

EDITORS' ADVANCE TEXT
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AN EMERGENCY TAX PROGRAM

FOR 1951

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A Statement on National Policy
by
THE RESEARCH AND POLICY COMMITTEE
of the
COMMITTEE FOR ECONOMIC DEVELOPMENT

March 1951

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AN EMERGENCY TAX PROGRAM FOR 1951

I. THE TAX PROBLEM IN THE EMERGENCY

In the decisions about taxes that must be made this spring the nation comes squarely up against a major problem. How can taxes play their necessary part in restraining inflation without at the same time seriously impeding the growth of production?

Taxes are already very high. Now we need still higher taxes - higher than we have ever had before, even at the wartime peak.

Higher taxes are needed as an element in a program to check inflation - which is, of course, one of the nation's main economic objectives. But there is also a danger in higher taxes. The danger is that extremely high taxes - especially if long continued and badly distributed - will interfere with the growth of production, which is also one of our main economic objectives.

In the past the tremendous growth of the American economy has permitted a substantial increase in government expenditures to be absorbed without extremely high tax rates. But with greatly enlarged defense requirements the problem of reconciling adequate taxation with dynamic production has become acute. It is likely to remain so for some time and perhaps become even more critical if defense requirements increase. We urgently need, but do not have, a balanced policy for dealing with this problem.

In our opinion the key to this problem lies in two facts:

First, taxes are only one element in the necessary program for controlling inflation. Taxes help control inflation by reducing the

demand for goods and services. But there are other ways to reduce demand. The government's demand can be reduced by economy in government expenditure. Private demand can be restrained by restriction of credit and by promotion of private saving. Our goal should be taxes high enough to serve as part of an adequate total program to control inflation. The program should be balanced in the sense that it does not rely on any one element - such as taxes - to the neglect of other measures that could restrain inflation with less impairment of production.

Second, different kinds of taxes differ greatly in their effects upon inflationary pressure and upon production. That is, per dollar of revenue yield, some taxes have much more anti-inflation effect and less anti-production effect than others. Therefore the possibility of developing a strongly anti-inflationary tax program without serious detriment to production will depend in large degree upon the kinds of taxes that are imposed.

We do not wish to suggest that the nation can now get along without a big tax increase. We believe that a tax increase should be enacted as soon as possible. But we do wish to point out that taxes can be too high as well as too low. In fact, there is a danger that taxes will be at the same time too high and too low - higher and more harmful to production than would be necessary if effective action were taken with respect to government expenditures, credit expansion and saving and yet not high enough to control inflationary pressure in view of the other policies that are actually followed. If, in addition, the taxes we impose are of a kind that put great restraint upon production and relatively little restraint upon inflation, we shall

have taxed ourselves at great cost for little benefit.

What is our present situation? In the past eight months we have had both a rapid increase of prices and a surplus in the Federal cash budget. Taxes were more than high enough to balance government spending; the budget surplus was at the rate of about \$2 billion a year. Nevertheless, prices (consumers' price index) rose about 7% in the eight months, mainly as a result of a great increase in business and consumers' expenditures financed by an expansion of bank credit and a reduction in the desire to save. Now, in an effort to retard the inflation, general price and wage ceilings have been imposed. But direct price and wage controls will not work well and may not work at all unless they are backed up by measures to curb the excessive demand for goods and services.

If we are going to bring inflation under control we shall need much stronger restraint on the pressure of inflationary demand than we have had in the past eight months. But in one important respect our position is going to deteriorate quickly unless vigorous steps are taken, for while we have been running a cash budget surplus in the past eight months, the Budget estimates show a \$13 billion deficit for the next fiscal year, which begins July 1, 1951.

One conclusion which might be drawn from these facts is that since the Budget shows a \$13 billion deficit for next year, and since the \$2 billion surplus we have been running has been inadequate by itself to control inflation, we need a tax increase big enough by itself to provide a still larger surplus. Such a conclusion would be a serious mistake. It would neglect

the potentialities of methods other than higher taxes for restraining inflation and would therefore place an unnecessarily and dangerously great burden of taxes upon the economy.

In our opinion, an adequate and balanced financial program would consist of the following parts:

1. Maximum possible economy in government expenditure, which would reduce Federal cash expenditure by some \$6 billion from the \$74 billion proposed for fiscal 1952.
2. Prompt enactment of a \$10 billion tax increase.
3. Tight restriction on the expansion of bank credit.
4. A national program to encourage private savings.

This program, fully carried out, would yield a cash surplus of two to three billion dollars in fiscal 1952. Thus it would maintain the anti-inflationary influence of the budget but would not rely exclusively upon higher taxes to do this. At the same time, it would greatly strengthen the defense against inflation at the points where the defense has been weakest - namely, control of the expansion of credit and the promotion of savings. This kind of a balanced program would assign to higher taxes their necessary part in checking inflation when defense expenditures are rising rapidly. But it would not expect high taxes to compensate for failure of the government to economize, to control credit and to promote saving.

