IOWA STATE COLLEGE
OF AGRICULTURE AND MECHANIC ARTS
AMES, IOWA

DEPARTMENT OF ECONOMICS AND SOCIOLOGY

August 29, 1942

Marriner Eccles, Chairman
Board of Governors
Federal Reserve System
Washington, D. C.

Dear Mr. Eccles:

The enclosure is a memorandum which I have sent this week to the White House and to the other agencies mentioned at the foot of the summary. It isn't an "open letter", and no other copies are going out; though the attached memorandum to the Senate Finance Committee is getting some circulation.

There's no use pretending that the anti-inflation battle is going well. Even if wages and farm prices can be checked, we'll soon be in trouble on account of excess spending power. In fact, trying to stop the food prices which are now uncontrolled will remove what has been the safety valve, and if anything will make the pressure harder to handle. Everybody knows that to work price control we must back it up by really radical taxation. But unless the Administration is put on record at this time as backing an adequate tax program, we stand not only to take a defeat on the inflation front but to take it in such a way that the public won't learn from the experience. If a sufficient tax program is put forward and wins, we ought to be able to hold the price line. If it's put forward and loses, the Administration can say honestly that the trouble with the inflation situation is failure to adopt a program which it put forward. If the tax business is left to go its own way, however, the public will simply learn that something went wrong somewhere in the government, which isn't a very valuable lesson!

Very truly yours,

Albert G. Hart.

Albert Gailord Hart.

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PLANNING AND PRESENTING THE ANTI-INFLATION CAMPAIGN

Memorandum to President F. D. Roosevelt
from Albert Gailord Hart,
Iowa State College

## SUMMARY

Introduction. If Labor Day is made the occasion for fresh pronouncements on wages and farm prices, the opportunity should be seized to restate the entire anti-inflation program. p. 1.

What it Takes to Block Inflation. Success abroad in blocking inflation rests upon the use of very heavy taxes and of consumer rationing to back up price control. In trying to operate price control without either of these supports, we are bluffing our way through; and this can't carry us very far. pp. 1-2.

Taxes and Rationing. The policy of limiting the scope of rationing implies heavier rather than lighter taxes than those used in Britain. While there is some possibility of reducing tax loads by very extensive rationing, or of limiting rationing by very heavy taxes, the minimum level for both lines of anti-inflation work is far above where we are now. pp. 3-4.

Revenue Needs. As Secretary Morgenthau told the Senate Finance Committee, we should do as well in covering our war spending by taxes as Britain and Canada. This implies about $16.5 billion of taxes besides those now in sight; other rules for estimating tax yields give similar answers. p. 4.

Possible Revenue Sources. Sales Taxes are much over-rated and cannot raise any large fraction of requirements. Profits taxes cannot be used much more for anti-inflation purposes. The great untapped source is personal incomes. If we enacted the Canadian system, for example, we could raise a good deal more than $10 billion beyond what is now in sight, and very probably solve our problem. pp. 5-6.

Compulsory Loans. Consideration should be given to following Canada by putting part of such a tax levy on a postwar-refund basis (compulsory savings). pp. 6-7.

Public Presentation--The General Problem. It is entirely feasible to get the causes of inflation understood by the man-in-the-street. The public's wishful superstition that price control alone can block inflation must be combatted; this is what makes it essential to stress taxes simultaneously with wage and farm price policy. The popular belief that it is healthy to "pay as we go" for much of war spending can properly be appealed to--if only to comfort the middle-bracket people who hold it as they face realistic taxes. pp. 7-8.

Public Presentation--Types of Taxes. We must convey to the public the need for effective income taxes--meaning high rates on the first few hundred dollars of income taxable and current collection of taxes. Compulsory savings, if introduced must be interpreted in terms of the need to assure each citizen that others are doing their share. The sales tax must be shown up as impractical (which it is), and mot merely "unfair". pp8-10.

An Anti-Inflation General Staff. To get the necessary concerted and continuous push behind an adequate anti-inflation program takes a standing committee representing government agencies like the Treasury, B. P. A. and O. W. I. and preferably also the responsible Congressional Committees. This committee should be charged both with framing the details of policy and with interpreting it to the public. It should have a skeleton staff, preferably directed by an economist attached to the Executive Office of the President. pp. 10-11.

Formulation of a Policy. The general lines of policy, including the announcement of a push for a genuine war income tax, can well be stated in the projected Labor Day talk, which might also announce formation of the committee proposed above. The Committee should be charged with putting the program on a working basis, and particularly with putting together quickly an adequate emergency tax bill. p. 12.

Copies of this Memorandum to:

Harold Smith, Bureau of the Budget
Randolph Paul (in charge of tax bill) U. S. Treasury
Marriner Eccles, Federal Reserve
Leon Henderson, Office of Price Administration
Elmer Davis, Office of War Information

No copies are being released in any form.

TAXATION AND THE CONTROL OF INFLATION

Memorandum to the Committee on Finance, U. S. Senate

from Albert Gailord Hart
Iowa State College

NOTE: For the convenience of the Committee, this memorandum is summarized on this sheet and its separate sections are so arranged that they can be read independently of each other.

