

Mr. Musgrave

Such:

Is this close enough
to the Chairman's views
to justify his approving
it? If not, where would
he take issue?



FEDERAL RESERVE BANK
OF BOSTON

RALPH E. FLANDERS
PRESIDENT

June 16, 1944.

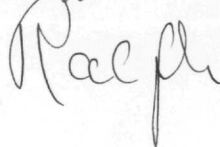
Honorable Marriner S. Eccles,
Board of Governors of the Federal Reserve System,
Washington 25, D. C.

Dear Marriner:

In accordance with what will be my regular policy of sending you copies of any talks I might give, I am enclosing herewith manuscript of a talk on Federal taxation which I gave before the New England Council yesterday.

While in introducing myself, I said I was speaking as Chairman of the Research Committee of CED and not as President of the Federal Reserve Bank of Boston, still it is not possible to completely dissociate my two capacities.

Sincerely,



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A FEDERAL TAX SYSTEM
TO ENCOURAGE BUSINESS ENTERPRISE, PRODUCTION, AND EMPLOYMENT

An Address before the New England Council
June 15, 1944

The Committee for Economic Development has as a major project the study of tax policy for the post-war period. The problem was assigned by the Committee to our Research Director, Mr. Theodore O. Yntema, and he, in turn, engaged Dr. Harold M. Groves, Professor of Economics at the University of Wisconsin, to head the study, with other tax experts as consultants. The results of this research have just been published by the McGraw-Hill Company in a book by Dr. Groves entitled "Production, Jobs, and Taxes." This study is the foundation of the Committee's forthcoming policy statement on the same subject.

While the policy statement of the Committee is based on the work of the research specialists, who take full responsibility for their work, the policy statement is the sole responsibility of the business group forming the Committee. During the long period of discussions between the economists and the business group, most of the differences of opinion have been ironed out, and the final differences will be comparatively unimportant.

Since the policy statement is not yet in its final form, what I am saying about it here is preliminary and unofficial, but will not, I am sure, depart very much from the completed statement.

A dangerous dilemma faces the post-war world as a result of the enormous taxes we shall have to pay. How can we pay those taxes without choking employment and production? How can we pay them without destroying the taxable income by which alone they can be paid?

The increase in the national debt resulting from the cost of recovery measures during the depression, and the much larger added burden of interest on

the war debt, will require such heavy outlay that we are faced with peacetime federal expenditures of unprecedented size. To this will be added the increased cost of maintaining an enlarged navy and standing army, and increased benefits for veterans. All of this adds up to around \$20 billion in taxes, including social security--three times the amount required before the war and six times the amount required in the twenties.

The government will need to raise twice as much as total corporate profits in a good year. There is danger that its mistakes will more or less automatically be big ones. In fact, unless we can devise a tax system which permits high production and employment, we cannot raise the required taxes--there will not be income enough to tax.

Throughout the history of this country, the increase in job opportunities and the improvement in the scale of living has obviously come from the expansion of old businesses and the establishment and growth of new ones. Few who have not studied the matter or have not experienced the effects of existing tax policies realize the heavy repressive hand that our present taxation has laid on this normal method of expanding the income of the wage earner and the markets of agriculture.

Business growth is financed in three ways. First, by the investment of venture capital in a new, untried but hopeful undertaking; second, by subsequent growth of the successful undertaking, financed by plowing back earnings; and third, by floating new security issues on the market.

As to new ventures, our personal taxes are such that, in combination with our corporate taxes, they direct the funds of the larger income groups away from risk-taking, expansive business undertakings into the gilt-edged securities of established companies or, more unfortunately still, into tax-exempt securities.

Until recently, the second means of financing, by plowing its earnings back into the expansion of its operations, was the normal means of growth of a

well-managed business enterprise. Instead of paying the major part of these earnings back to stockholders, a good share of them was invested in new equipment, larger supplies of raw materials, and wages for more men. And, of course, the new equipment and the added raw materials, in turn, meant more wages for more men among the producers of these commodities.