This policy statement is mainly devoted to recommending ways to carry out a 'pay-as-you-go" policy in the Federal budget for the fiscal year 1952 by curtailing government expenditure and raising taxes.* However, before

* Footnote by Beardsley Ruml: "A program to provide adequate defense without inflation is highly desirable. To this end, a "pay-as-you-go" ideal for national fiscal policy is important. However, the "pay-as-you-go" ideal has not yet been sharply defined for precise policy decisions in every sector. For example, I doubt whether the budget to which "pay-as-you-go" applies should include as expenditures disbursements for purchase of interest-bearing assets or disposable inventories.

proceeding to these recommendations we wish to emphasize again that sound budget policy is only one element of a sound economic policy for rearmament; by itself it is not sufficient. In particular, our recommendations for the budget are intended as part of a total program which would include much more vigorous action than has yet been taken to restrict credit and promote savings.

Since the outbreak of the Korean war in June, effective restraints upon the expansion of bank credit have not been imposed, apparently because monetary action was dominated by the desire to assure a stable government bond market and to avoid higher interest rates on government securities. The failure of recent money-debt policy is shown by the \$9 billion increase of bank loans in the second half of 1950.

A recent statement by the Treasury and the Federal Reserve gives reason to hope that the desire to keep interest rates on government securities at arbitrarily cheap levels will no longer be a barrier to anti-inflationary money-debt policy. The offering of a new long-term nonmarketable bond to yield 2-3/4 percent - announced this month (March 1951) - is a step towards the more flexible management of the Federal debt that is urgently needed. The adequacy of money-debt policy cannot be judged by the terms announced on a particular issue of Federal securities. It can only be judged by its success in curbing the growth of credit and the money supply, and thereby contributing to the control of inflation. The essential point, which must be the continuing test of policy, is that the expansion of the total amount of credit and the money supply should be limited.

In 1948 the Research and Policy Committee of CED recommended establishment of a Commission on National Monetary and Financial Policies, to study the

money-debt problem.^{1/} We believe that such a commission, established by Congress and including both public members and qualified private citizens, could now serve an extremely useful function. Objective study, leading to greater public understanding of the issues involved, can contribute to more effective monetary policy in the present inflationary situation. The interest of the general public in money and debt policy has greatly increased. Public opinion is likely to be increasingly influential in determining policy in these fields and it is therefore more important than ever that the public be well informed. In addition to examining current policy, the Commission should take a long look ahead to consider the possible debt management policies that might be appropriate if still greater defense or war expenditures should force large deficits upon us. One thing we have certainly learned in the past ten years is that unless a long view is taken, the debt management policies that seem expedient in a particular emergency situation may pile up difficult problems for the future.

One aspect of stabilization policy that has been seriously neglected is the promotion of voluntary private saving. Anti-inflationary policy requires an effort to keep the community as a whole from trying to buy more goods and services than are available. In this effort the government has certain clear responsibilities -- to economize in its own expenditures, to raise taxes, to tighten credit. But the action of private individuals can be decisive in the success or failure of this effort. As members of a free society engaged in a struggle for survival each of us has a responsibility to assist - by saving.

^{1/} Monetary and Fiscal Policy for Greater Economic Stability, December, 1948, pp. 37-38.

A national program of education is needed to bring home to our people their individual responsibility to save. For such a program we should enlist the cooperation of the leadership that exists in our communities. The government should cooperate by instituting an aggressive campaign for the sale of savings bonds. The program should be more than a drive for savings bonds -- all forms of savings should be encouraged.

II. THE FEDERAL BUDGET FOR FISCAL 1952

The expenditures of state and local governments are a large element in the total non-military demand for products and labor. We cannot tax the state and local governments in order to restrain their expenditures. In fact, as long as interest on state and local government securities is exempt from Federal income taxes, an increase in Federal income taxes will make it easier for states and localities to borrow. Making interest on future issues of municipal securities subject to Federal income tax, as we have repeatedly recommended on other grounds, would help to deter deficit financing by states and localities. Tightening the supply of credit will also be helpful. But beyond this we should be able to count upon the voluntary cooperation of the states and localities to reduce or defer their less urgent expenditures as their contribution to the national anti-inflation program.

The budget figures in this statement refer to the Federal cash-consolidated budget, more conveniently called the cash budget. The cash budget is the best single available indicator of the net economic impact — the net inflationary or deflationary effect — of Federal payments and receipts. It is therefore the best single guide to overall budget policy, which should be concerned with achieving a certain net economic impact — in present conditions an anti-inflationary impact.^{1/}

^{1/} The other budget in common use is the administrative-control budget, which is a guide to Congress and the administration in controlling operations of particular Government agencies under particular appropriations. The main difference between the cash budget and the administrative-control budget is that the cash budget includes the operations of the social security trust accounts. Since the trust accounts ordinarily receive more money than they pay out, the cash budget ordinarily has a larger surplus or smaller deficit than the administrative-control budget. For fiscal 1952 the cash deficit would be about \$3 billion smaller than the deficit in the administrative-control budget. For reconciliation of the two budgets, see appendix table, page 30.

In the second half of 1950 there was a cash surplus of about \$1 billion. The first quarter of 1951 will show a substantially larger surplus. Most of this will be due to the seasonal peak of tax collections in the first quarter. But this summer, unless taxes are raised, deficits will appear. According to the President's Budget the cash deficit in fiscal 1952 will be \$13 billion with present tax rates. ^{1/} There is no official estimate of the division of this total within the year. Presumably the rate of deficit will be less than \$13 billion in the first half of the fiscal year -- possibly around \$11 to \$12 billion -- and more in the second half -- possibly around \$14 to \$15 billion.

What we apparently face, therefore, is a shift from a surplus in fiscal 1951 to a deficit estimated in the budget at \$13 billion in fiscal 1952.