A. REVENUE NEEDS OF 1942-43. (pp. 1-4)
Secretary Morgenthau suggests we should raise as large a proportion of expenditures by taxes as Britain and Canada; this would mean an additional $15 billion of revenue. (p. 1)

Foreign experience indicates blocking inflation takes both sweeping rationing and taxes on this scale. (pp. 1-2)

Study of American experience (table, p. 3) confirms our need for at least $15 billion of revenue beyond present Revenue Bill. (pp. 2-3)

In view of uncertainty, we should be in a position to raise at least $5 billion more if needed; compulsory savings may be included, in limited amounts. (pp. 3-4)

B. TYPES OF TAXES TO BE RELIED UPON. (pp. 5-9)
Possible sources of funds are reducing civil expenditures, sales taxes, profits taxes, taxes and compulsory savings based on personal incomes. (p. 5)

Maximum expectation from reduction of civil expenditures is $1.5 billion. (p. 5)

Sales taxes are not a practical solution for our needs because yields are so small (c. $2.5 billion at a 5% rate) and effects on price control bad. (pp. 5-7)

Profits taxes are unlikely to help much against inflation because there is little room to raise them and because dollar for dollar they affect consumer spending but little. (p. 7)

Personal income taxes have enormous revenue possibilities (table opposite p. 8) and should be our main reliance. (pp. 7-9)

C. TRANSITION TO A CURRENT BASIS FOR INCOME TAX COLLECTIONS: (pp. 10-12)
Mr. Beardsley Ruml's plan for skipping 1942 taxes and collecting 1943 taxes in 1943 is sound except for differential benefits to estates of large taxpayers. For persons with surtax net income above some stated figure, 1942 taxes should be deferred for settlement with their estates. (pp. 10-11) Administrative suggestions (pp. 11-12)

D. ELIMINATING TAX EXEMPTION: (pp. 13-15)
The defense of tax exemption is the legitimate expectation of security-holders, which does not extend to war taxes; the solution is to include such income at a fraction (60% suggested) of face value.

E. PROFESSIONAL QUALIFICATIONS OF THE WRITER. (p. 16)
Summary like that customarily filed by witnesses before the Committee.

# TAXATION AND THE CONTROL OF INFLATION

Memorandum to the Committee on Finance,
U. S. Senate
from Albert Gailord Hart
Iowa State College

## A. REVENUE NEEDS OF 1942-43

Secretary Morgenthau told your Committee on July 23, 1942 that "Canada. . . in the fiscal year 1943. . . expects to raise about 55 percent of its total government expenditures from taxes. The United Kingdom . . . expects to raise 53 percent from taxes. In the United States, however, including Federal, State, and local governments, only 37 percent of all fiscal 1943 government expenditures would be financed by taxation on the basis of the Revenue Bill now before you. . . I do not see why we should not do at least as well as Great Britain and Canada."

Allowing for the balanced budgets of state and local governments, this standard would imply covering about 50% of federal expenditures by taxation. With expenditures estimated at $77 billion, this means more than doubling the estimated $18 billion yield of present taxes. Since the present so-called $6 billion revenue bill, allowing for delays in getting taxes into operation, can scarcely yield over $4 billion by June 1943, the Treasury's new view is that the bill is about $15 billion short. By the rule of two-thirds coverage which the Treasury advocated in 1941, the deficiency would be $13 billion greater.

### Fairness of the Comparative Standard

While foreign experience is always instructive, it is generally unwise to try to apply it too literally. But in this case the comparison is unusually close. As the Secretary pointed out to your Committee, the proportion of national resources being used for war is fairly similar in all the English-speaking countries for 1942-43. Furthermore, all three countries are trying to fight the war and block inflation without sacrificing democratic institutions.

Down to the present war, there was no instance of a major power fighting a major modern war without a serious inflation. In this war, however, several of the belligerents--notably Britain, Germany, and Canada--have broken this precedent, and we are trying to do so too. The methods of Britain and Canada, being clearly compatible with democracy, are those we are most interested in; but it should be remarked that German inflation controls are in large part the same. The recipe in Britain and Germany is price-control supported by nearly universal consumer rationing and by heavy taxes. In Canada there has been much less use of rationing, but taxes have been comparable to those in Britain. It should be added that before the recent tax increase in Canada there was a small but ominous rise in living costs from May to June and again from June to July, 1942, necessitating upward wage adjustments under the Canadian wage-control plan. As this development suggests, inflation controls without rationing are always somewhat insecure.

Contrary to this foreign experience, the United States is for the present trying to bluff its way through the inflation crisis with price control alone. We are neither rationing any large part of the goods consumers buy nor levying sufficient taxes: where the British and Canadian central governments cover more than half their outlays by taxes, our federal government (allowing for the new tax bill) stands to cover less than 30%. If both rationing and heavy taxes are needed elsewhere, how can we hope to get by without either? Experience says we can't! So does the Office of Price Administration in its official utterances. The weakness of our rationing setup suggests we should go further in taxation than these other countries, rather than lag behind. As a general indication of how much revenue we need, the Treasury's comparison is very helpful.

Taxes and Excess Spending Power

The need of much heavier taxes is confirmed by examination of the relation between consumer spending power and prospective civilian supply in the United States. The Office of Price Administration puts out estimates of the excess of spending power in the neighborhood of $20 billion. While the calculations behind these estimates are apparently somewhat crude, all estimators using respectable methods come out with similar figures.

