

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

March 19, 1945.

To - Mr. Williams
From - Mr. Thurston

The Chairman suggested that I send you the attached letter and report on this vicious proposal for a 25 per cent limit on income, inheritance and gift taxes. You may have seen Lowell Mellett's excellent essay on it in the Washington Star of March 8.

It is fairly obvious that this snowball is getting bigger all the time, and the Chairman thought we ought to prepare as effective an argument against it as we can muster, for we are going to hear from it in letters and otherwise for a long time to come.

Could you undertake preparation of such an answer, not to this particular letter, but for future use?

E.T.
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Attachments

MAIN AT ELM ST.



ROCHESTER 4, N. Y.

March 13, 1945

Mr. Marriner S. Eccles, Chairman
Federal Reserve Board
Washington, D. C.

Dear Sir:

A few days ago you were quoted in the public press as having said, regarding the proposed Constitutional limitation on Federal taxation, "I can't imagine any action that would be more inflationary". I realize, of course, that this quotation is only a part of what you said in reply to Representative Patman's question, but it is all that was published in the article that came to my attention. If your full statement included the comment that such would be the case under the present war time conditions, sharply limiting the supplies available for civilian use, it would, of course, have validity.

There are, as you know very well, two methods of controlling inflation. One method is to limit purchasing power, which may be necessary in time of war but is certainly not the American method. The other way to control inflation is to expand production. This is the proper way in peace time and is, I am sure you will agree, vital to the future of the country if we are to provide the jobs and payrolls needed after the war. It is vital also if we are to provide the revenue necessary to the Federal Government to enable it to carry ~~the~~ the tremendous burden of debt and to carry on its other necessary activities. The highest conceivable rates will not produce sufficient revenue unless the national income is greatly expanded. The way to expand the national income at a rapid rate is, in my opinion, to adopt the proposed amendment.

I am taking the liberty of enclosing an excerpt from the report of a committee which recently gave careful study to this proposed amendment.

Respectfully yours,

Gilbert J. C. McCurdy
Gilbert J. C. McCurdy

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Encl.

Adoption of the proposed 22d Amendment is, in the opinion of this Committee, highly desirable for the following reasons which were presented at its meeting:

- ✓ 1. To make possible a sufficient volume of capital saving and investment in productive enterprise in order to assure maximum production and therefore maximum employment in coming years.
2. To bring about a resumption of the long-term growth in the national income, which in the period from 1790 to 1930 has doubled approximately every eighteen years.
3. By so doing to assure a continually rising standard of living.
4. To make possible maximum tax revenue to the Federal Government, thereby making it possible not only to carry but, in time, to retire the national debt. Excessively high rates of taxation never have and never will produce maximum revenue.
5. To safeguard the independent sovereignty and taxing powers of the states.

It should be pointed out that the Committee, in favoring this proposed amendment, has taken no stand on the question of federal expenditures. The Committee is of the opinion that a very high level of revenue will be necessary to the federal government, no matter how economically it may be administered, in order to carry and to retire the national debt. It believes that maximum tax revenue can be secured within the rates contemplated by the amendment, rather than by higher rates such as have been incorporated in recent revenue measures. This is so primarily because of the restrictive effects of higher rates. The size of the national income is of far greater importance than the percentage taken from various individuals and corporations. A reasonable percentage of a constantly growing national income will produce a much larger total revenue than would a greatly increased percentage of a static or declining national income. This has been amply proved by the history of the income tax in prior years.

The objection has been raised that to limit the maximum rate to 25 per cent would mean the elimination of the graduations in the tax. This is not the intention. A reduction in rates in all brackets is contemplated, with the maximum not higher than 25 per cent.