Under our present tax laws and, to a lesser extent, those in the immediately preceding years, so large a share of the earnings of a growing company went into excess profits taxes that little or none was available for expansion, and increase of employment was thus heavily penalized. 77

This repression of expansion applied particularly to the small or middle-sized company which, under existing S.E.C. Regulations, had no effective access to the third means of raising funds, by new stock issues, even though the opportunities for profit might be obviously good. A security issue of \$500,000 is too small for the complicated and expensive procedure now required. The big, established company, on the other hand, has free access to the security market and can expand, by this third method. Our present tax laws restrain the new, the small, and the growing organizations, and tend to leave expansion as a perquisite of the large, established ones. 78

Another unfortunate tendency, in companies of all sizes, has been in the direction of financing by debt as against equity; or, in simpler language, by borrowing on bonds instead of by the sale of stock. Interest on bonds or other debt is not taxable as coming out of profit. Dividends on stock are taxable as coming out of profit. There is, therefore, a tendency toward a type of corporate financing which puts heavy fixed charges on the business, whether times are good or bad, whether operations are at a profit or at a loss. This unfortunate tendency tends toward bankruptcy in depressions and contributes to the instability of our economy.

Of course, the extremes of the situations described above are made inevitable by the height of war taxes. But only a small part of the damage is inevitable in properly devised peace-time taxes, and it is the purpose of our study to find ways in which we can avoid serious mistakes in going from war to post-war taxes.

In view of the conditions described above, we make the following recommendations for changes in corporate taxes.

Repeal the excess profits tax. *when?*

While clearly justified as a war measure, we are convinced that the retention of this tax after [?]the war, even at reduced rates, would have disastrous effects on national production and employment. The present excess profits tax is a ceiling tax on gross profit, since virtually all profits above the 1939 levels for most concerns are appropriated by the government. What strong incentive is there to do business beyond the 1939 level? — *not in volume?*

In addition to being exceedingly repressive for business enterprise as a whole, we have seen how it places growing companies with small capital bases and unsatisfactory past earnings at a serious disadvantage compared with old established businesses which have either a satisfactory record or a large capital base. As such, it is clearly in opposition to the objective of promoting a dynamic and expanding economy, with its increased markets and employment.

Reduce corporate income taxes to a level equal to the post-war normal withholding tax rate for individual incomes.

The wage earner, as well as the stockholder, has a definite stake in these two proposals. By leaving corporate profits lightly taxed, there is not only an opportunity for more dividends and easy expansion, when expansion is indicated; that expansion offers more and better job opportunities. The tax relief also will permit lower prices for the things the wage earner buys. Indeed, the case has been strongly argued that corporate taxes are not paid by the corporation, but are

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reflected in prices paid by the customers. We believe this statement to be too strong, and are particularly concerned with the effect of these taxes on the expansion of employment. Yet there remains, without question, an opportunity for favorable effects on prices.

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Reduce double taxation by freeing from corporate taxation those profits paid out in dividends, or by leaving the stockholder free of the normal tax on dividends on which the normal tax has been paid by the corporation.

With the corporate tax and the normal tax on personal incomes equalized, this proposal is intended to avoid the inequitable and repressive system of double taxation of dividends which we now have. Neither of the solutions above is perfect. From the standpoint of simplicity, we prefer the payment of the normal tax by the corporation on its entire earnings, and the remission to the stockholder of the normal tax on the dividends received.

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Business income should be allowed to carry forward losses to apply against subsequent earnings for a period of six years. As a temporary measure, we also recommend that the existing privilege of applying post-war losses against current excess profits be extended to cover a period of three years after the war.

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The theory of taxing income solely on an annual basis of accrual has placed a substantial premium on regularity of income. By failing to make allowance for business incomes which by their very nature fluctuate from substantial losses in one year to substantial gains in another, it has resulted in a heavier tax burden over a five or ten year period for such irregular incomes than for incomes which are stable. Frequently this situation causes the payment of taxes out of capital rather than out of actual net income. There is nothing sacred about an annual tax basis to justify such inequality. Moreover, this method of taxation creates a particular hardship for new small enterprises which, in general, tend to have considerably greater irregularity of income than those of large, well established businesses.

W.B.