The writer of this memorandum has recently made a special study of the excess of spending power, now in press at the Review of Economic Statistics, and scheduled to appear before the end of August. The writer tried to resolve all doubtful decisions in estimation in such a way as to understate rather than exaggerate the excess of spending power. In the following table, which sums up the results of the study, an estimate in which figures tend toward the alarmist side is shown for comparison in the right-hand column.

To remove the $11 billion of excess spending power presumably calls for more than $11 billion of additional taxes; for additional taxes are always paid partly with money which was destined to be saved rather than spent. How much the needed taxes must exceed $11 billion will depend on the type of tax levied and on how people react to taxation. But the figure of $15 billion beyond the existing revenue bill, obtained below by applying the Treasury's comparative standard based on British and Canadian practice, should not be wide of the mark.[1]

1. The present writer stated before the Ways and Means Committee on March 18 (Hearings . . .on Revenue Revision of 1942, p. 704) that the situation called for at least $12 billion of additional revenue--perhaps as much as $20 billion--including the amount to be raised by the 1942 revenue bill. Expenditure estimates then stood at about $60 billion for 1942-43, but were in course of upward revision. The $12 billion minimum figure, with the $18 billion in sight from existing taxes, was thus a proposal for somewhat less than 50% coverage of expenditures from taxes. In short, the writer's position of last March and Seccretary Morgenthau's position now check very closely. The larger tax figures suggested in this memorandum are adjusted to the higher expenditure estimates.

Table 1. Rough Estimates of Excess of Consumer Spending Power over Supplies of Consumer Goods

(billions of dollars)

| Estimate | Calendar year 1941 In 1941 dollars | Calendar year 1941 In March 1942 dollars | Fiscal yr.42-43, Mar.42 This writer's estimate | Fiscal yr.42-43, Mar.42 Alarmist estimate |
|---|---|---|---|---|
| 1. Income received by consumers | $94.5 | - | $119 | $125 |
| 2. Less personal taxes | 6.2 | | 11 | 10 |
| 3. Disposable income | 88.3 | 95.9 | 108 | 115 |
| 4. Normal savings | 10.4 | 11.3 | 14 | 16 |
| 5. Spending power | 77.9 | 84.6 | 94 | 99 |
| 6. Consumer goods supplies: | | | | |
| a. Durable goods | 10.3 | 11.2 | 3 | 2 |
| b. Nondurable goods & services | 65.5 | 71.2 | 68 | 65 |
| c. Total | 75.8 | 82.4 | 71 | 67 |
| 7. Excess of spending power | 2.1 | 2.2 | 23 | 32 |
| 8. Existing offsets--reduction of spending through: | | | | |
| a. 1942 revenue bill | 0.0 | 0.0 | 2½ | 2 |
| b. Added social security proposed last January | 0.0 | 0.0 | 3/4 | ½ |
| c. Reduction in installment debt etc. | 0.0 | 0.0 | 4 | 2½ |
| d. Savings above "normal" | 2.1 | 2.2 | 5 | 3 |
| e. Total, approximately | 2.1 | 2.2 | 12 | 8 |
| 9. Excess after all allowances | 0.0 | 0.0 | 11 | 24 |

Source: Iowa State College Study of War Finance. For details see A. G. Hart, "What it Takes to Block Inflation," Review of Economic Statistics, August 1942.

Allowance for Fiscal Uncertainties

In the face of wartime uncertainties, nobody can hope to lay down a specific figure for the needed revenue which will be finally correct. We are uncertain how fast consumers' disposable incomes will rise, how much of those incomes consumers will voluntarily save, how fast and in what directions consumer supplies will shrink, and how fast and how far consumer rationing will be extended. Accordingly we need a flexible system under which revenue can be adjusted in the light of experience.

Both foreign experience and American statistics indicate that taxes in addition to those now contemplated should amount to about $15 billion for 1942-43, as a minimum. It would not be at all surprising if this estimate turned out to be over-optimistic. The revenue system should therefore be so set up that collections should be increased by $5 billion or more (annual rate) on very short notice.

For the sake of holding down the public debt, it is desirable to get revenues as high as possible. This is the reason why economists in general do not seem to support Professor Fisher's scheme for exempting savings from taxation. The present writer would hold that war destroys the functions not only of consumer spending power (which we can't afford to match with consumer goods) but of much of private saving(which we can't afford to match with fine new houses, factories to produce consumption goods, railway equipment, etc.). Consequently it is desirable to levy taxes to cut heavily into savings: if our attempts to cut spending power by $11 billion also reduced saving by $10 billion, this would be good public policy. But from the standpoint of inflation control as such the crucial question is spending and not saving. Consequently compulsory savings--i.e., refundable taxes, for which the taxpayer gets bonds repayable after the war--may replace plain taxes in a minimum anti-inflation program to some extent. It is urgent, however, to put compulsory savings chiefly on low income brackets (so that they will consist of money otherwise spent, not just require relabelling of funds which would be saved anyhow), and to limit their total amount so that postwar release will not produce inflation then.