The question is also raised as to the advisability of a Constitutional amendment to accomplish this purpose. It should be pointed out that the sole power of the federal government to levy an income tax is derived from the 16th Amendment to the Constitution. When this amendment was before Congress a federal income tax return of 2 per cent was in mind. It was suggested that a limit of 10 per cent be placed in the proposed amendment. This was laughed off on the ground that it was ridiculous to think that the federal income tax rate ever would be as high as ten per cent. We must remember that the Constitution was designed not merely to construct the frame work of the federal government but also to limit the powers of the federal government. This was paramount in the minds of the framers of the constitution. No power of the federal government is as strong as the power to tax and no power is more liable to abuse. The majority of the Committee believe that a constitutional amendment is the proper method of dealing with this situation.

The Committee believes that the adoption of this amendment would be the strongest possible incentive to increased production and employment and to rising standards of living after the war. Much is being said about providing opportunities for returning veterans to establish businesses of their own. Under present taxing policies they would be unable to accumulate sufficient capital out of earnings to insure their success. This amendment would restore the opportunity of every American citizen to get ahead in the world.

March 19, 1945.

Mr. Gilbert J. C. McCurdy,
Main at Elm Street,
Rochester 4, New York.

Dear Mr. McCurdy:

This is to acknowledge your letter of March 13 enclosing a copy of the report on the proposal for a 25 per cent maximum rate on income, inheritance and gift taxes. I enclose a copy of an article that appeared in the Washington Star the other day, with which I would agree, bringing out how vicious this proposal would be. It seems almost unbelievable to me that anything as basically unsound as this is could have gained as widespread acceptance as already appears to be the case.

It is, of course, essential as a means of combatting inflation in wartime to impose high taxes on consumption, but to make that a permanent policy by making it mandatory under a Constitutional amendment would completely undermine and, I believe, destroy our system.

The long-range problem in this country is greatly to increase consumption. If you were to put an arbitrary limit on income taxes, which are based on ability to pay, it would be necessary to make up the difference in needed revenue by heavy taxation on consumption if the budget is to be balanced. It is not possible to balance it under war conditions, but it is vital to do so afterwards.

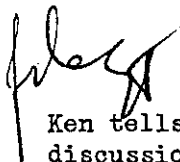
I am venturing to enclose a copy of an address which I gave before the National Industrial Conference Board last November which states what the problem is, as I see it, in the postwar. It should make clear why this 25 per cent limitation proposal is so thoroughly unsound.

Sincerely yours,

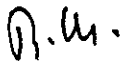
M. S. Eccles,
Chairman.

Enclosures

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A handwritten signature in dark ink, appearing to be 'H. H. H.' or similar, written in a cursive style.

Ken tells me that you wanted a brief discussion of the proposal to limit Federal tax rates to 25 per cent. If you would like to have more detailed material please let me know.

Handwritten initials 'H. H.' in a cursive style.

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date April 26, 1945

To Mr. Thurston
From Richard A. Musgrave R.A.M.

Subject: Constitutional Amendment to
Limit Federal Tax Rates

A constitutional amendment has been proposed which would prohibit Federal income and estate tax rates in excess of 25 per cent. Resolutions calling upon Congress to initiate such an amendment have been adopted by the legislatures of 15 States. The movement is supported by the Committee for Constitutional Government and similar groups, combining extremist "States Rights" and anti-government attitudes.

Some of the main objections to the proposal are as follows:

1. The loss of yield would be serious, although dollarwise not as striking as might be expected offhand. 1944 income tax rates, at a good postwar level of income, may yield approximately \$14 billion of surtax and \$3 billion of normal tax. If surtax rates were cut to 20 per cent (which together with a 5 per cent normal rate would be the permissible maximum), the loss of yield would be approximately \$3.2 billion. A postwar corporate tax rate of 35 per cent might yield approximately \$5.3 billion; if the rate were cut to 25 per cent, the revenue loss would be \$1.5 billion. Limitation of estate tax rates to 25 per cent would result in a revenue loss of several hundred millions. The revenue loss from the combined sources would thus be close to \$5 billion, or 22 per cent of their yield from current rates.

Since postwar expenditures are likely to remain high, this will be a serious matter, necessitating either a substantially larger deficit or increased taxes from other sources.

