BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

# Office Correspondence

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To Chairman Eccles

Subject: Methods of Tax Reduction which would not increase inflationary pressures

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## I. The Problem

Many people are convinced that present high personal income taxes, by reducing the incentives to work harder and to save more are acting as a brake on the expansion of production. Yet, sound fiscal policy cannot permit any reduction in tax yields which by increasing the amount individuals can spend would intensify inflationary pressures.

What is needed is a method which would reduce income tax liabilities -- that is, give individuals a substantial stake in the fruits of their increased efforts -- but which would not decrease tax collections immediately. Several possible methods for accomplishing this are described briefly in the following paragraphs.

## II. Tax Reduction Bonds

One method would be to effect a tax reduction by treating a certain part of each individual's tax payment as payment for a special nonmarketable government security. This security might be made irredeemable for a fixed period such as five years, or for an indefinite period until Congress decides that the inflation emergency is over. After this time, it could be cashed or converted into other government securities. Interest need not be paid on the security currently unless it were felt that payment of interest would make the plan much more palatable to taxpayers. It would also be possible to begin interest payments only after the maturity date had been reached or been declared by Congress and to arrange the redemption values and interest coupons in such a way as to encourage continued holding of the bonds by taxpayers should that be desirable. The amount of the tax payment to be treated as payment for bonds by each taxpayer would depend on the type of tax reduction given, but in general, a single or moderately graduated percentage cut would lend itself most readily to the plan from an administrative standpoint.

The proposal has the advantage of a precedent in that the recent Terminal Leave Bonds were handled in a similar way. Moreover, Chairman Millikan of the Senate Finance Committee is reported to be exploring the possibilities of a scheme of this sort. On the other hand, Chairman Knutson of the House Ways and Means Committee has indicated his opposition to this approach.

## III. Anti-inflation Tax Payment Bonds

If the dangers of inflation are expected to be such as to warrant an actual increase in immediate tax collections it would be possible to raise taxes temporarily by say 5 per cent across the board and to give taxpayers a special non-marketable bond to the amount of the temporary increase. It would then be possible to combine the plan with the tax reduction bond plan by providing for a 5 per cent increase in taxes with, say, 15 per cent of the total tax payment treated as bond purchase.

The method of increasing tax rates and devoting all or part of the increase to bond purchases was used during the war by Canada and Great Britain, and by this country under the wartime excess-profits tax. The Treasury, however, steadfastly opposed the plan as applied to the individual income tax during the war and can be expected to continue to opposition to it.

## IV. Offsetting Income Tax Reductions by Temporary Anti-inflation Consumption Taxes

A third possibility would be to impose a series of special high temporary anti-inflation excise taxes on commodities now scarce or likely to be extremely scarce next year, such as meat and gasoline. With the increased revenue from this source it would then be possible to permit an equivalent amount of income tax reduction without decreasing total tax revenue. The plan would offer a true and immediate tax reduction to consumers who refrained from purchasing the ultra scarce goods and who either saved their money or bought only the plentiful commodities. People who insisted on purchasing unreduced amounts of the scarce goods would on the average get no net reduction and might even have their total taxes increased. These commodities are due to rise in price next year anyway so that the excise also has the desirable effect of preventing the emergence of windfall or scarcity profits by producers and particularly by those now holding back supplies in anticipation of the rise in prices to come.

The plan would undoubtedly work some hardships under certain circumstances but so would the inevitable price rise and so would direct price controls. The tax reductions would have to be very carefully allocated among income groups (so that the cuts and increases would roughly balance at each level) if maximum effectiveness is to be achieved. The amount of income tax reduction possible would be considerable since a 25 per cent tax on meat would yield over 2 billion dollars in all probability.

The plan would create a very delicate problem on the wage front since excises are included in the cost-of-living index, but income taxes are not. To meet this problem, the plan would have to be dovetailed with some formal or informal wage stabilization measures.

## V. Increases in Social Security Taxes, Coverage and Benefits

Additional revenue could be raised by increasing the Social Security payroll taxes and by broadening the coverage of such taxes to groups which do not now contribute or enjoy the benefits. The increased revenue would permit some reduction in income taxes and the lower income groups, who would largely bear the increase in taxes, could be given the promise of larger pension and other benefits in the future.

The plan has the advantage that increased benefits and coverage are highly desirable and some reduction in income taxes now would not be too high a price in the long run for overcoming Congressional hesitation over an expanded rpogram. It would be the least difficult of all the possibilities from the administrative point of view. On the other hand, there has been considerable reluctance by Congress in the past to use the payroll taxes as a fiscal device although the broadening of the coverage to include a larger fraction of the population might reduce some of the objections raised in the past. There is also the very great possibility that organized labor would not readily submit to the redistribution of the tax burden which the plan involves even given the larger eventual benefits. Here again some formal or informal agreement on wage stabilization would be necessary if the plan were to have any anti-inflationary effect.