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Chairman Eccles

Martin Krost

Secretary Morgenthau's
suggestion for 6 per cent limit
on corporate profits

Information from the Tax Research Division of the Treasury and from other sources indicates that the Secretary's proposal was made without previous consultation or study of the problem, and that details of the proposal are still in a formulative stage. It was suggested that unless there were a direct exchange of views with the Secretary, it might be desirable to say that, since the details of the Secretary's proposal were not available for study, you were not in a position to comment upon it.

In the event that you wish to state your views on the issue, however, the following brief notes might serve as a rough indication of the general nature of the reply. There are also attached references to the excess profits tax in your testimony before the Ways and Means Committee, in your speech before the Chamber of Commerce, and in your FORTUNE article.

"I have not had an opportunity to study the Secretary's proposal in detail. I do not believe that the Secretary meant to propose a rigid 6 per cent limitation on profits for each individual corporation. I think his statement reflected a very general feeling that excess profits ought to be more effectively taxed than they are under the Revenue Act just passed. Perhaps the Secretary meant to suggest that industry as a whole should be satisfied with a 6 per cent rate of return under present conditions, with an appropriate adjustment of this ratio as between corporations to reflect variations in operating efficiency. That would be a practical effect of placing a ceiling on the amount of base-period earnings that can be claimed by a corporation under the present law. Some allowance for differences in earning power as reflected in base-period earnings would be made.

"The Government has not requisitioned industry and placed corporation executives in a position of hired Government employees. So long as it has not done this, it must leave some incentive for corporation management to operate efficiently and to avoid waste in the use of man power and materials. If the Government took everything above 6 per cent this incentive would be gone. That is why, although I am in favor of very high tax rates on excess profits, I should be opposed to a rigid and inflexible upper limit on profits."

Attachment

MK nb

Excerpts from

Statement before Ways and Means Committee, May 7, 1941:

"In my opinion an effective excess profits tax is the keystone of a well balanced tax program. Any tax program will have to include a substantial increase in the rates of taxation for corporate incomes in general and for individual incomes. You should not impose increased taxes on the great numbers of business concerns of small and moderate size and on millions of individual taxpayers until you have given them every reasonable assurance that the funds they are being asked to provide will not go to swell the excessive profits of some corporations.

"The excess profits tax now on the statute books does not give any such assurance. If you allow the idea to take root in the public mind that through these vast expenditures a few are being made rich and a few who are already rich considerably richer, the result is bound to endanger the success of our defense effort. In order to prevent an inflationary spiral of price and wage increases, labor should be willing to moderate its demands for increased wages, but labor cannot be expected to follow such a course if employers are permitted to retain excessive profits.

"* * * The revenue-yielding potentialities of an excess profits tax were well demonstrated by our own experience during the World War. The present statute could be made to realize those revenue potentialities by changes in a few important respects. I shall mention three:

"1. Restrict the use of the income method of computing the excess profits credit, either by reducing the 95 per cent of past average earnings now allowable to 75 per cent, or by any other method that may recommend itself to the Committee. I agree with Mr. Sullivan's view that all excessive profits, as well as profits directly or indirectly attributable to the defense program, should be subject to special taxation.

"2. Increase sharply the rates now applicable to excess profits. In the light of the maximum 80 per cent rate in force in this country during the last World War, a maximum rate of 75 per cent is not too high. It is also important that the tax brackets used in the present law be revised. I recognize the strength of the arguments for graduating the rates according to the percentage of excess profits to invested capital, the method used at the time of the World War, but if the present method is continued, there is no reason why the maximum rate should not apply to excess profits at a very much lower level than \$500,000. A corporation with this amount of excess profits cannot fairly claim favored treatment as a small enterprise.

"3. Reduce the rate of return allowed under the invested-capital method of computing the excess profits credit from the present figure of 8 per cent to 6 per cent. The figure of 8 per cent was used during the days of the World War. The rate of return that investors

could reasonably hope to realize on investment in securities has been materially reduced since that time. We should make a similar adjustment in our ideas about an appropriate rate of return on equity capital."

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Speech before Chamber of Commerce, May 1, 1941:

"The first source of defense revenue should be the corporation tax and the excess profits tax because, in general, corporations are the greatest beneficiaries, directly and indirectly, from defense expenditures. In other words, the surplus accruing from the expanding national income tends to become concentrated in the first instance in the possession of business corporations. The most certain way to insure against inflation is for the Government to levy on these earnings and divert the proceeds directly into the defense program before they are distributed into the general income stream through higher wages and higher dividend payments.

"Thus, the most direct way to attack the inflation problem is through heavy corporate income and excess profits taxation. If these surplus funds are not thus collected in the first instance at the source, but are later distributed through large wage increases and large dividend payments to the community, it becomes necessary subsequently for the Government to abstract excess incomes through the personal income tax, excise taxes, and other forms of mass taxation. The problem is not avoided but only delayed and made more difficult by failure to tap the profits at the source.

"High taxation of personal incomes and excise taxation will be necessary in any event, but the amount needed from these sources will be reduced by a prior collection at the points where the profits originate, namely, in the business units. If excess profits are not tapped, they will lead to demands for higher wages. Apart from the question of equity and the problem of allaying industrial unrest, is the question of going directly to the source of the increased flow of income and diverting it into the defense program before it spreads out into the community and adds private mass purchasing power on top of the Government's demands springing from the defense program.

"With greatly increased surtax rates, especially in the middle income brackets, and in the absence of an undistributed profits tax, there will be a tendency on the part of some corporations to hold back disbursements of dividends. This is a further reason for heavy normal and excess profits taxes on corporations."

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FORTUNE Magazine, "Price Fixing Not Enough"

"During the emergency we shall have to rely heavily upon the excess-profits tax and the tax on corporate incomes. This is true because, generally speaking, business units are the greatest beneficiaries, directly and indirectly, from defense expenditures. The profits accruing from the expanding national income tend to become concentrated here in the first instance. Consequently, one of the surest ways to safeguard against price inflation is for the government to levy on such profits and divert them directly into the defense program before they are distributed into the general income stream through higher wages and increased dividends.

"Perhaps the most compelling reason of all for the imposition of the excess-profits tax is that, if not taken by the government, such profits will lead to further demands for higher wages. If wage increases continue to be freely granted to those who have already received substantial increases, they will swell unduly the volume of private purchasing power. Labor should certainly be willing to moderate its demands for increased wages, but it cannot be expected to follow such a course if employers are permitted to retain excessive profits. Moreover, with increasing personal income taxes, many corporations may be expected to leave a large proportion of their profits undistributed. In the absence of an undistributed-profits tax, therefore, these will be beyond the reach of the government, unless recovered through heavy taxes on corporations.

"The corporate form of ownership is the principal institution through which capitalism functions. Owners and managers of corporations, vitally interested as they are in preserving capitalism, have every reason to favor, not oppose, heavy taxation of their profits, for thereby they will help to protect the country against the inflationary dangers that would undermine the foundations of capitalism. They have the greatest stake in democracy--the most to preserve. They should not expect those who have the smallest stake to pay an unjust share of taxation.

"During the emergency the excess-profits tax should in my opinion, be the keystone of a well balanced program. Increased taxes, however, should not be imposed on the great numbers of small business concerns and on millions of individual taxpayers until they have been given every reasonable assurance that the funds they are being asked to provide will not go to swell the profits of wealthy individuals and corporations."