We recommend that expenditures be reduced and taxes be raised sufficiently at least to balance Federal cash expenditures in fiscal year 1952 as a whole. The tax increase should come in one step and should be made as quickly as possible. It is already later than would have been desirable. Last November we recommended that both individual and corporate taxes be raised effective January 1, 1951. However, only corporate taxes were raised. Now prompt action is imperative. The higher taxes should go into effect as early as possible in the second quarter of 1951, to moderate the shift from the current surpluses to a deficit this summer.

^{1/} The deficit actually shown in the Budget document is \$12,759 million. However, this allows for \$240 million net receipts of trust funds under the proposed health insurance trust fund program.

There is, of course, considerable uncertainty as to what cash expenditures will be in fiscal 1952 and therefore as to how much tax increase is needed to balance the budget. Over half of the \$74 billion budget estimate for fiscal 1952 is accounted for by a round figure of \$40 billion for the Department of Defense; this figure will almost certainly be different when it comes to be supported by a detailed appropriation request. There are widely varying estimates of the amounts by which Congress may cut the appropriation requests. Even after the regular appropriations are passed, which may not be before July 1, the actual expenditures in the following twelve months will be uncertain.

In this situation, and given the imminent prospect of large deficits, it seems to us wise to raise taxes quickly by the amount necessary to balance the estimated expenditures after minimum allowance for economies. If we set tax rates to balance the budget in the expectation that maximum economy will be achieved, we run a real risk of a deficit, which in our prospective situation would be very bad. On the other hand, if in setting taxes we count on only a smaller amount of economy, we have a chance of achieving a surplus, which would be welcome. Any economies actually achieved beyond those counted on in setting taxes this year can be considered in setting taxes next year.

It seems to us a reasonable minimum goal to hold cash expenditures in fiscal 1952 about \$3 billion below the \$74 billion estimated in the Budget. We believe that a much greater reduction, probably twice as large, is possible. We strongly urge and support every effort to achieve the larger figure in order to produce a budget surplus. But we recommend a tax program that would at least balance the budget even though maximum possible economy were not achieved.

On this basis we recommend prompt enactment of a \$10 billion tax increase. This should be the last levy applicable to 1951 incomes and sales, unless some drastic event not now foreseen should occur. A \$10 billion tax increase should balance the cash Budget for fiscal 1952 as a whole. If promptly enacted it will prevent a deficit this summer when we are struggling to achieve stability in prices and to strengthen confidence in the value of the dollar.

Expenditures

The need for government economy is clear. Our tremendous productive machine, running at full tilt, is still incapable of meeting all the demands that are placed upon it. We shall all have to do without things we want, things to which we feel entitled and for which we would be willing to pay. High taxes and credit controls are imposed to compel us, as individuals and businesses, to restrain our expenditures; we are exhorted to recognize our responsibility as citizens to save. It is intolerable that the Federal government, which next year will spend about one-fourth of the national income, should not share in the general belt-tightening. (Federal, state and local expenditures will account for about one-third of the national income!) In fact, the government's responsibility is greater than even its large percentage share would indicate. The government is in a position of leadership. The extent to which it demonstrates self-restraint will have a great influence upon the willingness of the public to accept the taxes and other restraints necessary to our economic and political strength.

Whenever a reduction in any part of the budget is suggested someone will arise to claim that great damage to the nation will result. We should be quite clear what the costs are of not reducing the less urgent and essential expenditures in the budget. The main point is that if the government uses more of our national output we shall have to use less privately, in our homes and businesses. A man can work either on a government public works project or on a private home-building project; he cannot do both at the same time. The more manpower, materials and productive capacity the government uses, the less we shall be able to use privately. In fact, the net cost will be more than the shift of output from private to government use. For if we fail to economize in government spending, we shall have higher taxes, which will retard total production, or more inflation, with all its evil consequences.

No one can reasonably expect that he will escape a share in the costs of failure of the government to economize. The costs will be widely distributed -- either by inflation or by taxes -- and everyone will be exposed to them.

The President's Budget recommended cash expenditures of \$74 billion for fiscal 1952. It is helpful to an understanding of this figure to break it down into four parts:

| | | |
|--|----------------|---|
| Defense and related items, including foreign aid | \$51.9 billion | |
| Interest and trust funds | 9.2 | " |
| Veterans' pensions and readjustment benefits | 3.8 | " |
| Other non-defense items | 9.1 | " |
| | <u>\$74.0</u> | " |

The figures in the Budget have become so large that the \$9.1 billion for non-defense items looks small. But the significant fact about this figure is that it is one-third higher than the actual expenditures in the same category in 1948. The nation did not suffer from inadequate domestic government services when \$6.8 billion was spent for these items in 1948. In our opinion, it does not need and cannot afford more in the critical conditions of fiscal 1952. If we divide this category into those major functions which have increased and those which have decreased since 1948 we find \$3.4 billion of increases and \$1.1 billion of decreases. Rolling back the increased functions to their 1948 levels would thus reduce the total by over \$3 billion, even with allowance for somewhat higher costs.

