



BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON

ADDRESS OFFICIAL CORRESPONDENCE
TO THE BOARD

August 24, 1943.

Dear Randolph:

I was much interested in your comprehensive and searching questionnaire on the economic aspects of the revenue program. I have undertaken to answer these questions in a general way and hope that the enclosed memorandum will be of some assistance to you. However, I did not have sufficient time to consider all the details thoroughly. I would, therefore, like you to consider these tentative comments as confidential and informal.

I appreciate your sending me the material on the Federal retail sales tax which I am sure will prove very helpful to us.

Sincerely yours,

(Signed) M. S. Eccles

M. S. Eccles

Enclosure

Honorable Randolph E. Paul,
General Counsel,
Treasury Department,
Washington, D. C.



Strictly Confidential

August 24, 1943

Reply to Treasury Questionnaire on Tax Problems

The questionnaire covers a broad range of economic issues behind the revenue program. The questions are searching and comprehensive, although one vital aspect of the problem — the role of savings, voluntary or compulsory — is neglected. Actually the tax and savings problems must be considered together. Any revenue program (taxation, compulsory saving or compulsory lending) will affect voluntary bond purchases and all compulsory requirements (for taxation, lending or savings) must be integrated into one consistent program.

Below are given brief replies to each question. Question 1 is answered in more detail since it applies to the entire group of questions which relate to inflation. A number of tables providing some basic data are attached.

A. Inflation

1. It is impossible to state the precise dollar amount of additional revenue needed which would just suffice as a guarantee against a possible breakdown of price controls or to estimate the exact effect of various amounts of additional revenue upon the inflation picture. Certain factors in the situation may be estimated with some accuracy but others are unknown, hence the impossibility of arriving at a precise conclusion.

Known Factors:

- a. For the fiscal year 1944 the deficit is estimated to result in an increase in the interest bearing public debt of over \$60 billion. Of the total, \$20 to \$25 billion at the most, and probably less, are likely to be sold to people who will pay for their bonds out of current income. Of this amount a considerable part will be bought by people in the higher income groups and will not be reflected in reduced expenditures. By far the larger part of the borrowing will thus have an inflationary effect — either by creating additional bank deposits or by activating funds which otherwise would not have been spent.
- b. Income payments to individuals for the current fiscal year will be well above \$150 billion, or more than \$20 billion in excess of last year's. For the calendar year 1944 they are estimated to exceed \$155 billion. Unless the fiscal situation is stabilized income payments will continue to increase and the dangers of inflation will become more acute.

- c. Personal taxes paid by individuals during the fiscal year 1944 will be double those paid in the fiscal year 1943. Nevertheless, disposable income will exceed \$130 billion. Goods and services available to consumers are estimated at about \$83 billion. That is, about \$50 billion will have to be saved if demand and supply are to be balanced at present prices. Intended savings thus will have to be about 37 per cent of disposable income, as against 24 per cent last year or 17 per cent for the fiscal year 1942.
(See Table II-A)
- d. The following breakdown may give an approximate picture of how the total of required savings might be allocated: \$20 billion security purchases, \$8 billion institutional savings, \$2 billion debt liquidation, leaving about \$18 or \$20 billion to be saved voluntarily in the form of increased holdings of currency and bank deposits.
(See Table II-B)

Unknown Factors:

- a. We can not predict whether people will be willing to increase their savings sufficiently to balance their expenditures with available goods and services without a price rise, or how close they will come to doing so. The outcome will depend on many factors -- public morale, the progress of the war, the availability of goods, the tightness of controls, and so forth. If people fail to arrive at this balance by increasing their intended savings, the figures given on Table II will prove too low; money income, expenditures and savings for the coming period will all be higher, and the next year's difficulties will become that much greater.
- b. People may not only decide to save less than the necessary amount but may actually dis-save from their previously accumulated balances. With a rapid increase in the holding of balances and of savings bonds this factor becomes increasingly important and weakens the usefulness of the usual concept of the "gap" which relates to saving and spending out of currently received income.
- c. Even if it were known what the actual excess of intended spending would be over available supplies at given prices, it would be difficult to determine the precise amount of taxes (or compulsory savings) which would be required to do the job. The amount needed would probably be less than the full excess -- but much would depend on the type of taxes used.
- d. One can not predict under what degree of pressure the price control and rationing system might actually "break". More likely there would be no sharp break but a gradual decline in the effectiveness of such controls.