## B. TYPES OF TAXES TO BE RELIED UPON

The upshot of the first section of this memorandum is that we need for 1942-43--as Secretary Morgenthau has indicated--revenues equal to about half the contemplated $77 billion of expenditures. Beyond the $18 billion in sight from present taxes and the $4 billion or so which the Revenue Bill as passed by the House of Representatives would raise in 1942-43, this indicates a need of around $15 billion, of which part might consist of compulsory savings. The revenue system should be so adapted that revenue could be further increased on short notice by $5 billion per annum or more.

### Possible Revenue Sources

Four types of revenue sources are widely mentioned:

(1) Reduction of civil expenditure (equivalent for inflation-control purposes to a tax of equal amount);

(2) Sales taxation and further excises;

(3) Taxation of corporation profits;

(4) Taxation of personal incomes and compulsory saving.

Of these, the first two are at best small relative to the magnitudes of war finance, and possibilities under the third head are largely exhausted. The fourth should be our main reliance.

### Reduction of Civil Expenditure

It is widely held that economies of up to $2 billion over the budget could be secured in federal civil expenditure without serious impairment of essential services. The writer of this memorandum has not had opportunity to survey the question himself, and is not entitled to express a professional judgment. But it is safe to say that if genuine economy prospects amount to $2 billion the most we may hope to get within a measurable period by political processes is $1 to $1½ billion. This is enough to be worth a great deal of effort; but it is small in the perspective of war finance. At best it would reduce revenue needs by a tenth.

### Sales Taxation

Among journalists it is popular to pretend that the chief fault of the tax bill reported by the Ways and Means Committee and passed by the House is its failure to include a general sales tax. The sales tax is being held forth as a panacea against inflation, and the opposition to a sales tax is being branded as merely sentimental.

All this is bosh. If the objections to a sales tax as the means of war finance were merely sentimental, the Nazis certainly would have preferred extending sales taxation to their actual policy of war income taxes far above our level. The Canadians would have raised their prewar sales tax rate, instead of letting that rate stand and merely extending coverage somewhat. The English would have made their "purchase tax" bite deep into mass consumption. (For 1942-43 it is expected to raise

80 million pounds--less than one-twelfth as much as the income tax and surtax.) The reason that sales tax is not the heart and soul of the war revenue system in each of these countries is not sentimental but practical.

In hard-boiled terms, the practical difficulties with sales taxation are as follows:

(1) More than any other tax--unless a tax without any exemptions levied on payrolls--a sales tax creates difficulties for wage control. It enters into living costs, and under the War Labor Board's formula is therefore ground for a wage increase.

(2) The base of a sales tax is the flow of goods to consumers. This base necessarily shrinks in wartime, so that sales taxes become less and less effective. (The opposite is true for income taxes, which are based on money incomes.) Canada expects a decrease of sales tax revenue in 1942-43 on account of this shrinkage of base.

(3) A sales tax levied above the retail level mixes badly with the enforcement of price ceilings. Retailers will refuse to itemize to their customers a tax which is based on the wholesale prices of all goods purchased. To make separate adjustments in all price ceilings to help retailers shift the tax to consumers would mean an intolerable overload of extra work for OPA. On account of the widely varying spreads of retailers, a blanket adjustment of retail ceilings would create huge windfall gains and losses for retailers. If no adjustment were made at retail, the purpose of the tax would be frustrated--it would fall upon profits instead of consumer spending power, and would become only a messy way of collecting part of the present excess profits tax revenue.

(4) If levied at retail to avoid these difficulties, the sales tax would be a big administrative problem. With the same effort in planning and administration, much more could be added to income tax revenue.

Besides these arguments against the sales tax, there is always the traditional argument that sales taxes are heaviest for people with small incomes and large families, while it is people with large incomes and small families who are best able to pay taxes. This argument may be "sentimental"; but it is none the less correct, and the heavier sales taxes we consider the more important it grows.

It is well known that both the Treasury and the staff of the Joint Committee on Internal Revenue Taxation estimate the yield of a retail sales tax in this country at the present time at about $500 million per point of tax--$2.5 billion for a 5% levy. Nobody responsible has come forward, so far as the writer knows, with proposals for an effective rate noticeably higher than this, allowing for the fact that 1% at the manufacturer's level is roughly equivalent to 0.5% at retail.

A yield of this magnitude scarcely makes a dent in the problem. If one seriously believed that the Treasury's original request for $7.6 billion was just the right size, of course, a contribution of $2 or $2.5 billion might look like the solution of the problem. But by the Treasury's own standards, the revenue bill as it now stands is not $2 billion but $15 billion too small. Take away $2 or $2.5 billion from this, and we still need $12.5 or $13 billion of further revenue. Even with the most optimistic allowances for civil economies, a sales tax could not reduce the need for extra revenue below $11 billion above the present bill. Another billion might be raised by further excise levies. But a $10 billion problem is much the same as a $15 billion problem--either one calls for drastic action on the income tax front.

Profits Taxes

Taxation of profits is one of the most technical fields of public finance, and the writer of this memorandum does not profess to understand all of its ins and outs. But on the surface of things it is plain that not much can be done to stem inflation by raising taxes on corporate profits to higher levels. The reasons:

(1) British and Canadian experience suggests that to preserve incentives for economical operation the maximum excess profits rate should not much exceed 80%--though more may be collected as compulsory saving, subject to postwar refund, as in Canada.

(2) Federal Reserve statistics on corporate profits show that the 1942 tax rates now forecast, combined with efforts to rewrite war contracts where costs fall, have pulled corporate profits below 1941 levels in nearly all fields.