The importance of this fact has been recognized in current federal taxation which permits the carrying forward of one year's losses to be applied against the income of the second. We believe that considerations of equity and the objective of stimulating venture capital require a substantial broadening of this principle.

In addition to the proposal that the privilege of carrying forward losses be extended for a period of six years, we also recommend that the existing carry-back provisions of the excess profits tax be broadened from two years to cover a period of three years after the war. Since the existing privilege is incorporated in the excess profits tax law, special action will be necessary, if this tax is repealed after the end of the war. Since a significant part of re-conversion costs and of losses during the transition period will be a direct effect of the war, we believe such action is desirable to make more equitable the overall burden of wartime taxation on corporations.

The heavy burden of taxation on business expansion which is inherent in our tax system is mitigated by the various suggestions just made, but the conditions are still far less favorable to an expanding economy than they were a generation ago. We therefore recommend that

The present differential taxation of capital gains of 100 per cent subject to tax, on securities held for six months and 25 per cent subject to tax, on those held for a longer period, should be retained.

There has been much theoretical discussion as to whether or not capital gains are income in the sense that makes them logically subject to an income tax. There is the precedent that in England capital gains are not taxed unless it appears that they are depended upon for income. Without subscribing to the theoretical objections to the capital gains tax, and without depending on the British precedent, we urge retention of the above policy as the best point in a modern tax structure at which to maintain a measure of the old conditions under which risk-taking and venture capital received the reward necessary to bring them into action.

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It is true that the very simple form of the proposal will not distinguish completely between market operations as a source of income and the investment of money in productive enterprise. It is true also that it makes no distinction between the securities of established enterprise and new securities issued for the establishment of new enterprise or for the expansion of older ones. An endeavor to draw these distinctions would lead to complications which would not be worth their cost. The thing to be desired is to get the liquid wealth of the nation attracted to the expansion of American production and employment. This is a strategic point at which to remove the barriers to the desired result.

Don't have to sell stocks?

After the close of the war, all federal excise taxes should be repealed, with the exception of those on tobacco and liquor.

We are opposed in principle to all general sales taxes in the federal tax structure. Their impact is particularly severe on low income recipients, and hence, they have an immediate depressing effect on demand for consumption goods, whatever stimulation might arise from later expenditures of this tax money by the Government. They are the source of much annoyance, and are usually costly to administer.

The same general arguments apply against most excise taxes levied on particular commodities or groups of commodities. Such taxes are not objectionable as wartime measures, but are definitely undesirable in times of peace.

We propose, however, that excise taxes be retained on tobacco and liquor. These taxes are collected at the source and are cheap and easy to administer. They are not taxes on necessities and, therefore, can be avoided. They are productive of an important amount of revenue with highly stable characteristics. We believe it desirable to retain such an element in our tax structure in order to avoid placing too great a reliance on the income tax.

The repeal of other existing excise taxes as suggested above will provide substantial relief after the war for the lower income groups. In addition, it will greatly simplify the federal tax structure.

Congress should pass at once a resolution declaring that all future issues by state and local governments will be fully taxable. If a Constitutional amendment should prove necessary, appropriate steps should be taken.

For many years we have been erecting a federal tax structure which, step by step, has tended to discourage the assumption of risks by enterprisers, and to promote a static capitalism. The refuge from high surtax rates afforded by tax-exempt securities may well be called the crowning arch of this structure. When, as at present, an individual in the top surtax bracket is forced to obtain a return of twenty per cent on an equity holding to give him a yield after taxes equal to that on a two per-cent tax-exempt bond, the effect on incentives is obvious.

The federal government has finally recognized this anomaly by making all of its current security issues fully taxable. The important remaining loophole still to be closed is that afforded by the exemption from income taxation of securities issued by state and local government agencies. Action should be taken at once in this connection, and without waiting for the end of the war.

We are not willing to recommend the removal of the tax-exempt privilege from outstanding securities. Such a step would be inequitable unless compensation were paid to the holders of existing securities. This would be costly to the federal government and difficult to administer. Moreover, we do not believe such drastic action is essential to incentive encouragement.

