

BOARD OF GOVERNORS  
OF THE  
FEDERAL RESERVE SYSTEM

# Office Correspondence

Date June 14, 1940.

To Chairman Eccles

Subject: \_\_\_\_\_

From Emile Despres

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The attached memorandum, prepared by Mr. Krost of this section, outlines a national defense tax program for the period before full employment is reached. We plan to proceed further with work in this field.

Attachment

*ED*

June 3, 1940

Trust

FINANCING NATIONAL DEFENSE

The basic task involved in an expanded national defense program is one of mobilizing and directing productive resources to national defense purposes. The problem of financing is not an isolated problem, but is merely one aspect of this more general task. The choice of financing methods should, therefore, be governed largely by the total economic situation, and, in particular, by the degree to which available productive resources are being utilized.

There is a widespread disposition to believe that we cannot expand our defense activities without an offsetting general curtailment in other sectors of the economy. As an outgrowth of this approach, the problem of financing is therefore concerned largely with the manner of apportioning the sacrifices which are made necessary by an expanded defense program. This view of our present financing problem completely ignores the most important fact of our present economic situation. Full utilization of our available productive power would result in an expansion in the output of goods and services of at least one-third. In this economic environment, the objective of financing policy should not be expansion of the defense program and curtailment elsewhere, but expansion of the defense program and expansion elsewhere. This objective is dictated not only by general social and economic considerations, but also by the broader requirements of the defense program itself.

In the years since 1929 the important industrial countries of the world have been able to approach full employment only after embark-

ing on large scale armament programs. In every instance -- in Germany, Italy, Japan, France and England -- these programs have been financed in large part by borrowing and by taxes on funds that would otherwise not have been spent. In no case have taxes tending to restrict consumer demands been the predominant source of funds; it is only now, after the virtual elimination of unemployment, that drastic measures of this nature are being imposed in England and France.

Military and Naval Expenditures and Industrial Production

1939 Relative to 1929 1/  
(Index numbers; 1929 = 100)

Country	Military expenditure	Industrial production
Japan	736	175
Germany	4,690	129
United Kingdom	580	115
Italy	260	103
France	187	81
United States	166	81

1/ Fiscal years ending in the indicated years. Sources: for production statistics, Monthly Bulletin of the League of Nations; for expenditure statistics, League of Nations World Economic Survey, 1938/39, except Germany, Barron's, October 9, 1939.

In the United States unemployment will not disappear until the national income has increased by about \$30 billion. The income derived from the national defense expenditures that have been proposed during the past few weeks, together with private capital and consumer outlays that may be generated by these expenditures, will not remotely approach this figure.

Although the existing plans for national defense expenditures involve amounts that are small in terms of our capacity to produce, these expenditures are unlikely to remain small. It is altogether possible that they will ultimately rise to levels which will strain our productive capacity to its limits. The best preparation we can make to meet future strains is to increase our productive power now. The productive efficiency of our working population will be raised through rapid expansion of general employment and incomes. The expansion of capacity in basic industrial fields, such as railroads and electrical utilities, can best be hastened by increasing our demands for current output from business as a whole. Full employment is vitally connected with public health and other aspects of our social preparedness. It should not be forgotten that 47

per cent of the men called up under the draft during the last war were found to have physical defects. Recent studies have shown the close connection of sickness with low income, of which unemployment is perhaps the most important cause.

The continued existence of unutilized capacity in industry as a whole is likely to be overshadowed by the attention devoted to the bottlenecks in the production of airplane engines, armor plate and machine tools which are now preventing rapid growth in the production of essential items of armament equipment. It has been suggested in some quarters that these situations should be dealt with by measures of taxation and more broadly that the solution of these minor and temporary difficulties requires important sacrifices on the part of the general consuming public. Taxation is an instrument too blunt for effective use in situations of this kind. These problems should be dealt with by appropriate measures of industrial policy such as programs of apprenticeship training to remedy scarcities of skilled labor and the setting up of priority schedules to insure the allocation of machine tools and scarce raw materials to those uses which are most vital from the point of view of the national defense program, rather than by over-all curtailment of private expenditure through taxation.