(3) A further rise in corporate profits is not likely unless as in World War I we have a substantial price boom with wages lagging behind--that is, unless the anti-inflation campaign collapses. Present price-control and wage policy is unfavorable to rising profits.

(4) Dollar for dollar, taxes on corporate profits are ineffective in reducing consumer spending. These taxes fall largely on undistributed profits. Even when they affect distributions, they still fall largely on consumers' savings rather than on consumption spending.

If more revenue from this source can be found, it should be regarded chiefly as a way for checking the growth of the postwar public debt problem, not for reducing consumer spending power. The size of the spending-power problem cannot be much affected.

Personal Income Taxes

Contrary to a sedulously cultivated popular belief, the possibilities of personal income tax are not exhausted. On the contrary, they have barely been tapped. An easy way to verify this is to calculate the additional revenue which could be raised by applying the new Canadian income-tax-and-compulsory-savings system to the United States. An estimate of this sort is presented in Table 2.

Opposite p. (B) 8.

Table 2. Estimated Revenue Yield of Present Canadian Income Levies Compared with Actual and Proposed United States Rates, Assuming Income Payments of $110 Billion*

(millions of dollars)

| Income group | Range of Incomes included: Families a/ | Range of Incomes included: Single Persons a/ | Canadian levies: Normal plus graduated tax | Canadian levies: Unearned income tax b/ | Canadian levies: Total tax proper | Canadian levies: Compulsory saving | Canadian levies: Total levy | U. S. Taxes: 1941 Revenue Act | U. S. Taxes: 1942 Revenue Bill as passed by house | U. S. Taxes: Treasury Proposal of spring 1942 |
|---|---|---|---|---|---|---|---|---|---|---|
| A | $0- 2,125 | $0- 850 | 69 | 0 | 69 | 68 | 137 | 0 | 0 | 0 |
| B | 2,125- 4,250 | 850- 1,700 | 1,453 | 0 | 1,453 | 1,383 | 2,841 | 113 | 568 | 675 |
| C | 4,250- 8,500 | 1,700- 3,400 | 2,838 | 46 | 2,884 | 1,781 | 4,665 | 702 | 1,670 | 1,873 |
| D | 8,500- 17,000 | 3,400- 6,800 | 2,189 | 62 | 2,251 | 742 | 2,993 | 657 | 1,218 | 1,436 |
| E | 17,000- 42,500 | 6,800-17,000 | 2,449 | 87 | 2,536 | 369 | 2,905 | 1,016 | 1,481 | 1,694 |
| F | 42,500-170,000 | 17,000-68,000 | 2,670 | 113 | 2,783 | 103 | 2,886 | 1,615 | 2,026 | 2,275 |
| G | 170,000 upward | 68,000 upward | 1,566 | 69 | 1,635 | 9 | 1,644 | 1,163 | 1,399 | 1,608 |
| All groups combined | | | 13,234 | 377 | 13,611 | 4,460 | 18,071 | 5,266 | 8,362 | 9,561 |

Source: Iowa State College Study of War Finance.

* Calculated by H. P. Greenwood and A. G. Hart by computing liabilities of average taxpayer in each of the 28 income brackets shown in C. G. Hildreth, Estimation of Income Tax Revenue and Incidence, (Research Bulletin 300, Iowa State College, Ames, Iowa, April 1942), Table 5, and multiplying by the number of taxpayers shown in each bracket. Families and single persons are treated separately in computation.

a. "Income" includes non-cash items. Corrected to "net income" for tax calculations by subtracting non-cash income, assumed understatement, and deductions (including state taxes).

b. 4% on interest and dividends. One-half excess of net income over $3000 is assumed to consist of such items.

The estimates of the Table assume a total consumer income of $110 billion (about that forecast for calendar 1942), and allow for a considerable amount of understatement of income on tax returns. On the whole they probably underestimate substantially the yield of the taxes analyzed. They show a yield of $5.3 billion from the 1941 rate and exemption system, compared with which the income tax structure embodied in the House bill of 1942 would yield $8.4 billion--a gain of $3.1 billion or 59%. But Canadian rates would yield $13.6 billion--a gain of $8.3 billion, or 159%. In addition, the Canadian system would raise $4.5 billion from compulsory savings, putting the total receipts $12.8 billion, or 243% above the 1941 rates. The total gain of receipts above those to be expected from House rates is about $9.7 billion. This in itself is enough to make a major contribution to the $15 billion needed.

The secret of the greater yield under the Canadian system of rates and exemptions is chiefly the substantial rate applied to the first few hundred dollars of taxable income. The lowest tax rate (including compulsory savings) in the new Canadian system is 37%, as compared with 13% under the House bill (the rate which applies to the amount of earned income credit). Furthermore, the Canadian rates rise 3 or 4% for each $500 of net income near the bottom of the tax scale, instead of for each $2000 as in the House bill. In consequence much of the revenue gain is in the low-middle income brackets which include what Time calls the "new rich." Of the $9.7 billion excess of the Canadian levy over the House levy, as may be seen from the first few lines of the table, $2.4 billion is below the $4,250 family income level, and another $3,1 billion between $4,250 and $8,500. This is where consumer spending can be most effectively cut by taxation.