The present seems a very appropriate time for the action proposed. Outstanding debts of state and local governments have been substantially reduced since Pearl Harbor and are likely to undergo further reductions while the war lasts. After the war, however, public construction needs are almost certain to cause a considerable expansion of these debts. Furthermore, current low interest rates provide an excellent opportunity for refunding short-term issues on a taxable basis.

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The net effect, in our opinion, would be that the volume of tax-exempt securities within five years after the war would be small in relation to total outstanding public debts. Their influence on incentives, therefore, would be relatively unimportant.

As already indicated, the post-war budget, even without provision for debt retirement, will run somewhere around \$20 billion. This will be true whether we have a Democratic or a Republican administration, and even in the case that the nation's finances are in the hands of highly conservative legislators and administrators, of whatever party. The problem of raising money for this unavoidable budget is going to be painful.

Because it is most favorable to the expansion of profitable, productive employment, we are proposing to place the principal burden for raising the post-war budget on the personal tax structure of the income tax. This is logical as well as desirable, since all taxes are ultimately taxes on persons, whether levied on corporations, sales, imports, or what not. Putting the burden on personal taxation is, therefore, realistic, as well as being socially favorable.

The postwar budget cannot be balanced with this main dependence on the personal income tax unless there are a very great number indeed of highly paid wage earners to pay their share. This is a fiscal necessity, as well as a social desirability.

The following policies are based on the above general conclusions:

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Present personal exemptions should be raised by repeal of the Victory tax, but with income tax exemptions maintained at approximately the present levels. The present combined withholding tax of 22 per cent should be replaced with a single normal tax at a moderately lower rate. The level should be raised at which sur-taxes begin to apply.

As set forth previously, the new normal rate should fix the level for the corporate income tax. Although it is not now possible to predict exactly what the postwar normal rate should be, it is clear that it will have to be much higher than the prewar normal rate, but probably can be somewhat lower than the present combined rate of 22 per cent. A level of personal exemptions close to those now applicable for income taxes, other than the Victory tax, will also be required.

In this connection, it is important to observe that individuals with incomes of less than \$5,000 received in the aggregate \$116.7 billions in 1943, or about 82 per cent of total personal incomes of \$142 billions. On the other hand, total incomes of those who received \$5,000 or more amounted to only \$25.3 billions. Although the pattern of income distribution will change in some respects after the war, no really great changes appear to be in prospect. Consequently, a substantial tax contribution will continue to be required from income groups receiving less than \$5,000 a year, if postwar revenue requirements are to be met.

Nevertheless, an adequate withholding rate combined with current personal exemptions, should permit a lifting of the level at which surtaxes begin to apply. At present, a family of five is exempt from income taxes (except for the Victory tax) on income up to \$2,250. Thus, if surtaxes started at a moderately higher level, the net effect would be that income taxes for the great majority of all individual taxpayers would be covered by the normal withholding tax.

Some form of income averaging for tax purposes should be available to individuals as well as to corporations.

We therefore recommend that individuals be granted the right to obtain tax rebates at the end of every five-year period by the use of some averaging device.

We believe that tax relief should be provided for those with widely fluctuating incomes. Such individuals are frequently required to pay much higher taxes over a period of years than those with equivalent stable incomes.

One possible method to accomplish this would be to provide for refunds to individuals to the extent that taxes actually paid during a five-year period exceeded some given percentage (perhaps 110 per cent) of what such taxes would have been if the aggregate income had been spread equally throughout the period. The object of using a figure such as 110 per cent would be to limit refunds to those who had been seriously affected by income fluctuations. *def of average*

Pending a comprehensive study of the problem of business fluctuations, we are unable at this time to suggest means by which they may be kept under close control. Indeed, it is not yet clear to what extent they can be kept under control. It is clear at this stage, however, that we have certain tools of control which we must learn to use. If these tools are misunderstood and misused, or even if they are neglected, they may easily become active factors in generating booms and depressions.

One of these tools, and an essential one -- though by no means the only one -- is the tax system adopted.

