

Desjeraux Knott  
April 30, 1941

DRAFT OF TESTIMONY BEFORE  
THE HOUSE WAYS AND MEANS COMMITTEE

Mr. Chairman and Members of the Committee: Because of my conviction that the impact of the present defense effort upon our national economy will depend greatly upon the tax program now undergoing formulation by this Committee, I particularly welcome the opportunity to present my views to you. In doing so I shall speak merely as an individual and not in behalf of the Board of Governors of the Federal Reserve System. The Reserve System is, of course, continuously engaged in the study of the workings of our economic system as a whole and is interested, as we all are, in seeing the defense program move forward with the greatest possible speed and with the least possible dislocation to our economic structure. One of the most important factors in determining whether economic dislocation will be great or small -- I think we all recognize that there must be some dislocation -- is the way in which we raise these great sums we are spending for national defense. I mean by that not only how much we tax as contrasted with how much we raise by borrowing but also, after we have decided how much tax revenue we ought to have, the kinds of taxes we use to get it.

The Secretary of the Treasury has recommended that during this emergency two-thirds of our Federal expenditure be covered by taxes. I strongly endorse this recommendation. Viewed in the light of the financial history of this and other countries, this goal may

seem an extremely ambitious one. No great nation, to my knowledge, has passed through a period of world disturbance like the present without borrowing a very much larger proportion of its expenditures than one-third. Viewed, however, in the light of our prospective economic situation, the goal is reasonable and, indeed, a modest one. During the past eight years I have repeatedly expressed the conviction that a large Federal deficit is appropriate during a period of widespread unemployment and depressed national income. I have always accompanied that statement by saying that a large Federal deficit is inappropriate to a period of virtually full employment. There have been some absurd exaggerations of the speed with which unemployment is likely to vanish and I fear that anyone who expects to see unemployment disappear by the summer or fall of the present year is in for a sad disappointment. It is true, however, that we may be very close to a general condition of having more jobs than people to fill them by the end of the calendar year 1942 and, of course, before that time there will be many specific products which we shall have to ask the civilian public to do without or to consume in greatly reduced volume because those products use materials and machines that are needed for defense production. At the present moment we are on the verge of this situation with respect to a wider range of products than is generally realized and as time goes on the needs of the defense program will increasingly trench upon goods available for civilian consumption.

Meanwhile the national income, expressed in money terms, is rising and will continue to rise as work proceeds on the huge volume of defense orders now on the books. As the wages, profits, and other incomes paid out in connection with this activity begin to be spent, it will become difficult to provide enough goods to meet these increasing money demands. When this condition prevails for a sustained period in consumer markets generally, prices are marked up and the situation is one of inflation.

That is what is likely to happen to us unless we do something to prevent it. One way of preventing it is by adequate taxation. The Government asks its citizens to give its money to the tax collector instead of spending it in the stores or shops. In this way civilian competition against Government for the use of men, materials, and machines can be restrained. It is always important that taxes should be levied in accordance with ability to pay but when taxes begin to represent real sacrifices, as they must do if they are to perform their function in the present emergency, when they begin to mean lard instead of butter in the frying pan, a vacation spent on the front porch instead of at the mountains, a college education for only the oldest boy and not for all the children, it becomes doubly important that they should be levied in accordance with ability to pay. When it is necessary to tighten belts, it becomes doubly important to tighten most the belts which are most ample.

That is why I find myself in general agreement with the main outline of the Treasury proposals and that is why I am doubtful whether

it would be prudent and statesmanlike to raise more revenue from excise taxes than the Treasury proposes to raise, especially when it means heavy taxes on commodities like coffee, cocoa, tea, and sugar. These commodities may be regarded as proper objects of taxation in some poverty-stricken countries of the Old World where governments must extract revenue from their citizens in any fashion that is expedient. They are not appropriate taxes in this country where an enlightened body of citizens is able to understand the broad policies of its government and is prepared to support those policies by the payment of direct taxes. Either an increase in income tax, when applied to the lower brackets of individual income taxpayers, or a tax on coffee will restrain consumer expenditure. But the difference lies in the fact that the individual income tax does this frankly and directly and does it in a fashion which adjusts the burden to the taxpayer's ability to bear it. A tax on coffee or any other article of mass consumption does it secretly and indirectly and in a fashion that makes the burden proportionately heaviest on those least able to bear it. Before democratic government came into the world indirect taxation was the only type of taxation. The history of direct taxation, and in particular of the income tax, is the history of the expansion of democracy.