The elimination of unemployment is also a necessary condition for the creation of the sense of unity required for the effective mobilization of the national efforts. The experience of other countries has shown that parties devoted to the overthrow of democratic forms of govern-

ment recruit their members most easily from the ranks of the unemployed. Moreover, it is equally important to prevent the growth among the broad masses of the people of the cynical view that our national defense expenditures are directed, not toward a truly national objective, but toward the creation of excessive gains for a few. The only effective method of implementing the President's pledge that our defense program will not create a new group of millionaires is to impose effective excess profits taxation and other taxation measures designed to recapture an appreciable part of the profits and capital gains that will be created by these expenditures. The necessity for measures of this type is shown by the following tabulation:

Annual Rate of Return on Net Worth on the  
Basis of Earnings During the First Quarter of 1940

	<u>Rate (per cent)</u>
Machine tool companies	
A	66.8
B	64.8
C	46.0
D	43.6
E	30.4
F	24.8
Aircraft manufacturing companies	
A	52.4
B	38.8
C	37.4
D	29.2
E	28.0
Automobile company	44.7

From the foregoing discussion the conclusion may be drawn that, so long as large-scale unemployment persists, it is desirable to rely on borrowing for a substantial part of the funds required to finance additional national defense outlays. To avoid the excessive growth of incomes swollen by profits and capital gains derived from the armament industries and to make preparations for a future period when it may be desirable to secure greatly increased tax revenues, the following proposals are advanced:

Proposals relating to the individual income tax:

1. Disallowance of the personal exemption and credit for dependents in the computation of net income subject to surtax. Reduction of surtax rates in the lowest brackets in order to avoid a sharp increase in taxes for those who are now exempt from surtax by only a small margin and for those who now pay small surtaxes.

This proposal represents a return to the procedure in effect before 1934. The present procedure represents in effect a system of grants from the Federal Government made in the form of tax remissions to taxpayers with incomes of \$4,000 and over. For married taxpayers with three dependents, the grant ranges from zero for taxpayers with incomes of \$4,000 to \$2,775 for taxpayers with incomes of \$5,000,000 and over. If grants of this type were made by the Treasury in the form of cash outlays, the unjustified expense would be generally condemned; in their present form these grants are just as costly and just as little justified as if they were made in cash.

2. Revision of the surtax rate schedule to secure additional revenue from incomes between \$5,000 and \$100,000.

The surtax rate schedule embodied in the proposed Revenue Act of 1940 now before Congress would serve this purpose, although that schedule in combination with the lowering of the personal exemption produces an abrupt increase in taxes on incomes of \$5,000 to \$8,000 that might have been avoided in a more carefully drafted plan.

Its effect is to move the American rate structure a short distance in the direction of the British rate structure. The United Kingdom's reliance on the income tax as a

principal source of revenue has been an important factor in moderating the severity of industrial fluctuations and in keeping industrial activity at a high level in that country.

The following table compares tax liabilities under existing legislation in the United States, under the proposals now before Congress, and under existing British legislation.

Married person, no dependents			
	Present rates	Congress proposals	British rates
4,000	44	70	872
8,000	248	317	2,248
20,000	1,589	2,336	8,220
80,000	21,269	30,650	52,072
400,000	232,190	255,392	323,072

3. Introduction of a compulsory joint return for husband and wife. Introduction of a compulsory joint return for "financial families", including the income derived from assets received by gift from the head of the family.
4. Inclusion of undistributed corporate earnings in income subject to individual income tax through the issue by corporations of certificates of participation in undistributed earnings.
5. A repeal of the provision allowing taxpayers to elect to be taxed on capital gains at a maximum rate of 15 per cent.
6. Removal of tax exemption from future issues of Federal Government securities.

The four measures listed above are designed to close loopholes through which large amounts of income now escape taxation. A high proportion of the forms of income that escape through these loopholes is typically saved. Proposals 3 and 4 are probably unconstitutional under past rulings of the Supreme Court, but there is some prospect that present Court might reverse these rulings.

Proposals relating to the estate and gift taxes:

7. Inclusion of gifts during the life of the donor in the computation of the taxable estate; that is, assessment of the estate tax on the total of estate passing at death plus gifts during life, with a credit for gift taxes previously paid.

Under existing law the initial transfers made under a tax-avoidance program designed to transfer an appreciable part of an estate by gift avoid taxation at the highest rate of estate tax to which the estate would be subject by incurring taxation at the lowest rates of gift tax. For example, a gift of \$10,000 from an estate that will amount to slightly more than \$1,000,000 at the death of the donor avoids a prospective estate tax of \$3,200 by paying a gift tax of only \$150. The proposal is designed to equalize the tax treatment of property passing by gift and by bequest.

8. Substitution for the present specific exemptions of \$40,000 under the gift tax and \$40,000 under the estate tax of an exemption of \$10,000 to be applied to the total of estate passing at death plus gifts during life.
9. Elimination of the insurance exemption.
10. Increase of estate tax rates to raise more revenue from estates of moderate size.

