

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date July 22, 1940

To Chairman Eccles

Subject: Some notes on proposals

From Alvin H. Hansen

for increased taxes

1. I should be concerned lest, under cover of financing the new defense program, we balance the entire Federal budget too rapidly.

2. I think we should be careful to avoid building up a tax situation too high in relation to the size of the national income. The existing tax rates will bring perfectly enormous revenues at \$90 to \$100 billion income level. Unfortunately, we are increasing our consumption taxes as fast as, or faster than, other taxes. We are educating the public to pay a big tax bill much faster than we are educating them to make large Government outlays (except for emergency defense). If this happens (as I fear it may) we shall be sunk with a tax millstone around our neck.

3. Even so-called nonconsumption taxes are more or less deflationary, partly because they, at best, fall more or less on the consumption stream, and partly because all taxes per se are inherently restrictive, while expenditures are inherently expansionist in their effect. We need expenditures and expansion, not taxes and restriction. We have already gone much too far on consumption taxes. Lowering the income tax exemptions and raising the rates on relatively low incomes (Revenue Act of 1940) was good, provided we had reduced existing consumption taxes by a corresponding amount. Instead, we raised consumption taxes and, in addition, broadened the income tax base. This was a serious mistake.

4. The defense expenditure in fiscal 1941 will probably be relatively small (say \$2.0 above 1940) and the relatively small expansionist effect may largely be offset by unfavorable trends in foreign trade and inventories and by a sharp increase in taxes.

5. The steady demand for new Government issues, springing from (a) takers of Baby Bonds (about \$1 billion per annum); (b) savings banks, life insurance companies, etc. (about \$1 billion per annum); and (c) Government trust funds (also about \$1 billion per annum) justifies a continuous deficit of about \$3 billion per annum from this standpoint alone. Private thrift in these channels and governmental loan expenditures are mutually complementary. These savings streams cannot in any case be tapped to any appreciable extent by high surtax rates, corporate taxes or excess profits taxes. They ought to be tapped by Federal borrowing.

July 22, 1940

6. For the present, we ought probably not to add to existing taxes except to enact an excess profits tax. While the rates on the excess profits might be pretty stiff, the "floor" and "ceiling" from which the excess is calculated ought to be liberal. A liberal exemption makes it easier to administer, while a liberal exemption combined with high rates above the base bring the widest possible popular support. The excess profits tax ought not to be designed to tax relatively moderate profits. For this, the general corporation income tax is appropriate. The "ceiling" possibly ought to be about 20 per cent.

7. We should stop some of the loopholes. Family (instead of separate) returns could at once be recommended. Inclusion of individual income for tax purposes of accrued earnings in the form of undistributed corporate profits ought to be pushed as soon as possible. It is probably not yet possible, owing to the recent undistributed profits tax debacle.

8. Taxes, as such, perform no useful purpose whatever (loan expenditures are always to be preferred) except for the considerations listed below:

- a. Taxes designed to tap the savings stream are useful and necessary as a check on too great inequality of income.
- b. Consumption taxes are positively harmful, except as a means to prevent inflation when full employment is reached. Even then they are necessary only in a situation in which it is not possible to reduce (as in wartime) governmental expenditures sufficiently to check inflation.

9. At the moment we ought to rely heavily on borrowing from the public. Later, when incomes have risen considerably and we have approached more nearly full employment, we ought to stiffen the excess profits tax, the estate tax, the corporate income tax, and the individual income tax--all designed to tap the savings stream. Finally, as it becomes necessary to divert production resources from consumption to defense expenditures, we shall have to impose consumption taxes.

WAS