I am therefore in general agreement with the Treasury's program both in its aggregate amount and in the general type of taxation it implies. I believe, however, that it could be improved by certain changes in emphasis with respect to the revenue sources on

which it draws. I shall devote the remainder of my testimony to describing these changes.

I. Excess Profits Tax

In my opinion an effective excess profits tax is not only the keystone of a well balanced tax program; it is an essential element in solving the economic difficulties which are beginning to confront the nation over a very wide field. Any tax program that you gentlemen may frame, whether it follows the exact lines of the Treasury proposals or not, will have to include a substantial increase in the rates of taxation for corporate incomes in general and for individual incomes. You cannot reasonably ask the great numbers of business concerns of small and moderate size who are not participating in defense contracts to assume the additional tax burden involved in an increased normal corporation rate (or in the special surtax on corporate net income), and you cannot ask millions of individual taxpayers to assume the additional burdens involved in increased individual income tax rates until you have given them every reasonable assurance that the funds they are being asked to provide will not go to swell the excessive profits of a few favored corporations.

It is an open secret that the excess profits tax now on the statute books does not give any such assurance. If you allow the idea to take root in the public mind that through these vast expenditures a few are being made rich and a few who are already rich considerably richer, the result is bound to endanger the success of our defense

effort. We cannot afford to let our citizens remain doubtful on this important point. Many of us believe that in order to prevent an inflationary spiral of price and wage increases we ought to ask labor to moderate the demands for increased wages which are now being heard and which will be heard in increasing volume as employment increases and employers find that they are bidding for labor on a seller's market. Such a counsel of moderation to labor cannot be wholly effective if employers are permitted to retain huge profits. Will they forego wage increases if we permit corporate earnings after normal tax to rise during 1941 to a level 75 per cent above 1939 and permit many individual corporations to realize, after payment of taxes, profits vastly higher than at any previous time in their corporate history?

It is often said that these corporate profits are effectively taxed under the individual income tax. If that were strictly true they would be effectively reached by the surtax schedules which the Committee has under consideration. But, as you gentlemen who frame our revenue legislation know, it is not true that corporate earnings feel the full force of our individual income tax rates. Corporate earnings may now be withheld from distribution without penalty; I need not recall the short and unhappy history of the undistributed profits tax. Since we do not have an undistributed profits tax we must have heavier corporate taxation along with heavier taxation of individuals. In the taxation of corporations primary emphasis ought to be placed on the excess profits tax.

The Treasury has suggested that an additional \$400 millions of revenue be obtained by amending the excess profits tax. I believe \$900 millions of additional revenue, or \$500 millions more than the Treasury proposes, can and should be obtained from this source. The Treasury, I understand, plans to present specific proposals for revisions in the excess profits tax after there has been an opportunity to analyze the current tax returns that are now being filed. For this reason, in appearing before the Committee which played such a large part in writing that complex and difficult piece of legislation, the Excess Profits Tax Act of 1940, I will not venture to make specific suggestions as to how this additional revenue should be obtained beyond the following rather general remarks. I am sure you are all aware of the revenue-yielding potentialities of an excess profits tax, as shown by our own experience during the World War. The present statute could be made to realize those revenue potentialities by changes in a few important respects. I shall mention four. Personally I should like to see all four of these changes made but I should welcome changes in any one of them or any combination of them.

1. Restrict the use of the income method of computing the excess profits credit, either by reducing the 95 per cent of past average earnings now allowable to 75 per cent, or by any other method that may recommend itself to the Committee. The technique by which this is done is less important than the principle that favorable earnings experience in the base period should not be allowed to operate to confer tax immunity for excess profits purposes for all future times.

I agree with Mr. Sullivan's view that all excessive profits, as well as profits directly or indirectly attributable to the defense program, should be subject to special taxation.

