

October 20, 1945.

Dear Fred:

Referring to our brief conversation when you expressed surprise at my opposition to the repeal of the excess profits tax at this time, I am venturing to enclose a memorandum outlining my reasons for my position.

I apologize for inflicting any reading matter upon you, knowing how busy you are, but I would like to have you know why I think it a mistake to take the tax off altogether now.

With best regards,

Sincerely yours,

The Honorable Fred M. Vinson,
Secretary of the Treasury,
Washington 25, D. C.

Enclosure

ET:b

MEMORANDUM ON THE TAX BILL

The main reasons for high wartime taxes, including the excess profits tax, were (1) to hold down the deficit and the need for borrowing particularly from the banking system, (2) to reduce inflationary pressures at a time of greatly excessive demands for goods and services relative to supply, and (3) to curb profiteering out of the war.

These underlying reasons for maintaining high taxes apply with equal or even greater force during the critical period of reconversion, because (1) we still face a heavily unbalanced budget; every dollar of Government expenditures not raised by taxes will have to be borrowed, and to the extent that banks furnish these funds new supplies of money will be added to the already enormous accumulations of liquid funds in the hands of the public as a result of war financing; (2) demands, both domestic and foreign, upon our economy are and will continue for an indefinite period to be greatly in excess of supply; and (3) the profits to be made in the next year, at least, will be a direct result of war expenditures and thus just as much war profits as if they were derived while hostilities were still in progress.

Taxation is the last real bulwark against inflationary forces because of the weakening or removal of other controls, such as the War Labor Board exercised over wages and hence prices, or such as the WPB exercised in the construction field. The most prudent course at this juncture would be to defer tax reductions until such time as supply is more nearly in balance with demand and we have begun to approach a balanced budget. At this stage we would be wise to err on the side of too much rather than too little revenue -- taxes can always be reduced.

To the extent that any taxes are reduced at this time, it means adding just that much more to the public debt, which is already approaching 300 billion dollars. Our first obligation is to protect Government credit and the billions upon billions invested in Government bonds and other savings. Unless the deficit can be overcome now that the war is over and demand continues to exceed supply, the question inevitably arises as to when, if ever, the budget can be balanced.

Since the basic problem today is one of shortages of goods in relation to demand and purchasing power, prudent fiscal policy requires that high taxes be maintained in order to reduce the deficit so far as possible. Not only is the backlog of demand unprecedented, but the supply of money in the hands of prospective customers is at an all time high and will be further increased as reconversion and employment in peacetime occupations occurs. The situation would be entirely different if we were confronted with a progressive deflation and inventories were in excess of effective demand. Then, the problem would be to create more demand for goods and to give employment, and fiscal policy would call for first reducing taxes on the lower incomes.

If any taxes are to be reduced now, however, reductions should not go first to those best able to pay, but to those least able to pay. So far as individual taxpayers are concerned, this can be accomplished by removing

the 3 per cent normal tax on individual incomes, as proposed by the Treasury. It is estimated that this entails a loss of revenue of about 2 billion dollars. This will remove from the tax rolls about 12 million taxpayers in the lower income groups. While it will benefit primarily the lowest groups, it will apply to all income taxpayers.

Similarly, if corporate taxation is also to be reduced, the benefits should go primarily to concerns which are not the most profitable, and this, in turn, would be accomplished by reducing surtax rates under the corporation income tax by, say, 4 points, as proposed in Section 121 of the House bill. The benefits would, likewise, go to all corporations but would be of the most help to the smaller ones. Such a reduction, it is estimated, would mean a loss of revenue of about 400 million dollars.

These two reductions, of primary benefit to the smaller individual and corporate taxpayers, would amount to approximately 2.4 billion dollars.

Any further reductions would benefit primarily those best able to pay. This is particularly true with respect to repeal of the excess profits tax. By and large, business and industry which is in the excess profits tax has never been so well off, never had such vast accumulations of cash or its equivalent, never had bigger earnings after taxes, and never had such glowing prospects of profits as are to be made in filling the unprecedented backlog of demands from domestic as well as foreign sources.

It is highly significant that expectations of outright repeal of the excess profits tax are having four adverse effects: (1) It is doing much to boom the stock market, drawing into this vortex of speculation funds that the Government ought to be getting. (2) Whetting the appetite of labor for bigger demands, reinforced by strikes. (3) Inducing corporations in the excess profits group to avoid any further sales in the last quarter of this year, because, obviously, profits after January 1 would go untaxed so far as the excess profits tax is concerned if Congress repeals it as of that date. (4) Inviting inventory speculation in anticipation of profits resulting from rising prices together with lower taxes.

Some moderate reduction in the excess profits tax may be justified in order to discourage wasteful expenditures, but the tax should be retained at a rate of 70 per cent, certainly not less than 60 per cent, during the coming year. This will bring in urgently needed revenue from those corporations best able to pay and will be a damper on speculation as well as a curb on war profits. It will help to demonstrate to the public that the Government means to hold the line and protect the purchasing power of the dollar.

The argument that business needs a special tax incentive to produce and to employ people at this time is inconsistent with the basic economic facts. The war demonstrated that if business has orders it will go ahead producing and furnishing employment notwithstanding high taxes. Business has never had such

a peacetime prospect for orders as it has today because demands -- foreign and domestic -- are so large and so far in excess of supply. With such intense demand and the sharp competition for markets, production would go ahead if there were no reduction in the excess profits tax. It cannot logically be held that removal of this tax will give needed incentive to existing business. As for new business enterprise, its main problem is to obtain material and labor in order to get underway in competition with established industry.