Additional Sources of Gains under Income Tax

The figures just given do not fully cover the revenue possibilities of income tax. To begin with, the Treasury's proposals for closing tax loopholes remain; and with heavier tax rates they would be much more productive than the Treasury now estimates. They should yield at least $1 billion. In the second place, the estimates make allowance for a good deal of income understatement. As we go over to collecting income taxes at the source, understatement will be automatically reduced among recipients of salaries and wages. This automatic improvement in the proportion of taxable income reported is capable of yielding $2 or $3 billion in revenue, though precise estimates for obvious reasons would be hard to formulate. A further improvement can be achieved by a systematic effort to get full reporting of income from farmers, merchants, and other self-employed persons, many of whom in the past have failed to file returns or to report their incomes fully. Such a campaign should include:

(1) A campaign of publicity to acquaint taxpayers with their obligations, and provision of a staff (possibly largely volunteer) to help taxpayers make out returns. As regards farmers, the Agricultural Extension Service could be of great assistance.

(2) Simplification of the taxpayer's problems by offering him opportunity to use an alternative tax form (like the wage-earner's 1040A) making blanket allowances for deductions.

(3) Announcement in advance of a policy of sampling taxpayers' returns for accuracy and completeness and carrying the check farther in areas where the sample discloses many irregularities.

(4) Use of information-at-the-source (for example records of elevators, creameries, livestock buyers, and AAA representatives in the case of farmers; use of sales tax returns in the case of merchants) to reduce temptations to understate.

Another source of further revenue would be to include in the tax base non-cash income--the rental value of homes occupied by their owners, and of farm homes rented by tenant farmers along with the acreage, plus the cash value of home-grown food eaten by farmers.

A resolute effort to make the most of income tax, using patriotic incentives and offering the taxpayer more advice and supervision, tapping all types of income, and applying a rate and exemption structure like the Canadian, could raise a good deal more than $15 billion in excess of the revenues now on tap or in prospect.

Current Collection

To get the full anti-inflationary value from our taxes, to help the taxpayer meet his obligations, and to simplify administration we must get personal income tax collections on a current basis, as Canada is doing. Several means of doing so--having a good deal in common with the partial current collection system embodied in the House bill and with the fuller system now being put into operation in Canada--were sketched in two memoranda submitted to your Committee a year ago by Dr. Walter Heller and the writer. As a method of transition to prompt collection, the scheme of Mr. Beardsley Ruml (discussed in the next section of this memorandum) is reasonably satisfactory.

## C. TRANSITION TO A CURRENT BASIS FOR INCOME TAX COLLECTIONS

The opinion of American tax experts and the example of Canada both point to the advisability of getting over to a current basis of collections on personal income tax--i.e., collecting taxes at the time when the taxpayer receives the taxed income. The 1942 Revenue Bill as passed by the House of Representatives provides for a step in this direction--the withholding at source, beginning January 1943, of part of 1943 taxes. But on account of delays in getting the bill framed, no part of 1942 taxes will have been collected in 1942; and with the entire 1942 tax liability payable in 1943, there is hesitation over putting any large part of 1943 taxes on a current basis. At this rate it will take years to get collections up to date.

### The Ruml Plan

A more drastic proposal was recently placed before your Committee by Beardsley Ruml--to cut the knot by skipping 1942 taxes and applying all payments made in 1943 to 1943 taxes. This permits collecting substantially the whole 1943 levy in 1943, and offers enormous administrative advantages over a gradual transition.

As Mr. Ruml has pointed out, the sacrifice of the Treasury's claim to taxes accrued but unpaid is not of great fiscal importance, since the Treasury's business will go on for ever and need never be liquidated. But in terms of equity, skipping 1942 taxes has one serious drawback--a differential gain to the estates of large taxpayers. Under present arrangements, if (for instance) a taxpayer dies late in December 1943, he will have just finished paying his 1942 income tax and his estate must settle his 1943 taxes. If the 1942 tax is abolished, the estate gains a year's taxes (minus, of course, estate tax on the amount thus gained). A comparable gain accrues if the taxpayer dies in a later year. On account of the progression of income tax rates, this gain amounts to the greater part of a year's income for the estates of high-income taxpayers, but only a small fraction of a year's income for the estates of low-income taxpayers. This conflicts with generally accepted standards of tax equity.

### A Simple Solution

Even with this defect, it would be better public policy to accept the Ruml plan than to proceed with gradual transition to current collection along the lines of the House bill. But the defect could be remedied by a relatively simple device suggested to the writer of this memorandum by Mr. H. Peter Greenwood.

This device is to suspend 1942 taxes instead of abolishing them, and to make these taxes (plus compound interest at some such rate as 2% per annum) a first charge on the taxpayer's estate at his death, before valuing the estate for regular estate taxes. To keep down the number of cases involving small amounts, the original enactment could provide that deferred taxes would be collected from estates only in cases where the surtax net income for 1942 exceeded some arbitrary figure (say $10,000).[1]

1. It would also be possible to provide that deferred taxes would be collected at settlement of the estate only when other estate taxes proved to be due; but this would be administratively more cumbrous, since the Bureau of Internal Revenue would not know in advance which of the 1942 income tax returns must be kept in the appropriate file.