2. Increase sharply the rates now applicable to excess profits. In my opinion, in the light of the rates in force in this country during the last World War, a maximum rate of 75 per cent is not too high. It is also important that the tax brackets used in the present law be revised to subject earnings which most American businessmen would consider very large to reasonably high rates of tax. A corporation earning excess profits of \$100,000 a year (which means total profits considerably in excess of \$100,000) is not a small corporation in terms of American business as a whole and yet the highest rate which such corporation would be called upon to pay under the present statute is 35 per cent.

3. Reduce the rate of return allowed under the invested capital method of computing the excess profits credit from the present figure of 8 per cent to 6 per cent. The figure of 8 per cent was used during the days of the World War. Ideas about a number of things have changed since that time, including the rate of return that investors could reasonably hope to realize on investment in securities. We see that change reflected all along the line in interest rates and we should make a similar adjustment in our ideas about an appropriate rate of return on equity capital.

4. Exclude borrowed money from the invested capital base. Profits are made by people who own equity capital and it makes for needless confusion and complication to define allowable rates of return

in other terms than rates of return on equity capital. If we wish to help the small corporation, it should be done directly by increasing the present specific exemption of \$5,000.

## II. Special Defense Tax on Corporation Income

If the excess profits tax is revised along the lines I have just indicated, it will then be fair and reasonable to ask American corporate enterprise as a whole to pay the special defense tax on corporate net income which the Treasury proposes. The arguments for enacting a special defense tax, instead of raising the rate of the corporation normal tax, seem to me to be clear and convincing. Most of the partially tax-exempt Government securities now outstanding were issued in years when the maximum rate of normal corporation income tax ranged between 12 and 15 per cent; the Government did not expect to grant, nor the purchaser of securities to receive, immunity from taxation at a higher rate. The maximum rate of normal corporation income tax now stands at 24 per cent. Since we have now stopped issuing tax-exempt Federal securities, I can think of no legitimate reason why we should confer additional tax benefits upon holders of outstanding securities by further increasing the normal corporation income tax rate. The only way of obtaining a significant amount of increased revenue from corporations generally without that undesirable incidental result is the special tax proposed by the Treasury. I am aware that commercial banks, which have special problems I have known intimately for many years both as an active banker and as head of the Federal Reserve System, will be among the groups most vitally affected by the

new tax; there are many banks that, as a result of this measure, will pay significant amounts of Federal income tax for the first time. But I do not believe that the banks will want to seek any special immunity from taxation when other business groups, and tax-payers generally, are cheerfully accepting their fair share of the load.

### III. Individual Income Tax

The effect of the surtax rates proposed by the Treasury is to leave many salaried workers and others living on relatively fixed incomes in a <sup>much</sup> worse position with respect to income after taxes than they enjoyed two years ago. It should also be recognized that it is this fixed income group that will be hit by even a small rise in the cost of living. I suggest that the additional revenue from revisions of the excess profits tax along the lines proposed above might well be used to moderate the individual surtax rates which the Treasury has proposed, especially in the lower brackets of the surtax schedule. For this purpose I would suggest a specific schedule of rates which I ask the Committee's permission to insert in the record. In contrast to the Treasury's proposal, no additional defense tax would be super-imposed on the tax resulting from the application of these rates.

It also seems to me an appropriate time to correct the rather illogical relationship between the exemptions for single persons and for married persons. We allow an exemption for married persons of more than double the single exemption. It seems to me that in so far as we attempt to measure by this method the increase in minimum necessary

household expenses that occurs at the time of marriage a serious error in measurement has been made. I propose the lowering of the exemption for married persons to \$1500, leaving the present \$800 exemption for single persons unchanged. It seems to me that anyone making over \$30 a week -- and this applies to a ~~large~~ considerable number of the millions of persons now being added to industrial payrolls and of the millions of others receiving increases in remuneration as a result of increased wage rates, overtime pay and promotion to better jobs -- ought to make a significant direct contribution to the support of his government. *300 for  
each child*

We need revenue from this group of our population as well as from better paid groups and if we can obtain it in this way rather than from the inequitable and cumbersome device of a sales tax, we shall have made a significant achievement in democratic finance and in good government.

#### IV. Estate and Gift Taxes

The strengthening of estate and gift taxes is the most needed reform in our whole tax structure. In a message to Congress in June 1935, the President said:

"The transmission from generation to generation of vast fortunes by will, inheritance or gift, is not consistent with the ideals and sentiments of the American people. Such inherited economic power is as inconsistent with the ideals of this generation as inherited political power was inconsistent with the ideals of the generation which established our government."