e. The length of the war itself is perhaps the most important "unknown" in the picture. A prudent policy, however, should be based on the assumption that the war will continue for several years to come. This seems the more justified since the need for safeguards against inflation will be at least as critical in the immediate post-war period as in the war period itself.

Conclusions

The situation is too complex to permit any precise conclusion regarding the amount of additional revenue needed. But the potential dangers in the situation are sufficiently evident to demand that every reasonable effort be made towards obtaining a sizeable fiscal program. An objective of \$12-\$15 billion of net additional revenue (after allowing for reduced voluntary purchases of savings bonds) is a good goal because it falls at the upper limit of what may realistically be considered possible.

If an additional \$12 to \$15 billion were turned over to the Treasury in the calendar year 1944, Federal net receipts would approximate 50 per cent of expenditures. Income receivers as a group would, after payment of taxes, be left with as much income at their disposal in the calendar year 1944 as they had during the past twelve months. And bitter experience has shown that disposable income during that period was sufficiently high to exert serious pressure on the price structure of the civilian economy. To be sure we cannot estimate the exact contribution of fiscal measures to the effectiveness of price and rationing controls but we know that these controls will be jeopardized severely by a failure to act on the fiscal front. We know, moreover, that price and rationing controls will have to become the more cumbersome and drastic the less adequate the fiscal program remains.

In his budget message of January 6, 1943, the President called for not less than \$16 billion of additional funds by taxation, savings, or both to be collected during the fiscal year 1944. In his summation of the 1944 budget dated July 27, 1943, the President reasserted the need of a truly stiff revenue program. Since the major part of the additional revenue to be provided by the forthcoming bill will not be obtained prior to the calendar year 1944, it will scarcely be feasible to reach the earlier objective for the fiscal year 1944. But every effort should be made in that direction for the coming calendar year. A bold effort must be made now to stabilize the fiscal situation and to bring it in line with other phases of our war effort.

2. Again, it is impossible to compute the precise amount of additional revenue which would be required to guarantee a safe inventory situation. If the fiscal effort were inadequate so that consumers' purchases were permitted to increase at a rapid rate, inventories could of course be depleted within a short period.

But if adequate fiscal measures were undertaken and consumer buying is kept from increasing, the situation does not seem too alarming as yet. Manufacturers' inventories have fallen since January 1943 but are still relatively high. Wholesale inventories have fallen since April 1942 by one-fifth and are at a low level particularly in view of record sales. Retail inventories have dropped since June 1942 at which time they were abnormally large. Now they are back to the level preceding the record increase in 1941 and early 1942. Sales, however, are much larger than at that time. Department store inventories have shown little change recently. New goods, of lower quality to be sure but still goods that can be sold, seem to become available to keep inventories up. (See Table III)

3. Without vigorous fiscal action, money incomes and expenditures will continue to increase and extensive black markets may well develop. Moreover, the greater the pressure on prices becomes, the more cumbersome and restrictive will have to be the system of price and rationing controls. Fiscal action will not only improve the functioning of these controls but will also reduce the scale at which they have to be applied.
4. If we provide for an additional yield of from \$12 to \$15 billion, and obtain this increase from the right sources (that is largely from taxpayers who will have to spend less because their tax or savings liabilities are increased), we will have done well. Beyond this point, it might be better to permit some moderate price rise rather than to advocate a revenue measure which would be considered unreasonably severe. Compulsory methods cannot be carried beyond a certain point since they apply rigidly to everyone and cannot allow for all differences between the financial position of individual taxpayers. Voluntary savings contributions are more flexible and must take up the slack wherever sufficient leeway is left after compulsory requirements are met.
5. The danger of advance buying in anticipation of the tax program would be most serious if a spending tax were contemplated. This point is the more important since Congress would surely be unwilling to pass a spending tax measure promptly so that consumers would have ample time

for advance purchases. The informal commitment not to increase taxes applicable to 1943 would make it difficult to render the tax sufficiently retroactive. There might also be advance buying in anticipation of sales and excise taxes, but if such taxes were limited to luxuries and non-essentials, the implications would be less serious.