Not unless it were to be carried over as a permanent part of the tax structure and at high rates, could the excess profits tax be considered a deterrent to new and small enterprises because it usually takes years at best for them to make earnings that would be subject to such a tax. Moreover, the Tax Adjustment Act of 1945 provides for an exemption of \$25,000 under the excess profits tax. This is a decided boon to the smaller concern, though it means little to the large and most profitable ones. Instead of benefiting from repeal of the excess profits tax now, the smaller corporations would lose the advantage of the exemption. And to repeal the excess profits tax and leave the normal corporation tax as it is would work still further to the advantage of the larger and to the disadvantage of the smaller concerns, generally speaking.

The argument is frequently made that repeal of the excess profits tax will make no great difference in revenue collections because corporations will pay in dividends to stockholders what would otherwise be taxed from the corporation in excess profits. This would only be true, however, if dividend recipients were taxable at the same rate and if there were a sufficiently effective tax on undistributed earnings to induce corporations to pay them out in dividends instead of retaining them and thus adding to the value of their corporate securities. Average rates under the individual income tax are much lower and there is no specific tax on undistributed earnings. The result of retaining them is to enhance the value of securities and to add to speculative trading in them. Most gains from such transactions, under present capital gains taxation, are subject only to a maximum rate of 25 per cent.

The contention that repeal will help to provide employment and prevent deflation is equally untenable in the light of the foregoing factors. The unemployment we are witnessing is transitional, not chronic. It is not spreading into a cumulative deflation such as we witnessed after 1929, and cannot take such a course so long as purchasing power and demand are so great. Under democratic government, labor cannot be ordered around but is drawn by economic pressure from places where jobs no longer exist in war production to places where jobs will exist in peace production. To characterize the immediate economic outlook as predominantly deflationary is superficial. In order to assure a rapid and permanent reemployment of service men and war workers, the first need is to prevent inflationary developments that would lead in the end to an ultimate breakdown and deflation.

Not only on economic grounds, but as a matter of equity, repeal of the excess profits tax is inconsistent with the facts, for it would benefit, generally speaking, the industrial giants, not small business. During the war years, profits of taxable corporations averaged about 25 billion dollars before taxes as compared with 7 billions from 1938 to 1940. Even after taxes, these profits averaged about 10 billions during the war years as against 6 billions in the prewar years.

While the excess profits have been received by corporations of all sizes, nevertheless, preliminary tabulations for 1943 show that less than 10 per cent of excess profits taxes for that year came from corporations with taxable excess profits of less than \$100,000, while over 70 per cent came from corporations with profits in excess of \$1,000,000. Also, the tabulation shows that income subject to excess profits tax has been a substantially higher percentage of total income for large than for small corporations. Thus, this ratio amounted to 30 per cent for corporations with taxable excess profits under \$25,000; 53 per cent for corporations with profits between \$25,000 and \$50,000; and approximately 70 per cent for corporations with profits in excess of \$500,000.

Not only have corporate profits been higher during the war than ever before, notwithstanding increased rates and the excess profits tax, but business in general has never before accumulated such vast amounts of liquid assets. According to estimates as of the end of 1944, corporation holdings of Government securities, bank deposits and currency amounted to nearly 50 billion dollars, or almost four times the amount of the same items at the end of 1939. In the face of this financial position, it cannot be said that business as a whole needs tax relief.

To take off the excess profits tax now means not only that corporations least in need of tax relief or incentive will benefit by some 2-1/2 billions -- half of what the Treasury sanctions in tax reduction at this time -- while the repeal would be of no benefit to the great bulk of small or new enterprise, but the position of the larger companies will be still further improved by prospective refunds and benefits under the Tax Adjustment Act of 1945, which are estimated to reach a total of over 4 billion dollars in the coming year.^{1/}

For many of the same reasons, the wartime excise taxes should be among the last, not among the first levies to be removed. These, broadly, are taxes on luxuries. To repeal them after July, as proposed in the House bill, would mean a loss in revenue estimated at about 550 million dollars. They should be retained until inflationary dangers are past and the budget in balance.

^{1/} This 4 billion dollars is estimated to include: 1.1 billion dollars from the cashing in of postwar refund bonds; 1.2 billion dollars from the carryback of unused amortization charges for plant and equipment purchased under Certificates of Necessity; 1.2 billion dollars from the carryback of anticipated (1946) losses and unused excess profits credits, applied against 1945 liabilities payable in 1946; 700 million dollars from the current application of the postwar credit against 1945 liabilities payable in 1946. Due to the many uncertainties involved these estimates, with the exception of the first figure, are necessarily un-

certain. However, the estimates are on the conservative side.

To sum up, if any reductions are to be made at this stage, they should benefit primarily those at the bottom of the income scale, not those individuals and corporations best able to pay taxes. Repeal of the excess profits tax in particular not only favors the few and the financially strongest corporations, but it would grant them these benefits, including refunds, at the Government's expense when revenue is of critical importance; it sets an example in pocketing what are in fact war profits that makes it difficult to argue that labor should be denied correspondingly large wage increases; and the effect is to invite the familiar wage-price upward spiral.

The underlying need at this stage is not to arrest a deflationary spiral and to put funds into the hands of people who will spend them or to offer special tax inducements to business to produce. The basic underlying need is to restore as rapidly as possible a budgetary situation which will maintain faith in the currency and preserve the buying power of the billions invested in Government securities and other savings.