 2.5 billion assumes a further slight increase in the assistance benefits and a possible liberalization of the eligibility provisions. It also assumes enactment of either a national health insurance program as recommended by President Truman or of some substitute measure such as that sponsored by Senator Taft providing for medical care for low income families and expanded maternal and child health benefits.

6. Agricultural and Agricultural Resources

The 1.3 billion estimate for 1949 assumes a continuation of the Government Price Support Program at the present level and a continued high

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level of farm prices. This program is due to expire in December 1948 but it is expected that it will be continued. The estimate also assumes a small reduction in expenditures for conservation and use of farm lands and a small reduction in loans granted by the Rural Electrification Administration. The higher estimate of 1.5 billion dollars is based on an assumed increase in expenditures for programs for the development and improvement of agricultural resources.

7. Natural Resources Not Primarily Agricultural

The 100 million dollars increase in the 1949 estimate of 1.3 billion dollars allowing for some increase in outlays for flood control and the Atomic Energy Commission. The higher estimate of 1.8 billion dollars assumes that the Corps of Engineers of the Army and the Bureau of Reclamation of the Department of Interior will carry out the present backlog of authorized programs at a somewhat faster rate and that the more advanced stage of many of these projects will require a somewhat larger outlay.

8. Transportation and Communication

The tentative estimate of 1.7 billion is 200 million above this year's figure. It assumes a continuation of Federal subsidies to the Merchant Marine and a Post Office Department deficit at approximately the present rate. It also assumes a slight increase in the outlays under the Federal Aid Highway Program and the Federal Airport Program. With regard to Federal aid for airport construction, Congress this year substituted a contract authorization for the appropriation recommended in the President's Budget. By this device appropriations for this year were held down but an

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increase in appropriations next year appears very likely. The higher estimate of 2.1 billion assumes that both the highway and airport construction work will be carried out at about the rate foreseen in the current programs, and that there will also be some expansion in river and harbor work.

9. Housing, Education, Commerce, Labor, Etc.

The estimate of 500 million includes comparatively small outlays for a number of different purposes. It is assumed that expenditures will be kept at the present level but that very likely there will be some offsetting adjustments within the components. For instance, there may be some increase in subsidies for low income public housing; on the other hand, repayments to the Home Owner's Loan Corporation willlhave ended by that time. The higher estimate of 700 million assumes that some kind of long-range housing program will have been passed by Congress, calling for a moderate increase in expenditures. It also assumes that a modest program for Federal aid to education will have been put on the statute books. The remainder of the increase is accounted for by the anticipated establishment of a National Science Foundation.

10. General Government

The reduction in the estimated expenditure for general Government from 1.4 to 1.2 billion is the result of a decline in expenditures for war liquidation from the current level. It is evident that no major savings can be made in this item which is only a small fraction of the total. The higher estimate of 1.4 billion assumes that there will be some increase in the rate of construction of public buildings.

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11. Tax Refunds

The reduction in expenditure for tax refunds is due primarily to the virtual termination of the excess profits tax refunds in 1949. On the other hand, refunds, both under the personal and corporate income tax will continue.

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THE 1949 BUDGET OUTLOOK

(In billions of dollars)

		Revised 1948 Budget	Low 1949 Estimate	Higher 1949 Estimate
1.	National Defense	10.8	9.0	11.0
2.	Veterans' Services & Benefits	7.5	7.8	7.8
3.	International Affairs & Finance	3.6	3.5	4.5
4.	Interest on the Public Debt	5.1	5.2	5.2
	Subtotal 1 - 4	27.0	25.5	28.0
5.	Social Welfare, Health & Security	2.0	2.0	2.5
6.	Agriculture & Agricultural Resources	1.5	1.3	1.5
7.	Natural Resources	1.2	1.3	1.8
8.	Transportation & Communication	1.5	1.7	2.1
9.	Housing, Education, Commerce, Labor, Etc.	.5	.5	.7
10.	General Government	1.4	1.2	1.4
	Subtotal 5 - 10	8.1	8.0	10.0
11.	Refunds of Tax Receipts	2.1	1.5	1.5
12.	Checking Accounts of Government Corporations	- .2	--	--
	Total	37.0	35.0	40.0

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