2. If other taxes are not increased, (or their reduction from wartime levels is not curtailed) a 25 per cent income tax limitation would necessitate a substantial deficit. If the general postwar situation turns out to be deflationary, this might be all to the good, but even then the need for deficit could have been considerably reduced if income taxes had been maintained and other taxes been cut instead. But this may be beside the point since the intent of the proposals is obviously not to provide for a deficit but to force a drastic curtailment of Federal expenditures.

3. If the \$5 billion are to be raised from other sources, this will have to be either through additional excises or a reduction of personal income tax exemptions. The \$5 billion might be provided through a general sales tax of 10 per cent or a reduction of surtax exemptions to about \$500 per person.

In either case the results would be highly deflationary, since both the sales and low bracket income taxes are drawn almost entirely from consumption expenditures, thereby reducing the level of consumers' demand and cutting into the market upon which production, employment and business profits depend. To anyone at all concerned with minimizing the need for a postwar deficit, the proposal to limit income tax rates would seem disastrous. While all taxes tend to be more or less deflationary, there is, nevertheless, a considerable difference between different tax sources. To give up the income tax as a major revenue source or in effect to transform it into a tax upon low income groups would be to discard tax policy as a means of maintaining employment, and--to the extent that fiscal policy is relied upon--to put the entire emphasis on deficit spending.

4. The proposal is in complete contradiction to generally accepted ideas about equity in taxation. While there may be disagreement in detail, the American public is fairly well agreed that the principle of progressive taxation is essential to a democratic society. The proposal would eliminate progression in the Federal tax structure; at best, Federal taxation would be reduced to a proportionate basis, but more likely it would in fact become regressive, that is, people in lower income groups would have to pay a larger portion of their income in taxes than people in the upper income groups. This tendency is already sufficiently present in some aspects of the State and local tax systems.

The proposed limitation would require lower surtax rates than the United States had at any time since 1916, with the exception of the years 1925 to 1931. If it were decided to reintroduce some degree of progression by using 25 per cent as the top surtax bracket while reducing the rates for the lower brackets, the additional loss of yield would be drastic. For instance, if the first bracket rate was cut to 10 per cent the loss of yield would be \$5 billion.

5. The proposal is made "to limit the Federal Government's power to destroy the private enterprise system". The reduction in progressive rates itself might of course stimulate business investment, but a drastic increase in consumption taxes might do as much or more to offset this advantage through a shrinkage in consumers' markets. Also, the fact is overlooked that much can be done to reduce the impact of taxation upon investment by a proper definition of net income through extensive loss offsets and so forth. It neglects such other deterrents to risk taking as the premium to gilt-edged investment now provided through tax-exempt government bonds.

It should be pointed out, however, that steeply progressive rates applicable to the upper income brackets with income in excess of say \$25,000, are not of very great yield significance. Thus, if top surtax rates were now to be cut to 50 per cent, the revenue loss would be not more than \$800 million. However, a proposition of this kind is, of course, very different from proposing a 25 per cent limit.

6. A narrow limitation of the Federal taxing power would seriously interfere with the credit standing of the Federal Government and its ability to service and finance the public debt in a manner compatible with maintaining a high level of income and employment.

7. In part, the proposal to limit the Federal taxing power is made to strengthen the fiscal positions of State and local governments. It is very doubtful whether this would be the case. So far, State and local reliance upon personal income taxation has been limited, partly because it is technically difficult for States to impose personal income taxes. Moreover, if the Federal Government would have to rely more largely on other tax sources, it would have to invade fields such as gasoline taxation which heretofore have been reserved largely for State and local use. Obviously, the Federal-State-local problem cannot be solved by incapacitating the Federal Government, but only by reasonable cooperation, sharing of revenue sources, and a proper grant-in-aid system.

8. The more general objections to the proposal need hardly be mentioned. For social and economic reasons it is of crucial importance that we should succeed in maintaining a reasonably high level of income and employment after the war. Also, it is clear that there is little chance of doing so without an active and effective fiscal policy. If the proposed rate limitation were adopted, fiscal policy would be rendered ineffective and the hands of the Federal Government would be seriously tied. The effects would obviously be disastrous.