6. It appears unsound, as a matter of principle, to grant a reduction in taxes as a reward for increased savings or savings commitments. Increased savings for purposes of current inflation control may be as good as increased taxes, depending upon the extent to which the savings are actually frozen. (Compulsory savings are superior in this respect to voluntary purchases of savings bonds because they permit the Government to retain control over the timing of redemption payments). In the long run, however, savings bonds are a liability to the Treasury, while taxes are not. Most important, taxpayers who are in a position to increase their savings bond purchases -- whether out of increased savings, idle balances or by shifting investments -- would be at a great advantage in obtaining tax reductions. Possibly a scheme might be devised through which gross inequities of this type are avoided, but this would be at the cost of serious administrative difficulties.

There is a stronger case for granting credits for increased savings or savings commitments against compulsory savings (or refundable tax) requirements. But even here there are good reasons why such credits should be limited, in particular:

- (1) If credits are permitted at all it will be very difficult to keep the credits from becoming unduly broad. As a result compulsory savings requirements, while appearing rather severe on the books, may turn out to be actually quite ineffective and give little net yield.
- (2) If credits are permitted it will be very difficult to integrate the compulsory savings requirements into the withholding system and to place them on a current basis.
- (3) In any case, voluntary purchases of savings bonds should not be permitted as credits. Otherwise one of the main objectives of a compulsory savings or refundable tax plan -- to obtain control over the redemption of the bonds -- would be defeated.

7. Yes. A salestax which would include necessities of life would result in a demand for higher wages but this should not be the case with respect to excises on luxuries or non-essentials. The danger would be less with respect to higher income taxes since due to exemptions these would not apply to the lowest income groups. An increase in Social Security payroll taxes would tend to stimulate a demand for higher wages but less so than a salestax.

B. Effect on Production

8. (a) No, not to any material extent. It works both ways in that it encourages some workers to work longer hours and discourages others. Those discouraged are probably in the minority.

(b) No, it does not appear to be a primary factor in absenteeism.

(c) Yes, especially the acceptance of jobs by married women, especially women with children. This is important because married women, and to a substantial degree those with children, are the only large source of manpower left to replace men called to service and to expand output. Moreover, it is a factor in the high quit and turnover rates of women workers. The net addition to family income obtained from working is often too small -- particularly where the entire exemption has already been taken by the husband so that the entire addition to the joint family income is subject to tax -- to offset unfavorable or tiresome working conditions for many married women.

To encourage married women to accept jobs and remain at work certain non-tax measures are urgently required, such as the operation of free public nurseries, provision for part-time employment for women, and allowing for essential shopping time, etc. On the tax side less can be done but one might consider whether some deductions from gross income could be made for increased household expenses (such as maid's salary) or whether larger exemptions could be allowed to working wives and non-working mothers responsible for the care of children under 10. A general reduction in the exemption for married taxpayers, although desirable on other grounds, would be harmful in this connection. The same applies to the elimination of separate returns.

9. (a) A 30 per cent initial tax rate would probably not materially affect absenteeism, overtime work, or willingness to accept employment of men and single women. It might add seriously to the problem of attracting and keeping at work married women.

(b) See 8(c).

10. (a) No. However, there are still a large number of people whose income is so low as to reduce their working capacity, but generally not because of taxes.
- (b) Yes. It will be necessary to impose heavier taxes on some people with incomes under \$2,000, since a substantial part of total income is received by that group. However, it does not follow that people with incomes of, say, \$1,500-\$2,000 should be lumped together with people with incomes of, say, under \$1,000. It is all important to differentiate between sub-standard incomes, low incomes, low to middle incomes, etc. For this reason the "low" income groups should be taxed through an income tax not a sales tax; the former permits exemption of the sub-standard groups, the latter does not.