Every item in this non-defense category should be reexamined. For example, is it necessary that in a year of high farm incomes, expenditures for aid to agriculture should be almost three times as high as in 1948? We do need a redirection of public works expenditures to emphasize projects essential to national defense. But do we need an increase of \$1.4 billion - 90% - above the 1948 level of expenditures for civil public works (excluding atomic energy)? The policy of the Federal National Mortgage Association in selling mortgages out of its portfolio is estimated to yield \$530 million of net receipts to the Treasury in fiscal 1952. This is certainly appropriate policy in the present situation. But it could be pushed farther, since it will still leave FNMA holding \$750 million of insured mortgages at the end of the period.

The opportunities for saving are obviously less in the categories of interest, social security and other trust funds, veterans' pensions and veterans' readjustment benefits. The amounts of these expenditures are determined mainly by existing contract or by legislative standards in long-term programs. However, in the case of the \$1.6 billion for veterans' readjustment benefits, more rigorous administration of the standards could result in considerable economies.

The big challenge of the budget is in its defense component, which as here defined includes the following items:

| | | | |
|---|------------------|--|------------------|
| Military Services | | | \$41,491 million |
| Department of Defense | \$40,000 million | | |
| Other | 1,491 " | | |
| Foreign Military and Economic Assistance | | | 7,112 " |
| Present Mutual Defense Assistance Program | 2,500 " | | |
| Proposed Military and Economic Assistance | 3,000 " | | |
| ECA | 1,200 " | | |
| Other | 412 " | | |
| Expansion of Defense Production | | | 1,100 " |
| Stabilization and Production Controls | | | 304 " |
| Civil Defense | | | 330 " |
| Defense Housing | | | 100 " |
| Atomic Energy | | | 1,277 " |
| Dispersal of Government Agencies | | | <u>164</u> " |
| | | | \$51,878 " |

A rapid build-up of our military strength and assistance to strengthen our allies are imperative. This is obviously going to cost a lot of money. It is also true that in the past rapid increases in the military establish-

ment have been accompanied by important waste of money, materials and manpower. That is, more efficient management was possible, and would have permitted achievement of as much or more military strength at much less cost. When defense expenditures are in the neighborhood of \$50 billion, as they soon will be, the savings from moderate gains in efficiency can be measured in billions of dollars.

Most of the figures in the defense category are round estimates of the costs of carrying out a program the size and character of which have not yet been made public. In any case, efficiency in national defense cannot be achieved by overall policy statements. It can only be achieved by more efficient continuing processes. It will require action both in the Congress and in the Administration, starting at the National Security Council which must determine that the programs are tailored to the requirements of our strategic situation. The work of the Congressional Appropriations Committees can be most usefully supplemented by investigating subcommittees, which can examine particular parts of the program closely and thus keep pressure on the whole program. The Office of Defense Mobilization has an important part to play in screening procurement schedules, preventing wasteful procurement practices, and bringing industrial engineering talent to work on the problem of designing specifications for equipment that will meet military needs at least cost. But the greatest responsibility is on the officials of the Department of Defense; without their vigilant efforts to save manpower, materials and money there will be no substantial economies.

The \$7.1 billion provided in the 1952 Budget for foreign aid is an increase of \$2.6 billion over the 1951 figure. In view of the great

recovery in Western European production, and the notable improvement of the world's balance of payments with the United States, there is a serious question whether so large an increase in our aid is required. If the Western European nations are to make their maximum contribution to mutual defense, they will still need assistance from the U. S. But in order to avoid excessive burdens upon the U. S. we must be careful to recognize not only the increasing need for defense assistance but also the dwindling need for recovery assistance.

Special attention should be given to the \$1100 million of expenditures included in the budget for the expansion of defense production. Clearly, the defense program calls for an expansion of productive capacity in many industries. Clearly, also, where the necessary expansions cannot be privately financed because of their specialized character, government financing should be available. But there is no evidence in the Budget to suggest that these specialized cases will amount to \$1.1 billion in fiscal 1952. We believe that if the present and prospective requirements are clearly spelled out, and with accelerated amortization available, much of this \$1.1 billion may be unnecessary -- especially the \$440 million that is estimated to take the form of loans. If programs of this kind are not carefully restricted we may find ourselves paying high taxes to finance government expenditure for investment that cannot be financed privately because taxes are so high.

The Budget includes \$330 million for civil defense. Recent official statements indicate that this amount will be substantially reduced because the shelter program has been revised.

We believe that a reduction of some \$6 billion in the total

budget is possible - barring some development which requires a change in the underlying programs- and should be strenuously sought.

Where to Raise the Money

The main requirement of a 1951 tax measure is that it be promptly enacted and adequate to balance the budget. Beyond this the most important objectives are a fair distribution of the tax burden, maximum restraint on inflation and minimum impairment of production.

Fairness in the tax program is important not only because fairness is valuable for its own sake, but also because national unity is essential and will be strengthened by a general feeling that the tax burden is fairly distributed. This means several things, not entirely consistent. It means that the taxes should be fair, in an "objective" sense, and also that they should correspond to the community's generally held ideas of fairness. It means that taxes should recognize differences in ability to pay and that those with more ability should pay more; it also means that taxes should recognize the right of an individual to have his earnings substantially reflected in his income after tax. It means that the tax system should avoid arbitrary discrimination among persons, lines of activity or forms of business organization.