On this basis, the inequity could be kept within bounds at small administrative cost and with a great revenue gain to the Treasury in the long run.

Administration of Ruml Plan with Suggested Amendment

Administratively, the Ruml plan with this amendment would work roughly as follows:

(1) On January 1, 1943, as proposed by the Treasury and approved by the House, taxation at the source of certain incomes should start--including dividends, interest, and the excess of salaries and wages over stated exemptions. The rate of tax should exceed the 5% enacted by the House, however, so that most taxpayers will keep payments in step with liabilities at 1943 rates (assumed enacted before the end of 1942).

(2) All taxpayers should be required to file Form 1040--the present blank with adaptations--covering 1942 incomes, by April 15, 1943. This form 1040 should carry 1943 rates of tax, and should be used by most taxpayers to approximate their tax liability by applying 1943 rates to 1942 incomes. Naturally there should be a simplified form (like 1040A) for wage-earners--preferably also other simplified forms for farmers, shopkeepers, etc.

(3) Any taxpayer should be permitted to file also a supplementary form (call it 1041) if his income for the first quarter of 1943 is below the 1942 level. Tax liability for the first quarter may then be based on 1041. Any taxpayer electing this option must either file a 1041 for each later quarter of the year or else bring his tax payments up to what they would have been if based on 1040.

(4) All taxpayers with surtax net income above a certain level on 1040 should be required to file a third form (1042). Starting with surtax net income (transcribed from 1040) and applying 1942 rates (say those of the House bill), the taxpayer would calculate his 1942 liabilities. These forms (a copy to be filed permanently by the Treasury, one to be retained by taxpayer) would be used to determine deferred 1942 tax when the taxpayer's estate is settled. Any corrections from audit of 1040 should be transcribed to 1042.

(5) Forms 1040 and 1041 should contain spaces for entering the amount of tax withheld in the first quarter of 1943. The taxpayer should be required to remit with his 1040 any excess of the first fourth of his approximate 1943 liability (from 1040) over the amount withheld.

(6) For the later quarters of 1943 the taxpayer should remit the same amount for excess tax as in the first quarter unless he elects to go over during the year to the use of Form 1041 (filing 1041 also for quarters already elapsed).

(7) In early 1944, a new 1040 for the income of 1943 should be filed. From this, 1943 liabilities can be finally determined. Any excess of liability over payments made during 1943 should be payable at this time. Any overpayment should be refunded, without other formality than the filing of the return unless the amount involved exceeds (say) $20 or $50.

(8) If 1944 tax rates diverge from 1943, an additional form (1044) taking net income from 1040 will be needed to approximate 1944 liabilities.

It will be observed that this arrangement permits changing 1943 tax rates within the year, if the Treasury is willing either to forego complete current collection of amounts not reached at the source or to call for new 1040's (carrying new rates) in the second, third, or fourth quarter of 1943.

## D. ELIMINATING TAX EXEMPTION

One of the most important loopholes in our income tax structure is that of tax exempt securities. Of the $68.1 billion of government securities (federal, state, and local) outstanding and privately-held at the end of 1941, $51.2 billion were wholly or partially tax-exempt. The Treasury has recently estimated that on the basis of the projected 1942 revenue act, its inability to tax the interest on state and local securities ($15.1 billion tax-exempts privately held) represents a loss of $200,000,000 annually. As the level of tax rates goes up, this revenue loss naturally increases.

Since the 1939 decision of the Supreme Court upholding federal taxation of the wage income of state and local government employees, the legal right of the federal government to tax the income from state and local securities is no longer in question. (The right of the federal government to begin taxing the income from its own tax-exempts has always existed, though never used.) Beyond the legal sphere, there are additional considerations in recent discussion of the tax-exempt loophole which appear to have been overlooked.

### Tax Exemption and the Cost of Government

It has recently been asserted that if the federal government begins to tax interest from state and local securities, the costs of local government will be increased. It is true, of course, that the taxation of the future issues of any government unit by another will raise the cost of government in the future to the issuing unit. It is inaccurate, however, to argue that the cost of government will be increased if any government unit begins to tax the income from government securities issued in the past with the tax-exempt privilege. The interest rate on such bonds is fixed and there is nothing about such taxation that can increase the costs of the issuing government. This is just as true, moreover, in the case where an issuing and taxing government unit are the same (federal government taxing bonds of its own previously tax-exempts) as where the issuing and taxing units are different (local and federal governments).

In the present case, the important issue is over federal taxation of interest from state and local securities of about $15 billion, since most federal bonds not wholly taxable are at least subject to the surtax. Such an issue is strictly between the federal government and the security holder and is not related to the present costs of local government. But even for future issues, there is no social gain in our present situation which, by forbidding the federal government to tax state-local securities, gives a continuing subsidy to those smaller units which choose to go in debt.

### Ethics of the Security-Holder's Claim to Exemption

The claim of the holder of previously issued securities to exemption is a claim of "legitimate expectation." The expectation, however, was of exemption from income taxes of peacetime character. There is nothing to indicate that the holders of any government tax-exempts (federal, state, or local) anticipated the war and were trying to avoid war taxes. If there were evidences of this sort of behavior, furthermore, the claim it would create would be decidedly shady; nobody has a right to "living as usual" because he foresaw national misfortune. In the present emergency, the holders of all tax-exempts should at least be subject to taxation representing <u>increases</u> associated with the defense and war effort.