Some reduction in income tax exemptions for married taxpayers and in the credit for dependents will be necessary but it should be noted that the impact of such a reduction falls not so much upon the new taxpayers, just above the lowered exemptions, but upon taxpayers already subject to the income tax.

11. The detrimental effects of the corporation excess profits tax may be significant. It is estimated that in 1943 out of about 470,000 corporations, as many as 70,000 might be subject to the excess profits tax. These corporations may have total gross receipts of around \$180 billion as against \$280 billion for all corporations and include most of the larger corporations. There is good reason to expect that the marginal tax rate of 90 per cent (or really 81 per cent) will give cause to waste and inefficiency, but not at a scale sufficient to outweigh other compelling arguments in favor of heavy excess profits taxation during wartime. An important point is that the investment incentive, so vital for the economy in times of peace, is of much less importance now. The bulk of excess profits corporations, moreover, produce under government contracts or sub-contracts which if properly drawn should provide a check against more extreme abuses. Also, there is the alleviating fact that after the war corporations will be permitted to carry back unused excess profits credits and thereby may recover a part of their payments under the excess profits tax.

The corporation income tax is less likely to result in waste and inefficiency. However, corporate tax rates are already high, particularly if allowance is made for the fact that corporate income — unlike the British method — is taxed for a second time under the personal income tax when distributed to the shareholder. Any further increase in corporation taxes should be limited to a 5 (or perhaps 10) point increase in the combined normal and surtax rates.

C. Equity

12. (a) See Question 6.

(b) If possible it would be desirable to allow for such deductions. However, the administrative difficulties involved might be prohibitive. Also, it would seem difficult to permit some deductions without broadening the range of deductions unduly.

13. No, for these reasons:

- (1) Less taxes during the war will result in more inflation. Inflation places a particularly severe burden upon the lower and middle income groups from whom the bulk of the additional revenue must be raised. If prices are permitted to get out of hand, the hardships suffered by these groups would greatly exceed those which additional taxes might impose.
- (2) Tax policies after the war should be adjusted to meet post-war needs and not be tied down in advance by a promised redistribution of the war burden.
- (3) Less taxes (and more borrowing) now and more taxes later (for payment of interest or redemption of debt) will mean a shift of the war burden to the higher income groups only if most of the debt will be held by the lower income groups and most of the additional post-war taxes will be collected from the upper groups. Neither condition is certain to prevail.
- (4) The distribution of the financial war burden can be more equitable if post-war refunds are granted for some tax payments. If income taxes are increased -- and it appears imperative that a substantial increase should be provided for in the forthcoming revenue legislation -- part of the increase may be made refundable, the refundable portion to be the larger the lower the income groups, and not to exceed a fixed dollar limit, say, \$1,000. Provision for the refunding of income taxes will do the same job as would a separate compulsory savings program and do it better.

