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Mr. Despres suggested that I send the attached down to you, in the event the Chairman wanted a copy.

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April 4, 1941. *cy*TAX PROGRAMThe Economic Background

1. The Budget Picture. Preliminary estimates for the fiscal year 1942 indicate a budget deficit of about \$13 billions with the existing tax system. However, non-cash items in the budget and the net increase in Social Security funds will together amount to about \$2 billions. The net cash disbursements of the Federal Government, including the unemployment insurance programs, are estimated therefore to amount to some \$11 billions, or a little under 50 percent of total expenditures. This is the sum which will have to be raised from borrowing. It is estimated that around \$2 billions will be raised directly from individual savings through purchases of baby bonds, leaving \$9 billions to be borrowed in the open market.

2. Taxes and Inflation. On the basis of the above estimates, new taxes are not now required in order to control prices. This is particularly true of taxes which fall heavily on consumption. A large margin of unemployment still exists. To remove this margin, expansion is needed in consumption and in jobs in consumer industries. An essential aspect of a real defense effort is the maximum use of productive resources. It is true that important shortages in basic materials have already appeared, and more will appear during fiscal 1942, giving rise to heavy upward pressure on individual prices. For some time to come, however, these shortages will be specific, not general, and they must be handled by specific means -- priorities, allocation, direct price control. General taxes are not an effective means for controlling such situations; they operate through depressing the level of total demand for goods. Total demand, and in consequence, total employment, would have to be curtailed in an exorbitant degree if the troublesome prices were to be significantly affected. We want, of course, more employment, not less, and to this end total demand must be permitted to increase. The necessary diversion away from bottleneck areas can be effectively accomplished through specific controls.

3. Future Inflationary Pressure. If the defense effort continues to grow in size, and if tax policies permit a level of full employment to be reached, our productive capacity may eventually be insufficient to meet both military and civilian needs. At that point measures for reducing the volume of consumption will have to be used. Before such measures should be undertaken, however, from the standpoint of equity and civilian morale it is essential that the existing tax burden be distributed far more in accordance with ability to pay than it is now. As national income rises, the rich get richer more rapidly than the poor become less poor. Tax measures other than those which strengthen the progressive nature of the tax system can only aggravate this tendency. The TNEC study indicated that in 1938-39 families with incomes under \$1,000 paid a greater proportion of their incomes in taxes of all kinds than did families with incomes from \$1,000 to \$10,000. In a defense effort, surely as much as in normal times, the tax burden should be distributed in accordance with ability to pay. The low income groups

cannot in all justice be asked to sacrifice more, before wealthier groups are contributing a fairer share than our existing tax structure requires.

4. Taxes and the Post-Defense Situation. During the defense program the impetus behind business activity is armament expenditure. It is the eventual withdrawal of that impetus which induces anxiety over a post-defense collapse. Plans are being formulated now for meeting the problems which will then arise. The severity of these problems, however, will in no small degree depend upon the further inequities in income distribution which are permitted to develop during the defense boom. Partly this is a matter of effective price control, but partly also it depends upon the tax measures which are instituted. There is no better way of preparing for the post-defense period, of assuring future markets for private enterprise, than to take steps now to remove loopholes and inequities, and to build up a sound progressive tax system.

5. Public Opinion. The major reason why taxes should at this time be increased rather than merely revised is political rather than economic. Public psychology, on the one hand, is profoundly disturbed by too rapid an increase in public debt, and on the other hand, is favorable towards a degree of financial sacrifice for the defense effort. The whole political atmosphere is favorable to increased taxation.

6. Desirable Tax Legislation. Economic analysis of both the current situation and likely future developments strongly suggest that we take advantage of the favorable political background to make urgently needed, long-run improvements in the general tax structure. Such a program should include revisions of income, estate, and gift taxes and a strengthening of the excess profits tax to abolish loopholes and to increase the equity and progressive character of the whole tax system. These measures will not bear heavily upon consumption, they will become of rapidly increasing productivity as income rises, and they will work against the tendency toward excessive inequality in income distribution with rising income. The suggested improvements in these taxes could easily produce an additional revenue of \$2 billions in the calendar year 1942, and it is doubtful whether much more than this could be raised by new taxes next year without causing unfavorable effects on the level of production and employment.

7. Excise Taxes. If, because of political pressure, it proves necessary to include some direct consumption taxation in the tax program, it would be preferable to have such taxation take the form of specific excise taxes on consumer durable goods rather than of general taxes or taxes on non-durables. Taxes on durable goods, such as automobiles, would serve to divert consumer demand away from those products using substantial quantities of material needed for armament

production, although the same end could be somewhat better achieved by direct controls. Furthermore, excise taxes on durable goods do not have as harmful effects on the income distribution as do other consumption taxes.

### Suggested Tax Program

1. Excess Profits Tax. It is suggested that the effectiveness and yield of the excess profits tax be increased by eliminating the "past-earnings" option and by reducing the invested capital exemption to 6 per cent -- provided, however, that some satisfactory option can be formulated for service corporations where invested capital requirements are small. This change would yield an added revenue of about \$750 millions in the calendar year 1942.

2. Normal Corporation Income Tax. Increasing this tax rate to 30 percent would yield an additional \$600 millions in the calendar year 1942.

3. Personal Income Tax. This is the most equitable of all taxes and should be the mainstay of a good tax system. The present tax, however, because of exemptions, withheld profits, other loopholes, and low rates in the middle brackets, will yield only 20 per cent of Federal revenues. The following revisions and improvements are suggested:

a. Abolition of the privilege enjoyed by husbands and wives of filing separate returns. Practically all wealthy couples make use of this loophole to reduce their taxes substantially.

b. Disallowance of the personal exemption and credit for dependents in computing the surtax. The present practice amounts to granting a subsidy which increases as income increases.

c. Increased surtax rates in the income brackets from \$5,000 to \$50,000. It is generally agreed that the rates on such incomes are unduly low.

The above changes, including a moderate increase in middle bracket rates, would yield around \$700 millions in calendar year 1942.

4. Estate and Gift Taxes. The strengthening of these taxes is, on both economic and social grounds, the most needed reform in our tax structure. The following changes are suggested:

a. Inclusion of gifts during the donor's life in the computation of his taxable estate, with, of course, a credit for gift taxes previously paid. At present tax liability at the highest estate tax rates to which the estate would be subject can be avoided by incurring taxation liability at the lowest gift tax rates.

b. Substitution for the present exemptions of \$40,000 under the gift tax and \$40,000 under the estate tax of an exemption of \$10,000 applied to the total estate at death plus gifts during life.

c. Elimination of the insurance exemption of \$40,000.

d. Increase in rates applicable to estates of moderate size. These are now unduly low.

The suggested changes would yield no additional revenue in the fiscal year following enactment, because of the 15-month lag in payments. In the past, this lag has been a major difficulty in getting action taken on the desirable revisions. The changes will, however, yield substantial revenue in subsequent fiscal years when revenue needs will be more pressing than in 1942. Moreover, the social desirability of these changes far outweighs any fiscal considerations arising from the lag in payments.

5. Combined Yield of Proposed Changes. It is estimated that the additional revenue from the revisions suggested above would amount to something over \$2 billions for the calendar year 1942. For the fiscal year 1942, which includes tax payments on about half of 1940 incomes to which the new taxes would not apply, the added revenue would amount to around \$1 billion. In subsequent fiscal years, as national income rises, the productivity of these revisions would rapidly increase.

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