By making use of the \$40,000 specific exemption under the gift tax, the \$40,000 specific exemption, and the \$40,000 insurance exemption under the estate tax, an estate of \$120,000, or \$120,000 of any estate, no matter how large, may be transferred to heirs free of tax. An additional \$80,000 may be transferred by gift subject to taxes of only \$5,100. Under the British estate duty, the transfer of \$200,000 would be exempt from tax to the extent of only \$400 and would involve taxes of \$24,000.

Proposals relating to the corporation income tax:

11. Taxation of insurance company income in the same manner as other corporate income.

Life insurance companies had almost a billion dollars of gross income in 1937 but paid only \$392,000 in Federal income taxes. Favorable tax treatment for the insurance companies, justified in some measure by their position as custodians for individual savings, has been carried so far as to confer virtual tax exemption on an important sector of American business.

12. Imposition of an excess profits tax designed to recapture for the Government a considerable part of the profits resulting from armament expenditures and the general business expansion that may result from armament expenditures.

The technical problems of measuring capital investment for purposes of determining the profit ratio and of preventing hardship for enterprises with special operating characteristics, though difficult, are not insoluble. The basic feature of the excess profits taxes now in force in Canada and the United Kingdom is the use of average profits over a short period of years as a standard from which to measure excess profits. To prevent hardship on enterprises with exceptionally low profits in the base years, an amount equal to 5 per cent on invested capital in the base years might be set as a minimum for "standard profits". To secure adequate treatment of enterprises with exceptionally high profits in the base years, an amount equal to 15 per cent on invested capital in the base years might be set as a maximum for "standard profits". Special deductions for rapid amortization of investments in defense industries would be allowed.

The additional revenue yield from the measures proposed may be roughly estimated as follows:

(In millions of dollars)

	At 1940 income levels	At full employment income levels
<b>1. Individual incomes - surtax:</b>		
a) disallowance of personal exemption and credit for dependents for surtax purposes	100	170
b) increase in surtax rates	300	550
c) introduction of compulsory joint return for husband and wife	200	340
d) inclusion of undistributed earnings in tax base	200	1,000
e) repeal of optional 15% rate on capital gains <u>1/</u>	---	---
<b>2. Corporation taxes:</b>		
a) revised treatment of insurance company income	100	100
b) excess profits tax	500	1,000
<b>3. Estate tax:</b>		
a) lowering of exemptions	50	80
b) inclusion of gifts in taxable estate <u>2/</u>	---	---
c) increase of rates	200	450
<b>Summary</b>		
Increase in revenue from proposals	1,650	3,690
Increase in revenue from rise in incomes to full employment levels	---	<u>4,625</u>
a) income and estate taxes		<u>3,225</u>
b) other budgetary receipts		1,100
c) net non-budgetary receipts (primarily excess of payroll taxes over unemployment and old-age insurance benefits)		300
Total	<u>1,650</u>	<u>8,315</u>

1/ Effect on revenue uncertain because of possible effects of the change in tax treatment on the realization of capital gains.

2/ Effect on revenue uncertain.

The most significant fact brought out by this table is that the additional revenue yield from the measures here proposed, besides being substantial at present income levels, would rise with extreme rapidity as national income increased. The revenues furnished by these proposals would be over 120 per cent higher at full employment levels of national income than at present income levels. Moreover, these tax increases would not impede the cumulative expansion of national income in response to increased defense outlays. In both these respects the taxes here proposed differ significantly from taxes on consumption. Consumption taxes offer a superficially easy and attractive way of increasing present revenue. Their future revenue-producing power is far inferior, however, to that of the taxes proposed in this memorandum both because the yield of consumption taxes rises less than in proportion to national income and because the very existence of such taxes impedes the expansion of incomes.

At a full employment level of national income the tax structure, revised in accordance with proposals in this memorandum, would yield aggregate revenues of \$14 billion. The present non-military expenditures of the Federal Government now amount to about \$6 billion. This means that military expenditures could increase to the total of \$8 billion without occasioning any permanent increase in the national debt if at the same time national income rose to the full extent permitted by our productive capacity.

If expansion of defense activities continues after conditions of full employment have been reached, taxes on mass consumption may be required as a part of a set of measures designed to reduce civilian consumption and the utilization of labor and equipment in non-essential industries. Such

taxes might be based on some variants of the "deferred wages" proposal put forward by J. M. Keynes, adapted for collection purposes to the available administrative machinery already set up for the payroll and income taxes.

In the interest of equity, it is important that such taxes should be imposed when they become necessary but in the interest of the effective use of productive resources the imposition of taxes of this type should be avoided until full employment has been reached.