

TO Gov.Eccles

FROM \_\_\_\_\_

REMARKS:

Chester Davis received to-day the attached memo from Galbraith with a covering letter to the effect that it might be presented to a meeting of the Farm Bureau directors. He asked me to send you this copy for your information and in case he might get a chance to talk with you further by phone.

ET

CHAIRMAN'S OFFICE

THE DEFENSE TAX BILL

Special Memorandum - J. K. Galbraith

In spite of the fact that it is very late in the session for such a measure, it seems probable that a National Defense Tax Bill will be passed within the next few days. An exceptional situation has arisen wherein some sort of tax action has become publically advantageous. Congress and the public generally are demanding an opportunity to pay for some part of the new defense program. The Administration finds itself with an opportunity to escape certain of the political liabilities supposedly attached to the unbalanced budgets of recent years. So it seems certain that a tax measure will go through.

On Wednesday morning last, Mr. Ogg and I talked at length with Governor Chester Davis on the agricultural aspects of defense taxation and in the afternoon we spent some two hours with Governor Eccles on the same topic. This memorandum follows these discussions and, while it is a statement of my own conclusions, I believe it would meet with the general approval of the principals in these conferences.

THE MEASURE

A tax bill introduced at this stage would have to be simple and the present measure meets this requirement. It proposes a 10 per cent increase in individual and corporate income taxes on income received in the calendar year of 1940 and either a 10 per cent or else specified increases in all other Federal excises. According to Representative Doughton's preliminary estimates the total revenue increase would be 656 millions divided as follows:

Income taxes	\$226,000,000
Gasoline taxes	112,000,000
Spirits	91,000,000
Cigarettes	77,000,000

Miscellaneous Federal Excises	76,000,000
Beer	46,000,000
Theatre Admissions	25,000,000
Stock and bond transfers	5,000,000

It is proposed that this revenue be specifically earmarked for the amortization of the three billion national defense loan. This loan will be financed by short term borrowing and the debt limit will be raised to provide therefor.

#### IMPORTANCE OF THE MEASURE

In my judgment -- and my view here is shared by the other participants in the discussion -- this tax bill is of profound importance to the farmer. This is the first of what will unquestionably be a series of national defense tax bills. As such -- as Governor Davis pointed out with particular emphasis -- it may well set the pattern for the revenue measures to follow. A sound analysis of the bill is consequently of first importance. I have put the following observations together in some haste, but I believe that they constitute an essentially correct analysis.

#### ANALYSIS OF THE MEASURE

The proposed measure can be divided into two parts, (a) the pay-as-you-go financing feature and (b) the taxation feature. The financing feature is a strictly political construction and somewhat unwise. It is not, however, extremely important. The idea of raising three billions at this time and paying it off over five years means that the debt limit can be raised without creating any political hue and cry. It means that everything borrowed over and above the debt limit has the revenue tagged on to it. There is the disadvantage that the securities of this term will be purchased only by the banks rather than by in-

insurance companies and investors. This inflates the volume of bank deposits and involves some difficulties in Federal Reserve control. Governor Eccles makes some point of this disadvantage and it is not a good precedent to establish. But the situation here can be dealt with. It is, of course, foolish to suppose as this financing feature does, that this is our last emergency national defense bill. It is the first of many; in fact a new one has already followed it.

The tax part of the measure is serious and very serious if it is to be the precedent for future national defense taxation. Of the \$656 million (preliminary estimate) \$430 millions take the form of consumption taxes. The Federal tax structure is already heavily weighted with such taxation -- of the 5.1 billions raised in the fiscal year ending 1939 not less than 2,750 billion were consumption taxes or, as in the case of payroll taxes, practically the same thing. Our state and local taxes have shown the same trend.

Looking ahead to further defense developments and the post war situation, this tax trend bears especially, in my judgment, upon farm groups. Consumption taxes intercept that part of income which is on the way to be spent. The core of that spending is for food and fibre products. Thus, even though the farmer were tax free so far as the levies are concerned, he is still standing several billion tax toll in the form of consumer income which does not reach him. But these taxes -- on gasoline, oils, tobacco, automobiles -- are also paid directly by the farmer and like all such taxes weigh regressively upon him. That is to say, they take a disproportionately large part of farm income in comparison with wealthier groups for the reason that farm income is not large. Income and profit taxation by contrast falls lightly or not at all on the farmers. At the same time it intercepts little income on the way to purchase farm products. It

intercepts a good bit of income which will not otherwise be spent at all.

Further this kind of tax misses the war and armament profiteer entirely and, as times goes on, will receive increasing support from him. Indeed, it is possible that this measure already has such support. Fortunes have already been made in sales of metals, machine tools and similar products to the belligerents and companies manufacturing war materials are contemplating profits of from 25 per cent to 50 per cent or more on this year's operations.

