BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

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To Chairman Eccles

Subject: Speech by Mr. Flanders

From Richard A. Musgrave R. A. M.

On the whole, Flanders' speech gives a pretty good view of the postwar tax problem. Both in his general approach and in his specific recommendations there are a good number of things with which you would agree; but there are also some points on which you might well differ. Mr. Flanders' discussion follows closely along the lines of Groves' Production, Jobs and Taxes, a summary of which I will send you in a day or two. It also agrees with the forthcoming official CED proposals for tax revision.

Summary of Mr. Flanders' Proposals

Flanders realizes fully that taxes are a matter of economic policy and that yields depend in the last resort on the level of income. In his introduction he places a good deal of emphasis on the effect of taxes upon business expenditures and financing, particularly upon the fact that the present system discourages equity financing. His main recommendations for postwar tax reform are:

(1) Repeal the excess profits tax.

(2) Reduce corporate income taxes to a level equal to the postwar individual income tax rate in the first bracket (between 15 and 20 per cent).

(3) Give the stockholder a credit equal to the first bracket rate on his dividend income.

(4) Permit business losses to be carried forward for six years. Continue the carry-back of excess profits credit for three years after the war and after repeal of the excess profits tax.

(5) Repeal of federal excise taxes except tobacco and liquor tax.

(6) All future issues by state and local governments should be taxable.

(7) Maintain the income tax at a level sufficiently high to balance a $20 billion budget at a high level of employment.

(8) Permit individuals to average their income every five years and to obtain rebates if tax paid exceeds the tax which would have been paid had income been received in even installments.

(9) Aim at a federal tax system which will provide a balanced budget at an average high level of employment and production.

Points of Agreement and Disagreement

In brief I would say that these might be your main points of agreement and disagreement:

Points of Agreement:

Recognition of tax policy as a most important means of economic policy; reduction of excises and primary reliance on income tax; elimination of double taxation of dividends by exempting dividend income from normal income tax rate; extended carry-forward of business losses; closing of tax exempt loophole; effort to balance the budget at high level of employment but not under deflationary conditions.

Points of Disagreement:

(1) Mr. Flanders' statement that "the retention of the excess profits tax after the war, even after reduced rates, would have disastrous effects on national production and employment", is too strong. The supporting argument (page 4) that the excess profits tax would leave "no incentive for business above the 1939 level" completely overlooks the various provisions under the excess profits tax law which permit for an expansion of the capital base and hence of the dollar amount of excess profits credit. Also you might want to point out that while it would be desirable to repeal the excess profits tax eventually, we should be careful not to repeal it prematurely and only in conjunction with the reduction in other corporate taxes.

(2) You might disagree with the suggestion that the excess profits carry-back provision should be continued for three years after the war and after the repeal of the tax itself. A year or two might be sufficient in most cases to allow for the incidence of "delayed" costs of war production (such as dismissal wages and certain parts of reconversion costs).

(3) There is some doubt whether lowering the corporate rate to 18 per cent in addition to exempting dividends from the normal rate under the personal income tax would not go too far in giving relief to income from equity capital. If the double taxation of dividends is taken care of, a further reduction in personal income tax rates might be preferable to a cut in the corporate rate.

(4) You might want to indicate that you are somewhat skeptical about excessive emphasis on tax "incentives" to investment and that you consider the reduction of tax pressure upon consumption of primary importance.

(5) Mr. Flanders, in his introduction, indicates that tax relief is particularly needed for new and small enterprise. Some of his proposals--such as the relief to equity financing, the extention of the loss carry-over and the averaging provision under the personal income tax may be of particular benefit to small enterprise, but others such as the sharp reduction in corporate taxes will be equally beneficial to large and profitable corporations. The question is raised why Mr. Flanders' proposals do not make more specific provision for the treatment of small and new enterprise.

There are a number of other minor points which need hardly be referred to.