14. No, it would be undesirable to reintroduce the salary limit in its original form. If a limit is to be set on income, it should cover all types of income, not salaries only. The obvious way to limit total income is to adjust surtax rates to the desired level. This is done in the United Kingdom where the amount of income retained by a married taxpayer is \$16,180 out of a net income of \$100,000, \$23,680 out of a net income of \$400,000 and \$38,680 out of a net income of \$1,000,000. The level of rates applicable to the highest income groups must be set with reference to considerations of equity and public morale. In their direct effect upon total yield or upon the restriction of consumers' demand, the taxes upon the highest incomes are of very little significance. Control of inflation being the primary objective of fiscal policy at this point, the policy with respect to income above, say, \$25,000 should be that which will create the most favorable conditions for an adequate increase in rates applicable to incomes below that level.
15. (a) On the whole the case is against a tax based on the increase in income, mainly for these reasons:
 - (1) The argument that "purchasing power must be cut where the inflationary pressure has developed, that is where incomes have increased" is incorrect. All that is needed is that purchasing power be curtailed where it is received, and where it can be spared best -- which is not necessarily by individuals who have had an increase.
 - (2) The case for a tax on increases in personal income is much weaker on equity grounds than is frequently thought. The equity argument has some substance if we compare two taxpayers who both receive the same current income but only one of whom has been accustomed to that income level for some time. The argument has much less substance, however, if we compare the case of say, a taxpayer who has just been raised from \$1,000 to \$2,000 with another taxpayer who has always received \$10,000. On equity grounds a compulsory savings plan based on increased income would be much less objectionable than a tax plan.
 - (3) Administratively, a levy based on increases in income would be very difficult. A statutory minimum income for the base period would have to be provided, equal to the income tax exemption for that period.

(b) The main aspect of the problem can be taken care of by increasing taxes for everybody, but giving relief to those whose income did not increase or failed to increase by more than a relatively small per cent. This relief should be given as a direct and current credit against the refundable part of the income tax (discussion of refunds, see below Question 13 (4)). The credit might be given as a percentage reduction in the tax, the percentage to be the higher the less the percentage increase in income or the greater the decline. It should be applicable to all income groups but not be allowed to exceed a fixed dollar limit of, say, \$500.

D. Post-war Considerations

16. (a) Whether we borrow \$5 billion or \$10 billion more or less a year will make no drastic difference with respect to the post-war interest burden. For instance, if the war continues until June 30, 1945, and \$10 billion more taxes are raised annually, the debt at that time might be, say, \$250 billion as against \$270 billion otherwise. Total interest payments might then be about \$5 billion as against about \$5.4 billion otherwise.

The same kind of consideration applies with respect to debt redemption. It appears that the post-war debt will be so large that any extensive redemption (that is, of a sizeable proportion of the total debt) for redemption's sake will prove impossible. Rather, the debt should be redeemed if and when such redemption is desirable for general fiscal policy reasons, that is when a deflationary policy is called for.

(b) Yes. It is very important to avoid any unnecessary further expansion in the total money supply. The money supply now is somewhat above \$110 billion; by June 30, 1945, it might be \$170 billion, as against \$74 billion in June 1941. (See Table IV) Such a vast increase in currency and deposits in the hands of the public would far outrun the increase which might be considered normal in view of a rising national income. Its dangers, in particular the interference with effective monetary control in an inflationary period, are evident.

It is important to note that some types of individual savings are held in a highly liquid form and are rapidly convertible into money. This applies particularly to savings bonds held by the public. With respect to the dangers which an excessive money

supply creates, there is only a difference of degree between such bonds and outright cash or deposits. The danger is particularly acute for the immediate post-war period and could be avoided by letting the Government retain control over the timing of redemption payments as would be the case under a plan for refundable taxes or compulsory savings.

(c) Yes. It is extremely important to make it clear that many of the taxes which have to be imposed now — in particular sales taxes and excess profits taxes — are wartime measures only and should be repealed once the transition to a peacetime economy is made. It would be very unfortunate, in particular, if the post-war Federal tax system would be loaded even more heavily in the direction of excise taxes. Just as it is important during the war and in the immediate post-war period to have a fiscal policy which will restrict the purchasing power of the public, it will be important thereafter to have a fiscal policy which will stimulate and expand consumers' and business spending.

