

Mr. Musgrave

● Rich - The Chairman suggested that I pass this on to you for preparing some acknowledgment

- It's a thoughtful letter certainly.

A handwritten signature, possibly "R. S.", written in dark ink. The signature is stylized with a large, sweeping initial letter and a horizontal line underneath.

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date February 28, 1944

To Mr. Thurston

Subject: _____

From Richard A. Musgrave R.A.M.

Attached is a draft for the Chairman's reply to Mr. Loeb's letter. I thought that the letter was sufficiently interesting and intelligent to warrant a somewhat more detailed reply.

E. F. HUTTON & COMPANY

SIXTY ONE BROADWAY

SAN FRANCISCO

NEW YORK 6, N. Y.

LOS ANGELES

February 11, 1944

Hon. Marriner S. Eccles,
Chairman of Board,
Federal Reserve Board,
Washington, D. C.

Dear Mr. Eccles:

I have been reading with a good deal of interest the address which you made before the tax symposium at the Hotel Pennsylvania, entitled "Curbing Inflation through Taxation."

Only a few days ago I started to write an article on the general subject of current taxation as a great instigator of inflation. Perhaps you can correct my economics. My experience in practical business tends to show that the 90 per cent. EPT rate that has prevailed for corporations and also the very high income rates which have prevailed for partnerships tend to raise prices for commodities as well as for labor. To cite a few examples:

A man came into an office last November and wanted to sell a very large number of envelopes. His price was high. As an argument he offered the thought that, as the firm in question had already completed about eleven months of its year and knew that it was in the excess profits tax bracket, the payment of the premium for those envelopes was 90 per cent. borne by the Government. I think he made the sale.

Let me give you another example. Surely you know that all kinds of capital have been raised from people who never ventured into the field before for the purpose of putting on theatrical shows on Broadway. This capital can be raised only toward the end of the year when people know that the Government will stand most of the loss. The money, of course, is used to bid for labor against war work and bid for materials, etc. in putting the shows on.

We are having a next-to-impossible time here to keep any employees for the simple reason that, despite all the labor regulations, corporations and individuals in the high profits brackets are careless about what they are paying because they say the Government foots most of the bill.

It is very hard, as you probably know, to buy advertising space. The pages of FORTUNE magazine and other publications of this type are full of very expensive full color spreads from a lot of companies that were unheard of a few years ago. No one even knew their names. What is the argument the papers use? The Government pays 90 per cent. of the bill.

February 11, 1944

I believe there is a limit above which, in a practical sort of way, income taxation does not accomplish its purpose. I would place that limit at 50 per cent. I think any corporation or any individual who runs business economically would refrain from paying excessive salaries or refrain from stocking up with materials in good years at any kind of prices and refrain from above-the-ordinary advertising and other luxuries if they had to foot half the bill instead of 10 per cent. of the bill as last year and probably 5 per cent. of the bill this year.

I am not an economist nor am I trained tax man, but my "horseback" opinion is that, if inflation can be controlled through taxation, it is more likely that it lies in a tightening and extension of the renegotiation sections of the act, and probably the application of renegotiation principles to regular tax administrative procedures coupled with a maximum income tax rate of 50 per cent. I believe a 50 per cent. rate maximum would yield more tax revenue to the Government if administrative procedure were strengthened. A sales tax also would have the effect of checking sales and thus checking inflation.

I have followed your various talks for many years and have been very much in agreement with the general underlying principles of attempting to smooth out the peaks and valleys of the cycles' variation in purchasing power monthly. I seriously question, however, whether steep tax rates in themselves do anything but accentuate such peaks and valleys.

Before closing let me cite another example: With very high taxation of security profits, many people refused to sell their stocks in 1937. Undoubtedly the withdrawal of this potential supply of securities allowed prices to go much higher than they would have ordinarily with a more sensible tax structure. Then the 1938 decline in the market was just that much deeper. Now we are more realistic about long-term capital gains anyhow and I think that undoubtedly the 1943 figures will show that the application of a straight 25 per cent. capital gains tax on long-term gains had a dually favorable effect of keeping prices from going unduly high and increasing revenue to the Government.

I would very much appreciate any comment you would care to make regarding these theories concerning the price raising effect of income taxation in excess of 50 per cent.

Sincerely yours,



G. M. Loeb
General Partner

GML/FRH

February 28, 1944.

Mr. G. M. Loeb,
E. F. Hutton and Company,
Sixty One Broadway,
New York 6, N. Y.

Dear Mr. Loeb:

Thank you for your thoughtful and interesting letter. As your illustrations well show, there is much truth in the argument that very high tax rates, such as now apply under the excess profits tax, will encourage wasteful business expenditures. I fully agree with you on this point and doubt the wisdom of increasing the excess profits tax rates further, as provided for under the Revenue Act of 1943. However, I feel that high excess profits rates of say, 80%, are a basic requirement of fairness in wartime taxation, even though they might give rise to some inflation pressure of the type which you mention.

Notwithstanding our high corporate tax rates, corporate profits after tax, for 1943, were twice the 1939 level. Without high excess profits rates, the increase in corporate profits would have been so huge as to make effective wage and price controls almost impossible. The basic difficulty, of course, arises from the fact that the prices obtained on war contracts and on civilian goods have been such as to permit the sharp increase in profits before tax, and I agree with you that a tightening of pricing and renegotiation would have been the more efficient approach. By checking the accumulation of excess profits in the first instance, much fewer corporations would have become subject to the high excess profits rates and some of the problems which you mention might have been avoided.

I also believe that the difficulty might have been met in part by tightening some of the provisions relating to allowable deductions from net income. In particular, I believe that the allowance for advertising deductions should be tightened, but the same principle might also be applied to other expenditures. As you put it, "renegotiation principles should be applied to regular tax administration procedure," although the administrative obstacles in examining all or most items of cost would probably be more than the Bureau of Internal Revenue could handle at a time.

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BOARD OF GOVERNORS

Mr. G. M. Loeb

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I did not wish to give the impression that I favor permanently high tax rates after the war as a means of raising or stabilizing the level of business activity. Rather, I wished to make these points: First, with respect to the transition period after the war, I think that taxes should not be relaxed prematurely. This covers the excess profits tax as well as other taxes, but does not exclude the desirability of lowering the excess profits rate somewhat to reduce the incentive to wasteful business expenditures. Liquid funds, in the hands of individuals and businesses will be so large at the close of the war that it will be most essential to maintain inflation controls intact until industry has been reconverted to a peacetime basis and is able to supply civilian goods in large quantities.

Second, with respect to the period after industry has been readjusted to peacetime production, I believe that a rather high level of taxation will have to be maintained. Tax rates should be sufficient to provide the yield needed to balance the budget at a high level of employment and income. This will permit some reduction in tax rates, but will not permit drastic reductions in all parts of the Federal tax system. Therefore, it will be necessary to apply tax reductions carefully and to reduce those taxes first which are most detrimental to a high level of economic activity. Thus excise taxes, which bear directly upon consumers' expenditures, should be reduced first and business taxes should be adjusted second. Business, I believe, will find the absence of a market for its products a more serious deterrent than even a substantial tax on net income. However, I think that in readjusting our business tax structure, we should eliminate the double taxation of income from equity capital which is now taxable under both the corporation taxes and the individual income tax.

Sincerely yours,

M. S. Eccles,
Chairman.

RAM:vmr