The tax program for 1951, to be most effective in restraining inflation, should exert its main impact on restraining consumption expenditures. To have any anti-inflationary effect the taxes must restrain expenditures of some kinds -- either consumption expenditures or investment expenditures. Since investment expenditures are only about 20% of total private expenditures, and since the maintenance of a high rate of real investment is important for the expansion of production, it is clear that the tax program should be mainly

directed to holding down consumption expenditures. This means that an impact on low and middle incomes is unavoidable, because it is these incomes that provide the largest part of consumption expenditures.

In the taxes we now enact we must seek to avoid excessive impairment of incentives to investment, work and efficient operation of businesses. This means that we should not take away in taxes too much of the additional earnings that result from greater contribution to the productive process. This problem, which has for some time been serious with respect to investment and managerial incentives, is now becoming increasingly serious with respect to work incentives. We are certainly going to be in a position where taxes will take 20 to 30% of the additional income earned by the average working man for longer hours or greater effort. We must now proceed with great care to avoid unnecessary reductions of the incentives to work at all income levels, as well as incentive to save and to invest.

In the light of these objectives and after considering the alternatives, we believe that the following combination of tax increases would best serve the present emergency needs for temporary additional revenue:

1. Individual Income Tax -- An additional 5% tax on taxable income after present exemptions and the present tax.
2. Corporate Profits Tax -- A new Defense Profits Tax which would bring the combined income tax rates on profits in excess of \$25,000 to 50% (compared to the present 47%). The excess-profits tax would be in addition to this.
3. Excises -- (a) An increase in the manufacturers excise tax on automobiles to 20% (from 7%) and on refrigerators, television sets and other consumers' mechanical

durable goods to 25% (from 10%).*

- (b) An increase in the present Federal excises on alcoholic beverages, tobacco and gasoline.
- (c) A new excise tax of 5% on retail sales of items not now subject to Federal excises, excluding food, housing, fuel, utilities and certain items difficult to tax. The main categories of goods subject to the new excise would be clothing and house furnishings.

*Footnote by Beardsley Ruml and John M. Hancock: "In my opinion excise taxes would have little or no effect in restraining the consumption of items under present circumstances. In the interests of equity and flexibility it seems to me preferable to impose a retail excise tax at a flat rate on all items to be taxed, with the exceptions of liquor, tobacco, gasoline and transportation of freight. The excise tax on freight transportation, now 3%, should not be increased; in fact it should probably be removed."

*Footnote by Harlow H. Curtice: "I dissent from the recommendation on excise taxes, because in the interests of equity and flexibility, and avoidance of dislocation of production and employment, it seems to me preferable to raise the necessary revenue through a uniform retail excise tax or a uniform excise tax on all end products of manufacture with the exceptions of food and food products, which should not be taxed, and alcoholic beverages, tobacco, gasoline and transportation of freight, which should continue to be taxed at present high rates. An excise tax such as recommended on automobiles of 20% and on refrigerators, television sets and other consumers' mechanical durable goods of 25% is an arbitrary discrimination against these lines of business. Additional excises should be equitably imposed with consumers' durable goods bearing only their fair share, rather than an increased discriminatory load.

"Furthermore, I do not agree with the premise that excise taxes should be used to control the production of items using material in short supply, since to superimpose a control by taxation on top of material regulations is not only unnecessary but contains elements of danger to the national economy.

"Emergency defense tax increases, whether excise or income, should be definitely labelled as such, and they should carry with them a provision for their automatic termination, when the reason for their adoption has ceased to exist."

*Footnote by Theodore O. Yntema: "These special excises on consumers' durable goods are highly discriminatory. They fall on items which are most important in improving the national standard of living. They cannot possibly be justified except for temporary demand-supply relations. Because of the danger that these excise taxes on consumers' durables will be frozen into the tax structure, it is my opinion that a general excise or sales tax is preferable to such special discriminatory levies as a means of raising revenues."

Miscellaneous Revisions -- A number of other tax revisions which would improve the tax system and increase the revenue should be made now if that can be done without delaying enactment of the main revenue measures. Among these revisions are taxation of future issues of state and local securities, provision for partial collection at source of individual income tax on dividends, and taxation of cooperative businesses. However, if consideration of these and other "loopholes" would cause delay, the main revenue increase should be enacted first and the loopholes taken up later in 1951.

The yields of these increases in a full year, at 1951-52 levels of national income, would be approximately as follows:

| | | |
|------------------------------------|-----------------|------------------------------|
| 1. Individual income tax | \$ 3.85 billion | |
| 2. Corporate income tax. | 1.00 | " |
| 3. Excises: | | |
| autos, refrigerators, etc. | 1.10 | " |
| liquor, tobacco, gasoline. | 1.40 | " |
| new retail excise. | 2.75 | " |
| 4. "Loopholes" | ? | |
| | \$10.10 | " (excluding "loopholes") |

Before proceeding to discuss each of these recommendations we wish to indicate the considerations which lead to this particular balance among the various revenue sources.

The taxation of corporate profits is already very close to the maximum limits that would be safe even in a temporary emergency, and far beyond the limits that would be tolerable for any protracted period. Since the outbreak of fighting in Korea, corporate taxes have been increased twice; these two increases provide \$6 billion of the \$9 billion tax increase enacted in that

period. The taxes now in effect will take about 50% of all corporate profits, and much more in many cases. Moreover, taxes, including the excess profits tax, now take 77% of any additional earnings made by a great many corporations.