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TABLE II

A. Use of Income Payments by Individuals 1/
(Billion Dollars)

	Fiscal Year			Calendar Year
	1942	1943	1944	1944
<u>Income Payments to Individuals</u>	102.8	129.9	152.8	155.7
- Personal Taxes	5.7	9.9	20.6	24.0
<u>Disposable Income</u>	97.1	120.0	132.2	131.7
- Payments to private industry	80.7	85.9	83.5	82.0
<u>Personal Savings</u>	16.4	34.1	48.7	49.7
Savings as per cent of disposable income	16.9	28.4	36.8	37.7

B. Types of Personal Savings 2/

Personal savings	16.4	34.1	48.7	49.7
1. <u>Applied Savings</u>				
Securities	6.2	11.0	(21.3)	
Savings and Loan Associations	.3	.4	(.5)	
Insurance and Pension Reserves	4.1	6.0	(7.5)	
Liquidation of debt	1.1	2.0	(2.0)	
Total	11.7	19.4	(31.3)	
2. <u>Increase in currency and bank deposits held by individuals</u>	4.7	14.7	(17.4)	
Total	16.4	34.1	48.7	49.7

1/ Estimates by Division of Research and Statistics, Treasury, July 31, 1943,
(Strictly Confidential)

2/ For 1942 slightly adjusted S.E.C. estimates of liquid savings are used. The figures for 1943 are estimated on the basis of the first three quarters estimates of the S.E.C. Hence they are fairly rough estimates. The bracketed figures for 1944 are reasonable guesses as to what the level of applied savings and hence the residual amount of increases in balances might be.

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TABLE I Income Payments to Individuals
(Billion Dollars)

	Fiscal Year 1/			Calendar
	1942	1943	1944	Year 2/ 1944
<u>Gross National Product</u>	132.7	171.9	196.2	199.4
- Business Taxes	21.3	25.9	26.3	26.9
- Increase in Business Reserves 3/	4.8	10.9	11.2	11.2
<u>National Income</u>	106.6	135.1	158.7	161.3
+ Transfer Payments	2.5	2.8	3.6	4.0
- Corporate Savings	3.4	4.4	5.0	4.8
- Social Insurance Contributions	2.9	3.6	4.5	4.8
<u>Income Payments to Individuals</u>	102.8	129.9	152.8	155.7

1/ Estimates by Division of Research and Statistics, Treasury, July 31, 1943.
(Strictly Confidential)

2/ Assumes second half of 1944 to exceed first half of 1944 by amounts of increase
from second half of 1943 to first half of 1944.

3/ Includes small adjustment for discrepancies.

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TABLE III

Data on Inventory 1/
(Billion Dollars)

	<u>Dec. 1939</u>	<u>June 1942</u>	<u>Dec. 1942</u>	<u>June 1943</u>
Manufacturers' Total	10.7	17.2	17.7	17.2
1. Durable	5.1	9.0	9.7	9.8
Nondurable	5.6	8.2	8.0	7.4
2. Raw Materials	4.5	7.9	8.3	8.1
In process	1.9	4.3	4.8	4.8
Finished	4.3	5.0	4.6	4.3
Wholesale	3.5	4.6	4.0	3.9
Retail Total	5.1	7.5	6.4	5.7
Department Stores	0.7	1.4	1.0	1.0
Apparel	0.7	1.1	0.9	0.8
Other	3.7	5.0	4.5	3.9

1/ Department of Commerce, Bureau of Foreign and Domestic, Domestic Economic Developments, August 6, 1943.

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TABLE IV Public Debt and Money Supply
(Billion Dollars)

	<u>Public Debt</u> <u>1/</u>	<u>Deposits</u> <u>2/</u>	<u>Currency</u> <u>3/</u>	<u>Total Money Supply</u> <u>4/</u>
June 30, 1941	48.4	65.8	8.2	74.0
June 30, 1943	140	95.0	15.0	110.0
June 30, 1944	205	--	--	130-135
June 30, 1945	260-270	--	--	160-170

1/ Total interest bearing debt, direct and guaranteed. Figures for 1945 based on the President's Statement on the Summation of the 1944 Budget, dated August 1, 1943. For the fiscal year 1945 the same increase in the debt is assumed.

2/ Adjusted demand deposits (including U. S. Government Deposits) plus time deposits, all banks. Figures for 1944 and 1945 are estimates, assuming 30% of the increase in the interest bearing debt to be taken by commercial banks and the Federal Reserve System.

3/ Currency outside banks.

4/ Currency and deposits in the hand of the public.