The problem of determining how much this tax liability should amount to is a knotty one. Ideally, the following solution is attractive: Calculate everyone's tax liability in the following ways <u>on the current year's income</u>.

(1) At current rates including previously tax-exempt interest.

(2) At the rates of the year in which he bought his tax-exempts, including tax-exempt interest.

(3) At the same rates excluding tax-exempt interest.

The excess of (2) over (3) would represent the taxpayer's legitimate expectation of tax exemption, and this could then be subtracted from (1). But obviously this solution is too complex, particularly since many holders have made purchases of tax-exempts at several past dates.

<u>A Practical Solution</u>

As between subjecting the entire amount of tax-exempt interest to present taxes and letting the entire amount escape war taxes, the former is preferable. But it should be possible to strike a compromise roughly representing the "legitimate expectation" of the holder. The writer is inclined to propose that interest from federal, state, and local securities previously exempt from both normal tax and surtax be entered at 50% of total amount under taxable income. This figure is arbitrary, but offers rough justice without complications. Federal securities exempt only from normal tax and privately-held amounted to $31.2 billion at the end of 1941. In equity, holders of these bonds should also be subject to the 50% rule with respect to the normal tax. In view of the relative unimportance of the normal rate, however, these securities can be fairly treated as at present.

<u>Symbolic Importance of the Tax Exemption Issue</u>

From the revenue standpoint, of course, a gain of $200 million is not of the first order of importance; and at the rates of tax now in prospect the adjustment proposed above would yield a good deal less than this. Even if we enact rates on the Canadian scale, as proposed earlier in this memorandum, the revenue gain can scarcely exceed $250 billion.

The reason for including the removal of tax exemption in this memorandum, which otherwise deals only with first-magnitude issues, is the symbolic importance of tax exemption. If we are to defeat inflation, we have to ask the ordinary man to accept taxes which push him below his ordinary standards of consumption. His willingness to accept such taxes will be enhanced if tax exemption is ended, for two reasons:

(1) A conspicuous method by which high-income taxpayers avoid war taxes will be eliminated, assuring the public that there are no exceptions to the rule that all income above bare subsistence must help carry war burdens.

(2) On account of the character of the agitation against removing tax exemption, it stands as a symbol of the "business-as-usual" mentality in civil government.

Similar arguments apply to the closing of the other "loopholes" of which the Treasury complains; but in terms of the public's willingness to face heavier taxes this is the most important of the loopholes.

E. PROFESSIONAL QUALIFICATIONS OF THE WRITER

Following the custom of witnesses before the Committee, the writer of this memorandum submits evidence of his qualifications.

Professional Connections:

Associate Professor of Economics, Iowa State College.
Member of Editorial Board, American Economic Review.
Member executive committee, Conference on Research in Income and Wealth.

Previous Connections:

University of Chicago, 1932-1939.
University of California, 1936.
Twentieth Century Fund (Director of Research, Committee on Debt Adjustment) 1937-38.
U. S. Treasury, 1934.

Major Publications:

Books, etc.:

Debts and Recovery (New York, Twentieth Century Fund) 1937.
Anticipations, Uncertainty and Dynamic Planning, Chicago (University of Chicago Press) 1940.
Paying for Defense (with E. D. Allen and others) Philadelphia (Blakiston Company) 1941.

Pamphlets:

Economic Meaning of the Townsend Plan, 1936
How the National Income is Divided, 1937
Economic Policy for Rearmament, 1940
All in Public Policy Series, University of Chicago.

Articles Dealing with Public Finance, etc.:

Paper in symposium, Review of Economic Statistics, May 1941.
"Consumption Taxes as Economic Regulator," Law and Contemporary Problems, Summer, 1941.
"Forced Loans and Social Security Taxes as Inflation Remedies" in J. W. Martin (ed.) Financing the War, Philadelphia (Tax Institute) January 1942. pp. 156-67.
"Flexible Taxes to Combat Inflation," American Economic Review, March 1942, pp. 87-102.
"What it Takes to Block Inflation," Review of Economic Statistics, August 1942.

Also numerous popular articles, mimeographed reports, etc.

September 3, 1942.

Mr. Albert Gailord Hart,
Associate Professor of Economics,
Iowa State College,
Ames, Iowa.

My dear Professor Hart:

On behalf of Chairman Eccles who is out of the city, I wish to acknowledge receipt of your letter of August 29 enclosing the memorandum on taxation and the control of inflation in which I am sure he will be interested, as I was, because of your effective presentation of the over-all picture.

Sincerely yours,

Elliott Thurston,
Special Assistant
to the Chairman.

ET:b

IOWA STATE COLLEGE
OF AGRICULTURE AND MECHANIC ARTS
AMES, IOWA

September 2, 1942

EPARTMENT OF ECONOMICS AND SOCIOLOGY

Marriner Eccles, Chairman
Board of Governors
Federal Reserve System
Washington, D. C.

Dear Mr. Eccles:

Due to a misunderstanding the attached memorandum, referred to in Mr. Albert Hart's letter of August 29, was not enclosed. I am sending it now in the hope it still may be of use.

Very truly yours,

Irma Disney

(Mrs.) Irma F. Disney
Secretary to T. W. Schultz

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