According to Treasury estimates, corporate profits before taxes in 1951 will be about \$43 billion, of which present Federal taxes would take \$21 billion. From the remaining \$22 billion must come dividends, on which the stockholder will be taxed at full individual income tax rates, and corporate savings from which to finance economic expansion. Some perspective on these figures may be gained by noting that personal incomes in 1951 are estimated at about \$245 billion, of which existing Federal individual income taxes and excises will take about \$30 billion. Personal incomes, after present taxes, are about ten times as large as corporate profits after present taxes.

However, these aggregate figures reveal only part of the reason why higher corporate tax rates can no longer be looked to as a major source of additional revenue. The aggregate figures do not show the losses of efficiency that result from having a large part of the nation's business done by corporations that can retain, after taxes, only 23¢ out of any dollar they may earn by being more efficient. Moreover, the basic unfairness of the corporate tax system is not a matter of overall statistics but of the relative treatment of different individuals.

One of the main defects in the taxation of corporate profits is that it violates the principle of progressive taxation -- which is that individuals with higher incomes should be taxed at a higher rate than individuals with lower incomes. A dollar of corporate profit is taxed at the same rate regardless of the income of the stockholder, whether it be \$1000 or \$100,000.

The excess burden resulting from taxing corporate profits first at the corporation level and second at the stockholder level is thus much greater on the low-income stockholder than on the high-income stockholder. Take the case of a retired married couple whose entire income is \$1000 earned, before taxes, by a corporation in which they have a small investment. The corporate profits tax will take about half their income, whereas if their income had come from any other source it would not have been taxed at all. Compare this with a stockholder subject to a tax rate of 75%. If the corporate rate takes 50% of his earnings from corporate investment and he pays 75% individual tax on the remainder, his total tax on corporate earnings is 87.5%. He is still taxed unfairly on corporate earnings as compared to the 75% he would pay on other income, but the excess is not nearly so great as in the case of the low-income stockholder.

In our opinion, a further increase in corporate taxes as large as the one billion dollars we recommend can only be justified by the existence of an emergency. Most of the 1951 revenue needs must be met from other sources -- which means essentially from direct taxation of individual incomes and from excises.

The question which then arises is how much reliance to place on individual income taxes and how much on excises.

We believe that the direct individual income tax is the fairest kind of tax and should continue to be the backbone of the Federal revenue system. We recommend another large increase in the income tax for 1951.

In considering how far to go with increased individual income taxation one feature of the individual income tax system is now very important. The individual income tax as now constituted is essentially a system of high marginal rates on a relatively small part of total incomes. Thus, according to Treasury estimates for 1951, out of a total personal income

of \$245 billion, the income subject to tax will be about \$90 billion. The tax rate on this taxable part starts at 20% now, and rises very rapidly to 50% on a taxable income of \$16,000 and to still higher rates on higher incomes. To put the picture in individual terms, a married couple with two dependents having an income of \$3,300 would have an income subject to tax of \$600. On this \$600 under present law their tax would be 20% or \$120. Thus, in order to tax away less than 4% of their total income we put a tax of 20% on their last \$600 of income. And this 20% rate or an even higher rate will apply on any additional dollars they may earn by longer hours or harder work.

A marginal rate of tax exceeding the average rate is a necessary feature of a progressive income tax. However, it is clearly wasteful of incentives. As long as the rates are moderate, this defect is outweighed by the advantages of a progressive income tax. But when rates are as high as they already are, it is desirable to go slow in raising marginal rates further and find part of the revenue in ways less damaging to incentives.

There are two principal ways in which substantial amounts of revenue can be raised in addition to increasing income tax rates -- one is by reducing income tax exemptions and the other is by increasing excises. Revenue needs for fiscal 1952 do not call for both of these steps. The choice between them is not black and white; there is much to be said on each side. In our opinion, the balance of considerations favors an increase and extension of excises, for the following reasons:

1. The excise method is safer from the standpoint of incentives than the reduction of exemptions, which would expose another layer of income-earners to the high marginal rate of income tax.

2. The excise tax is somewhat more effective in restraining expenditure since it leaves open to the taxpayer the choice of reducing his tax by reducing his expenditure.

3. To some extent excise taxes can be selectively directed to products that use materials in especially short supply and thus can assist in reducing excess demand for these products.

4. Excises can reach some of the incomes that are not reported for income taxation even though large enough to be taxed.

The tax increases we recommend are designed to meet a temporary emergency situation. Our present very large expenditures for defense may prove to be a two or three year bulge required to provide initial and reserve equipment for expanded forces and to enlarge productive capacity. In this case the emergency tax increases should be reduced or repealed after the peak of expenditures has been passed. On the other hand, if a high level of expenditures proves to be necessary for a longer period, all of the tax increases made since Korea should be reconsidered in an effort to develop a more rational tax structure with which we can live not just for two or three years but for a decade.

Taxation of Corporate Profits

In considering any further taxation of corporate profits we should seek to avoid unnecessary exaggeration of the evils of this kind of taxation. The most damaging and unnecessary feature of our present corporate taxes is the very high marginal tax rate imposed under the excess profits tax. Total corporate taxes now take about 50% of total corporate profits. But corporations that have "excess profits" according to the arbitrary standards of the act pay in taxes 77% of any additional earnings. For these corporations,

extra efficiency, extra enterprise are worth only 23 cents on the dollar. And the most efficient and enterprising corporations, whose growth is in the national interest, retain only 23% out of any additional earnings to finance growth, and of course even less after payment of dividends.