Finally, the end of the war is likely to bring a serious collapse of private investment. If it ends quickly through a German victory we face in addition the severe curtailment of our foreign trade. If the Allies win we will also have a slump in armament expenditure both domestic and foreign. If our consumption expenditure is strangled by taxes and if new large fortunes have been built up while at the same time there are no investment outlets for the income they receive and save, then we shall see a slump in national income of unparalleled proportions. Agriculture will again be among the leading victims.

To conclude, if my analysis of this method of financing defense is correct, we place a maximum burden on agriculture, do a minimum to make use of funds that are now idle and men and materials that are now unused and leave ourselves with a serious problem of post-war readjustment -- a problem that is in any case bound to be difficult.

#### THE ALTERNATIVES

Before one can oppose a tax at this time, one must be ready to support alternatives. The alternatives are two: other taxes and further borrowing. As a practical matter we will have additional borrowing and we can probably afford to have it. The big problem in borrowing is not so much that the debt is serious in itself as that people think it is serious. The debt is something we owe to our-

selves and while we will have to pay it off we will also be receiving the pay-off. The charge for debt service i.e. for interest payments is now (fiscal 1939) \$940,540,000 as compared with \$1,055,924,000 in 1924.\* The volume of this service, like the installments on a mortgage, is an important item, but because of the fall in interest rates, it has increased far less rapidly than the nominal debt total. I cite these facts about borrowing not because I endorse it especially, but because we will have it and I don't think we have reached the stage for serious worry about it.

However, additional taxes will be demanded and must be levied. There are four outstanding possibilities and in my judgment all of them should be used. They are:

- (1) The Personal Income Tax
- (2) The Corporation Income Tax
- (3) More effective application of these two taxes
- (4) An excess profits tax or an excess war profits tax.

The personal income tax and the corporation income tax should be our major reliance for the reason that they place no serious burden on our severely depressed consumption and therefore we can have an expanding national income in spite of these levies. (If we tax consumption national income will stay low and all taxes will be hard to raise). I have considerable faith in the revenue possibilities of these taxes. In the last war they were still new and imperfect yet

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\* National Government finance, Statistical Abstract  
of the United States 1939, P. 168

in 1920 they yielded just under four billion dollars -- more than the total cost of the present defense program. It is generally believed that the greatest possibilities for added revenue from the personal income tax is in the middle brackets - \$5,000 to \$100,000 of income.

It is the view of tax administrators that considerable needs to be done and can be done to plug holes in these taxes. In the present emergency income from tax exempt securities should be reached and in my judgment the exemptions should be lowered and the base of the personal income tax thereby broadened. An excess profits tax (we now have one of negligible importance) is our only real attack on war profiteering. Possibly we should not go as far as the English have gone and impose a 100 per cent tax on profits above a certain minimum, but it should be high. A specific war profits tax, i.e. an excess profits tax which is particularly heavy on returns from war orders, should receive serious consideration.

Certain business groups will presently begin to argue that taxes should be reduced in order that they may make their maximum contribution to national defense. This will in the main be a blind for war profiteering. It does not apply at all to the personal income tax. In the case of the corporation income tax and excess profits tax some bottleneck concerns may argue that only the bait of large returns and quick amortization of plant can justify their expansion for war purposes. The difficulty with this argument is that the concern which does not expand and charges the war prices will be in an even better position. It will have reaped the profits and will have the cash. It will have avoided the risk of expanding plant for a demand that will not continue. To cover this situation we should not abstain from taxation or abate taxes. We should instead stand ready

to underwrite the amortization of war-expanded plants. This, with pending legislation, the R.F.C. will be in a position to do. Thus we will guarantee against the sudden withdrawal of war orders at the same time there will be no legitimate excuse for heavy war profits.

IMMEDIATE ACTION

The present defense measure may be so far advanced and the harmony sentiment so strong that corrective action will be difficult. The best thing that could happen would be to allow tax legislation to lie over until a special session or until January and in the meantime have a special committee of Congress give the whole question of defense taxation as careful study as the situation permits. Then the calendar 1940 income, which is taxed in this bill, could be taxed just as well in the new bill. If this line of action is politically impossible, as it may be, then we should:

- (1) Declare ourselves against the principle of paying for a national defense from consumption taxes.
- (2) Declare for an excess profits tax as part of the present measure.
- (3) Declare for higher income and corporation levies and vigorous check upon present gaps for evasion and avoidance.
- (4) Request immediate Congressional study of the whole problem of defense taxation and writing of a comprehensive defense tax bill to replace present stop-gap measures as soon as possible. According to newspaper reports this morning (June 1) Secretary Morgenthau is agreeable to this procedure.