Form F. R. 131

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

# Office Correspondence

Date June 13, 1940

To Chairman Eccles

Subject: National Defense Tax Bill

From Emile Despres

From a political point of view, the prompt enactment of new taxes seems essential. The country is eager to bear sacrifices and Congress is naturally responsive to this mood. Moreover, our traditional modes of thought about financial matters have remained very much as they were ten years ago or even a hundred years ago. It is not yet understood that a national defense program is essentially a question of men and materials, not of money. When an expanded defense program is announced, the first question which is asked is: "Where shall we find the money?" and not: "Where shall we find the men and materials?" This attitude toward financial questions is a stubborn fact which our financing program must take into account, and the popular desire to undergo sacrifices has to be indulged.

From an economic point of view, the central fact of our present situation is the widespread underutilization of productive power. We estimate that the total output of the economy could be expanded by at least one-third and, perhaps, by 40 per cent. It is essential, if our productive power is to be effectively used, that the defense program be financed in ways which do not restrict production and employment in other sectors of the economy as expenditure on armaments increases. General curtailment of civilian buying power may become necessary after our available productive resources have been put fully to work, but it is the worst sort of preparedness to undertake such curtailment now. This means that for the present tax revenues should be obtained in ways which will have the smallest restrictive effect on the volume of private expenditure and that new taxes should be levied especially on the abnormal profits of war-affected industries.

An opportunity may present itself at the next session of Congress to undertake a thorough overhauling of the Federal tax structure. The immediate task, however, is to seek to amend the defense tax bill passed June 11 by the House, in such a way as to indulge the country's mood for sacrifices without too seriously restricting buying power. From an economic point of view, the increases in commodity taxes are the worst feature of the tax bill. These increases will tend both to reduce the consumption of the taxed articles and to leave less income available for expenditure on other consumers' goods and services. In addition, these taxes, being indirect, pass largely unnoticed by the consumer, so that he does not derive from them the feeling of active contribution to the national effort. It is therefore recommended that these tax increases be dropped and that the revenue be obtained instead from an adequate and comprehensive excess profits tax. Such a tax is an indispensable first step if the President's pledge that our defense program will not create a new group of millionaires is to be implemented. The profits of aircraft and machine tool companies are already running at the rate of 30 to 60 per cent per annum at the same time as the incomes of important groups of agricultural producers are being threatened by war developments. Unless effectively dealt with, these distortions are likely to impair seriously the sense of national unity required for a vigorous defense effort. Since the details of an excess profits tax have already been worked out, this substitution could be made without delaying enactment of tax legislation at this session.

A basis for an amendment to the pending bill exists in the form of HR-9513 drafted by Representative Voorhis of California, in consultation with a well-qualified technical adviser. This bill, which provides for a tax on excess profits of corporations with net income above $10,000, would yield an estimated $500,000,000 of revenue on the basis of 1940 corporate earnings, as compared with an estimated loss of revenue of $380,000,000 through elimination of the commodity taxes called for in the present National Defense Tax Bill. The Voorhis bill uses the base period method of determining standard earnings, a method successfully employed in the existing British and Canadian excess profits taxes. The base period is to be the average of three out of the four years, 1935, 1936, 1937, 1938. These three years are to be selected by the corporation. Base period net income is defined as net income over this period, except that base period net income is not to be less than 5 per cent of capital investment (in order to protect corporations with exceptionally low earnings during the base period from excessive taxation) or more than 15 per cent of the capital investment (in order to prevent inadequate taxation of corporations with exceptionally high earnings during the base period).

The tax is to apply to the excess of net income over net income during the base period. For purposes of the excess profits tax net income is defined as net income for ordinary income tax purposes minus (a) Federal income taxes, (b) the dividends received credit, (c) a deduction for the amortization of plant and equipment expenditures made after January 1, 1940, (d) a specific exemption of $10,000. On the excess of net income so defined over base period net income, the following rates of tax are imposed:

| Percentage of net income in excess of base period net income | Tax rate |
|---|---|
| 0 - 10 | 10 |
| 10 - 25 | 25 |
| 25 - 50 | 50 |
| Over 50 | 75 |

ED