In order to avoid these depressing effects on production we recommended last fall that an increase in corporate taxation take the form of a moderately increased rate on all profits rather than a very much higher rate on a part of profits defined as excess. However, an excess profits tax was enacted. This Act will expire on June 30, 1953. We hope that in the light of further consideration and experience the act will not be renewed. Meanwhile, in raising corporate taxes now we should avoid increasing the 77% marginal rate.

The system we suggest would increase the tax of all corporations but would not raise the marginal rate of any above 77%. The rates would compare with the present rates as follows:

| | <u>Present Law</u> | <u>Proposed</u> |
|---|--------------------|-------------------|
| Normal tax on all profits | 25% | 16% |
| Surtax on income above \$25,000. | 22% | 22% |
| Defense Profits Tax on all profits. | - | 12% ^{a/} |
| Tax on "excess profits" - including above . . | 77% | 77% |
| Maximum limit on tax as % of total income . . | 62% | 65% |

^{a/} In November, 1950, this Committee recommended a 15% Defense Profits Tax without an "excess profits" tax. Since we now have an "excess profits" tax, the Defense Profits Tax on all profits should not be as high as 15%.

Taxation of Individual Incomes

We recommend a 5% additional tax rate on individual income in excess of the present exemptions and tax. Thus for a family with \$600 of taxable

income above present exemptions the present tax is \$120. The additional tax would be 5% of \$480, or \$24. For taxpayers in the first bracket the 5% tax on income after tax is the equivalent of a 4% tax on income before tax.

This is a simple and fair way to take account of the fact that what is now available for additional taxation is the income after the present tax. A flat addition to the present tax has widely different effects upon the take-home income -- the income left after tax -- depending upon the proportion already going in tax.^{1/} The superficially even-handed system of a moderate flat addition to present rates has very uneven effects on the income that counts -- namely income after tax.

The system we propose would reduce by 5% in all brackets the amount of an additional dollar of earnings retained after tax. It would reduce total income after tax by a percentage which rises gradually towards a maximum of 5%, as is shown in the table:

Effect of a 5% Tax Levied on Income Above Exemptions and Present Tax
(married person -- 2 dependents)

| <u>Net Income</u> | <u>Income after Tax, Present Law</u> | <u>Additional Tax</u> | <u>% Cut in Income After Tax</u> |
|-------------------|--|-----------------------|--------------------------------------|
| \$ 3,000 | \$ 2,880 | \$ 24 | 0.83% |
| 10,000 | 8,408 | 300 | 3.57% |
| 50,000 | 31,116 | 1,436 | 4.61% |
| 100,000 | 48,088 | 2,284 | 4.75% |
| 500,000 | 97,544 | 4,757 | 4.88% |

Excise Taxes

The increased corporation and individual income taxes recommended by the Committee would yield almost \$5 billion of revenue. The remaining revenue

^{1/} Thus a flat 4 point addition to present tax rates would reduce income after tax by .8% for a family (4 persons) with \$2,900 of net income after (present) tax, 8.1% for a family with \$50,000 of net income after tax and 20.4% for a family with \$90,000. From the standpoint of incentives the effect on marginal rates is more important. For a family with \$50,000 of net income after tax, a 4 point addition to present tax rates would reduce take-home income per dollar of additional earnings by 14%.

requirements -- slightly over \$5 billion -- should be raised from excises.

Federal excises are now levied on items that account for about 25% of consumers' expenditures, at rates ranging from 4% to 40% in terms of retail price. Another 50% of consumers' expenditures consist of items, such as food and housing, that should not now be taxed in order to safeguard the very lowest incomes or items that are difficult to handle administratively -- such as domestic service. This leaves about 25% of expenditures not now taxed and potentially eligible for new Federal taxation -- the main items being clothing and household furnishings.

Within the category of items now subject to Federal excises we recommend increases in two classes:

a. Alcoholic beverages, tobacco and gasoline -- These items are the main revenue producers among Federal excises. We have previously recommended that in the ultimate "normal" Federal tax system these should be the only items subject to excises. We believe that rates in this class could be increased sufficiently to raise their yield by about 30% -- \$1.4 billion -- without undue burden upon consumers.

b. Automobiles, refrigerators, television sets and other consumers' durable mechanical goods -- The production of these items will have to be curtailed because of heavy defense requirements for the materials used in their manufacture. Increasing excises on this class of goods will help reduce the excess demand for the remaining civilian supplies. Raising the tax on automobiles from 7% to 20% and on the other items from 10% to 25%, at the manufacturers' level would yield about \$1.1 billion.*

Except for these cases we see no reason for widening or even preserving the discrimination against producers or consumers of the items now subject to

* See footnotes by Messrs. Curtice, Hancock, Ruml and Yntema on page 19.

tax. Therefore, we suggest a tax on the eligible items not now taxed -- which would cover mainly items in the following categories: clothing, house furnishings, transportation, personal care (such as haircuts, clothes cleaning), and recreation. In addition to sales of new items the tax would apply to sales of second-hand items in the same categories and to second-hand sales of items already subject to Federal excises -- such as automobiles. A tax rate of 5% of the retail price would raise about 2.75 billion dollars. We suggest imposition of the tax at retail for the sake of uniformity and visibility. However, if there should be strong administrative reason for imposing the tax on any of these items at the manufacturers level this could be done, with appropriate adjustment of the rate.