The task of bringing law into conformity with our American ideals, begun in the Revenue Act of 1935, should be completed now.

For this reason I am thoroughly in accord with the Treasury proposals, but for this reason I believe also that we should go a great deal farther. Even a lowering of exemptions and a considerable increase in the rates of estate and gift taxation are only a part of the task. The avenues for tax avoidance are both broad and numerous under our existing system of estate and gift taxes, and so long as these avenues are allowed to remain open, the task of bringing transfers of wealth within the framework of a progressive tax structure will remain incomplete. A rather extensive redrafting of existing statutes is, therefore, essential.

Since detailed recommendations on methods of closing existing loopholes can be furnished only by qualified legal experts, I shall try merely to indicate the general principles which, in my judgment, should guide the revision of our estate and gift tax laws. I think there is little disagreement regarding the underlying purpose of estate and gift taxes. It is to subject the passage of wealth -- from individual to individual and from generation to generation -- to an effective system of taxation at graduated rates. The amount of tax ought not to depend in any significant degree upon the form in which wealth is transmitted -- whether directly or through life insurance or through tax-avoidance trusts -- nor upon the time of transfer -- whether during life or at death. With this in mind, I hope the Committee will give consideration to the following proposals:

1. For the present exemptions of \$40,000 under the gift tax, \$40,000 under the estate tax and an additional \$40,000 for life insurance -- a total of \$120,000 -- there should be substituted a single, consolidated exemption of \$25,000 applicable to the sum of gifts and estate, including insurance proceeds.

2. Because the gift tax schedule is 75 per cent of the corresponding estate tax rates, many people have inferred that the net saving through transfers by gift is only 25 per cent. This inference is incorrect. At present tax liability at the highest estate tax rates to which an estate would be subject can be avoided by incurring tax liability at the lowest gift tax rates. This type of avoidance can be prevented only by combining gift and estate taxes into a single tax on transfers of wealth. I prefer to leave to lawyers the explanation of the several possible methods of effecting such a consolidation. If consolidation were effected the taxpayer would be free to choose how much of his property to dispose of during life and how much at death, but his tax liability would not be influenced by his decision. Until this step is taken, the opportunity to save a great deal on estate tax by payment of a small gift tax will remain open.
3. Under existing statutes estate and gift taxes can frequently be either entirely avoided or substantially reduced through the use of various devices involving long-term trusts. To close this avenue of avoidance, the legal concept of "gifts" and "transfer at death" ought to be broadened to include all transfers of property that transmit wealth from one generation to another.

#### V. Consumer Taxes

I am in general agreement with the Treasury proposal to raise a substantial amount of additional revenue from taxes bearing directly on consumer expenditure, including in this term taxes on liquor and tobacco as well as the manufacturer's excise taxes. Within the range of articles upon which it is proposed to levy increased rates or new taxes, much heavier taxes than are proposed by the Treasury should be applied to articles that use materials, skills, and facilities that could make a significant contribution to defense production and lighter taxes on articles whose decreased production

will release men, materials, and facilities for which there is no important military use. The Treasury has proposed to obtain only \$80 millions of additional revenue from new automobiles as contrasted with \$255 millions additional revenue from gasoline. The automobile industry has already committed itself to curtailing production by 20 per cent in its next model year, at a time when the national income, and the civilian demand for new cars, are rising rapidly. I do not know what would happen in the automobile industry if people wanted to buy five or six million cars at a time when only four million were available, but in other industries with which I am familiar this situation would lead to a rise in prices, a rise of considerably greater magnitude than could legitimately be attributed to the increase of 3 1/2 per cent of the manufacturer's price which the Treasury is proposing. If the situation is to be handled by an increase in prices -- and up to the present moment I have heard no feasible suggestions as to how automobiles could conceivably be rationed -- I know no reason why the Government should not take a considerably greater share of the increased price people will be paying for automobiles than the Treasury proposes. In my opinion a tax of 20 per cent would be more appropriate than the rate of 7 per cent which the Treasury has suggested.