A specific tool of control is provided by the volume of money taken out of the economy for the payment of taxes, particularly if applied to the retirement of bonds held in the banks. If this volume is heavy during an inflationary period, it tends to restrain inflation and thus acts favorably. If it is heavy during a deflationary period, it tends still further to deepen the depths of deflation. If, therefore, a tax system were designed solely from the standpoint of controlling the business cycle, it would doubtless provide for variations in rate which would apply drastically high taxes as inflation appeared, and decrease taxation during the deflationary period. This latter would not merely decrease the liquidation, but would, as well, allow larger margins for spending and business revival, both on the part of individuals and businesses.

The difficulty with using the tax system positively as a means of controlling the business cycle is most obvious at the time when it most needs to be applied: namely, when an inflationary curb is needed. In the first place, the increased taxation must be applied more quickly than is possible by legislative enactment; and in the second place, if it is left by law to administrative discretion, the extreme unpopularity of the required moves would make the process politically unfeasible.

We are, therefore, making the following recommendation in advance of a thorough study of the other tools of control, and with the knowledge that the results of that study may lead to putting more dependence on variable taxation. In such case, we may have to accept the variable rate (or, alternatively, the variable base) in spite of the great difficulties in administration.

We propose that the federal tax system be revised
to provide a balanced budget at an average high
level of employment and national production.

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The level at which the budget should be balanced will require careful study. It must be neither too high nor too low. If the point of budget balance is set too low, taxation will tend to have a repressive effect before our desired level of production and employment is reached. If it is set too high, the budget will not be balanced over the business cycle, and we will have a continuously increasing debt. We desire neither the one condition nor the other, but an intermediate position which will maintain us at the required high levels, on a self-liquidating basis, rather than on the basis of indefinite and cumulative deficit financing.

At this point we run head-on into our dilemma. If the kinds and rates of taxes are to be low enough to encourage business expansion and employment, they can only balance the budget if the national income is high. From the best figures as to postwar budget, tax rates and tax returns, applied to the tax program we have

been describing, it would seem the only safe rate of net national income we can plan for in the postwar world will be around \$140 billion. Several independent calculations which have been made indicate that at the 1943 price level, this income will be achieved with 55 million people gainfully employed at 40 hours a week. Above and below this level we may expect our economy to alternate but without destructively serious fluctuations.

We recommend to Congress and the Treasury the establishment of a stable income tax structure, within which rates may be adjusted without requiring radical new legislation.

It is recognized that one Congress cannot bind another. If, however, a tax law is drawn up, having a coordinated structure directed toward high employment and production in addition to a raising of the required revenue; and if, furthermore, such a tax structure is comparatively simple and equitable, there will be less temptation for successive Congresses to change the structure itself.

Tax legislation has become a serious burden on Congress and its committees. Anything which lightens that burden should be appreciated by successive Congresses. As suggested, we do urge that rates be stabilized eventually, so that this element of the conditions affecting business and employment will become established, so that in turn business confidence can support business enterprise.

Business confidence needs to be defined. It is often considered to be a psychological factor affecting businessmen and keeping them vibrating between jubilant optimism and blank despair. This is a better definition of the psychology of speculation in securities and commodities than it is of productive business. Business confidence, in the latter field, can be simply defined as a reasonable hope of profit. As such, business confidence is absolutely essential to the expansion of productive employment, and the various proposals of this document are directed to that end.

This group of tax proposals is not complete. Other items will require attention to make a well-rounded federal tax policy. But these are the most important proposals so far as concerns business confidence and expansion and a high level of productive employment.

Let us revert once more and finally to the difficulties of the balanced budget in the postwar world. It is confidently believed that the proposals made will balance the budget, and it is also confidently believed that they will permit business enterprise and high employment. Permit is the word to use; they will not guarantee these blessings.

At the outset of this talk the dilemma ~~was~~ stated: that unless we set our mark high in employment and production, we would have to have a tax system which would prevent us from reaching high employment and production on a balanced budget. The solution of the dilemma lies in attaining and maintaining that high level of national income of around \$140 billion. These tax proposals permit reaching this goal, but the actual attainment will have to be made by the individually wise activity and enterprise of the whole mass of American businessmen, employees and farmers. The postwar world can be a success only as it is supported by the cooperation of all of us.

Ralph E. Flanders
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