It is, of course, fundamental to tax policy and stabilization policy that the new or increased excises should be excluded from the measurement of the cost of living in any controls that link permitted wage increases to the cost of living. The purpose of linking permitted wage increases to the cost of living is to permit achievement of equitable relations between wages and other private shares in the national income. It is not to enable anyone to escape the share of the defense burden that Congressional tax legislation would impose upon him. Similarly, increased corporate profits taxes should be excluded in any consideration of allowable price increases.

Miscellaneous Revisions of the Tax System

The need for additional revenue and higher rates of tax makes it more important than ever to subject each special tax exemption or concession to scrutiny and to require its justification if it is to be continued. One exemption which in the opinion of this Committee is unjustified is the exemption

of interest on state and local government bonds from Federal income taxation. Also, we believe that steps should be taken to subject the income of cooperative business organizations to taxation more comparable to that imposed on other forms of business.

All possibilities of reducing tax avoidance and tightening up tax enforcement should be thoroughly explored. One step in this direction would be a requirement for withholding part of the individual income tax on dividends at the source.

There are a number of cases where unjustified privileges and opportunities for avoidance have been alleged to exist. The Committee has not studied all of these cases. Certainly, we are not suggesting that every alleged "loophole" is an actual loophole requiring correction. However, we do suggest that all these cases should be carefully considered by Congress.

Important as we believe reform of the tax system to be, we do not believe that it should be allowed to delay prompt enactment of measures to raise \$10 billion of added revenue. If the reforms cannot be agreed upon in time for inclusion in the revenue act that is needed now, action on them should be postponed until the revenue act is completed. There will then be time during the rest of 1951 to consider these revisions and make them applicable as of January 1, 1952.

In deciding to have a large defense program America has necessarily decided to accept certain sacrifices. The size of the defense program as now foreseen will not, in the aggregate, necessitate great sacrifices. There will be absolute reductions in the supplies of some kinds of things that consumers want. Some individuals are already having to reduce their total level of consumption. But in the main the sacrifice will take the form of not being

able to buy more even though we produce more. This is a real and necessary sacrifice, but certainly not unbearable.

In this statement we have presented a program which would, in our opinion, distribute the necessary burdens in ways that would not result in unnecessary sacrifices. The central problem is one of balance: balance between direct and indirect controls, between budget policy and money, debt and savings policy, between higher taxes and reduced expenditures, and balance among different kinds of taxes.

ADDITIONAL FOOTNOTES

Comment by Mr. S. Sloan Colt on recommendation for "tight restriction on the expansion of bank credit": "All non-essential and speculative types of credit should be vigorously curtailed, but I have reservation to the tight restriction of bank credit in a broad and indiscriminate manner. Some bank credit expansion may be necessary if higher levels of total industrial output are to be attained. Certainly the military program is already beginning to call for a substantial increase in credit for defense production, and this can be provided most expeditiously by the existing machinery of the banking system. Finally, bank credit requirements are subject to seasonal fluctuations, for which allowance must be made."

Comment by Mr. S. Sloan Colt on increase in bank loans in 1950: "It seems doubtful that any policy of credit restraint short of very drastic action could have prevented a substantial increase in bank loans in the second half of 1950, in view of the normal seasonal increase in the need for bank credit, the rising volume of production and sales, the understandable desire of business to maintain production at peak levels and the world wide scramble for basic raw materials and other goods. It is clearly evident that these factors, together with resulting higher prices, contributed substantially to the large demand for bank loans. It is not so easily demonstrated that the increase in bank loans contributed significantly to the price inflation in this period."

Comment by Mr. Carlyle Fraser on recommended increase in tax limit on corporations: "I believe that the excess profits tax is basically so unsound that it would be unwise to raise the maximum combined tax limit from 62% to 65% of total income. On the contrary, I believe that the maximum limit should be reduced to 60% in order to moderate the most extreme impact of the excess profits tax when added to the other very high corporate taxes."

APPENDIX

RECONCILIATION OF ADMINISTRATIVE CONTROL BUDGET AND
CASH-CONSOLIDATED BUDGET ^{1/}

Estimates for Fiscal 1952
(Millions of Dollars)

| | <u>Receipts</u> | <u>Expenditures</u> | <u>Deficit</u> |
|--|-----------------|---------------------|----------------|
| Administrative Control Budget | 55,138 | 71,594 | 16,456 |
| Inclusion of other Government Accounts: | | | |
| Trust Accounts | +8,620 | +5,043 | -3,577 |
| Partially-owned government corporations | | + 103 | + 103 |
| Clearing Account | | + 8 | + 8 |
| Exclusion of intra-government payments: | | | |
| Transfers to Trust Accounts | -1,058 | -1,058 | — |
| Internal interest payments | -1,035 | -1,035 | — |
| Internal capital transfers | - 15 | - 15 | — |
| Internal reimbursements for services | - 19 | - 19 | — |
| Deductions from employees salaries for retirement funds | - 311 | - 311 | — |
| Exclusion of non-cash transactions: | | | |
| Net accrual of interest on savings bonds | | - 325 | - 325 |
| Seigniorage on silver | - 29 | | + 29 |
| Expenditures made in bonds (redemptions +) | | + 66 | + 66 |
| Cash-Consolidated Budget | 61,291 | 74,050 | 12,759 |

1/Data from Budget of the United States for fiscal year 1952.

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