In contrast to this situation we have proposed a very considerable increase in the tax on gasoline. With some minor exceptions petroleum and its products are not commodities which are in scarce supply. They are commodities which are in over-abundant supply. No significant contribution will be made to the immediate problem of curtailing civilian

demands for steel --- and I think it is an immediate problem --- by encouraging people to restrict the use of cars which they already have.

The same general principle applies to the proposed check tax. The people who work in banks are admirable people, but I am afraid few of them would be of any use in an aircraft factory or a shipyard. If you encourage people to restrict their use of banking facilities by using currency instead of checks you will be releasing resources which have no significant contribution to make on the production lines of our defense effort. The people who will in fact avoid the use of checks by withdrawing their bank accounts will be for the most part individuals of small means who will thus be deprived of a safe and convenient method of making money payments which will continue to be enjoyed and utilized by wealthier depositors. In so far as checks are issued by business concerns, businessmen will find it easy in this period of general economic expansion to pass on the small addition to their costs of doing business to consumers in one way or another. Moreover, during our earlier experiment with the check tax many corporations found a wholly satisfactory method of tax avoidance through the use of drafts drawn on themselves. In the Federal Reserve System we have for many years been trying by every means at our disposal to make the process of transferring funds by check easier, safer, and less costly for the ordinary citizen as well as for business enterprise, and we naturally regret to see any measure adopted that would represent a backward step in the development we have tried to encourage. For these reasons I propose

that additional revenue of about \$300 millions be obtained from automobiles; that the gasoline tax be increased by only half a cent instead of a full cent; and the proposed check tax should be eliminated from the list of excise taxes presented by the Treasury.

VI. Revenue Yield

The following table, which I would like to insert in the record, rather than to read at this time, summarizes the differences between yields from various revenue sources under the suggestions I have made and the Treasury proposals. There is no significant difference in the aggregate yield of the two sets of proposals.

<u>(Yield in millions of dollars)</u>		
<u>Source</u>	<u>Eccles</u>	<u>Treasury</u>
<b>Corporation incomes:</b>		
Excess profits tax (lower credits, higher rates)	900	400
Surtax as proposed by Treasury	534	534
<b>Individual incomes:</b>		
Surtax increases (lower schedule)	700	1,521
Reduction in married person's exemption to \$1,500	125	---
Estates and gifts (apply estate tax rates to gifts)	500	347
<b>Excise taxes:</b>		
Gasoline (1/2 cent instead of 1 cent per gallon additional)	128	255
Passenger automobiles, parts and accessories (20 per cent instead of 7 per cent)	375	80
Checks (eliminate proposed 2 cents tax)	---	57
Other excise taxes as proposed by Treasury	<u>842</u>	<u>842</u>
Summation of items	4,104	4,036
Less: Allowance for interrelated tax bases	<u>500</u>	<u>436</u>
<b>TOTAL</b>	<b>3,604</b>	<b>3,600</b>

VII. Loopholes

Because I understand that the Treasury intends at a later time to submit proposals dealing with loopholes, I have not emphasized that topic in my testimony, except in so far as the whole structure of the estate and gift taxes may be considered a loophole. That is not because I think the subject is unimportant. Every time the individual surtax rates are raised, it increases taxpayers' incentives to make use of tax-avoidance devices that are available under existing law and it increases the Treasury's loss of revenue from tax-avoidance. No list of such devices could be comprehensive but the following items would surely appear in any list:

1. Transfers by corporations to pension trusts for their high-salaried executives, instead of direct cash bonuses, serving the double purpose of avoiding payment of individual income tax on the amount so transferred and of shifting income from years of high salaries to years of retirement when income may be much reduced and hence taxable only in the lower brackets.
2. Use by husband and wife of the privilege of filing joint or separate returns.
3. Investment in tax-exempt securities, especially in State and local securities exempt from both normal and surtaxes.
4. Retention of corporate earnings or distribution of non-taxable stock dividends.
5. Transferring income-producing property to members of the family or others in lower tax brackets, either by outright gift or the creation of irrevocable trusts.
6. Making charitable contributions not in cash but in property which has enhanced in value, deducting the current value of the property, thus avoiding taxation of the capital gain.

I do not wish to dwell at length on these matters, but I hope that the Committee at a later date will undertake to deal comprehensively with them.