BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

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To Chairman Eccles

Subject: Tax Situation

From Richard A. Musgrave R.A.M.

At Friday's meeting of the Interdepartmental Tax Committee, Mr. Blough reported on the tax situation. Current thinking seems to be that a reconversion tax bill must be passed this fall for political if no other reasons. The consensus seems to be that it should be considered an Interim Bill and that the more general problems of postwar tax reform should be postponed until next spring. Then extensive hearings would be held and the more basic changes would be expected to go into effect on January 1, 1947.

I find myself in agreement with this general view. The question to be considered is what the Interim Bill should contain and how far it should go.

Budget Outlook

The budget outlook under present legislation is given in Table I. The figures are necessarily quite tentative but are based on the most recent confidential information. Receipts are based on the assumption that present tax rates continue.

The table shows that the budget may be expected to come into balance sometime in the early spring of 1947. The deficit will decline rapidly from now until then, the drop being particularly steep during the next two quarters.

Budget Effects of Revenue Changes

The budgetary effects of two possible approaches are shown in Table II. No program has as yet been concretely formulated but the table shows two hypothetical plans which illustrate the kind of measure which is being considered. Plan B would be on the moderate side, Plan A somewhat more drastic. Blough's views would probably tend to fall in between the two, while Colm might favor something like Plan A. Others such as Milton Gilbert from the Commerce Department and Jacob Mosak from the OPA would favor much more drastic cuts, but it is quite unlikely that the Treasury would wish to go much beyond Plan A.

Plan A provides for the repeal of the Excess Profits Tax and the personal normal tax as of January 1946, as well as for a 5 point reduction in the corporation surtax. This plan would reduce tax liabilities for the calendar year 1946 by about $7 billion and

TABLE I

Budget Outlook
(in billion dollars)

	Fiscal Years			Annual Rates, Calendar Years			
	1945	1946	1947	2d half '45	1st half '46	2d half '46	1st half '47
Expenditures							
War	90	50	17	65	35	20	14
Nonwar	10	16	16	15	18	16	16
Total	100	66	33	81	53	36	30
Net Receipts	46	37	31	37	37	32	30
Deficit	54	28	2	44	16	4	--

TABLE II

Possible Revenue Changes for Interim Bill
(in billion dollars; calendar years)

	Reduction of Liabilities 1946	Reduction of Receipts 1946	1947
Plan A			
Repeal Excess Profits Tax	2.9	--	2.9
Reduce corp. surtax 5 points	.8	--	.8
Repeal capital stock tax	.1	--	.1
Repeal personal normal tax	2.2	2.2	2.4
Repeal wartime excises	1.0	.8	1.1
Total	7.0	3.0	7.4
Plan B			
Reduce Excess Profits Tax to 60%	1.0	--	1.0
Reduce corp. surtax 5 points	.6	--	.6
Repeal capital stock tax	.1	--	.1
Consolidate personal normal tax	.8	.8	1.0
Repeal wartime excises	1.0	.8	1.1
Total	4.5	1.6	3.8

TABLE III

Deficit in Annual Rates
(billions of dollars)

Calendar Years	No Change	Plan A	Plan B
2nd half of 1945	44	44	44
1st half of 1946	16	18	17
2nd half of 1946	4	8	6
1st half of 1947	--	7	4

receipts by about $3 billion, the difference being due to the fact that the corporate reductions would affect receipts only in 1947.

Plan B, which is more moderate, includes a reduction in the Excess Profits Tax to 60 per cent and consolidation of the 3 per cent normal tax with the regular personal income tax. 1/ This plan would reduce liabilities for 1946 by $4.5 billion and receipts by $1.6 billion.

If the plans were adopted, the deficit situation would be as shown on Table II. Again, the effects on the deficit would be relatively slight until 1947. The budget under either case would not come into balance until later that year. Note that under either plan much of the reductions would not become effective, in terms of actual receipts, until 1947.

The General Economic Considerations

A brief summary of the economic situation behind tax policies for 1946 may be useful.

The termination of the war and developments since have brought out these known factors in the situation:

(1) It is now evident that cutbacks will be quite rapid. It is estimated that war expenditures on goods and services which in July were at an annual rate of $80 billion will fall to $40 billion in the last quarter of this year, $33 billion in the first quarter of 1946, and $17 billion in the last quarter of that year. They are estimated to decline to about $10 billion by the middle of 1947.

(2) It appears that the physical proceeding of reconversion will proceed more rapidly and materials become available more promptly than anyone had expected. This means, for instance, that the automobile industry should have resumed a prewar scale of operations by the middle of 1946.

(3) Disposable income in the hand of consumers may be expected to decline by about $20 billion from July of this year to spring of next year. This may well result in a drop in demand for nondurables below available supplies.

1/ Personal income tax exemptions now applicable to surtax income would be applied to normal tax income as well. That is, the normal tax would in effect be repealed and all surtax rates would be raised by three points.

The major <u>unknowns</u> in the situation are:

(1) The levels which private capital formation will reach in the latter part of 1946.

(2) The degree of patience which consumers will show in waiting for durables to reach the market, a factor which will depend greatly on price expectations.

(3) The extent to which inventory speculation and speculation in capital assets will develop.

(4) The speed with which price controls will become ineffective.

(5) The rate of demobilization from the armed forces. It is estimated in this connection that the armed forces will be down to four million towards the end of 1946.

Piecing together the parts of the puzzle, the following picture is obtained: As far as the remainder of this year and the earlier part of 1946 are concerned, demand will remain in excess of supplies in most areas, with the exception of some nondurable goods. As far as the middle of 1946 is concerned, and increasingly so towards the end of the year, large scale civilian production will hit its stride and most specific shortages (excepting housing) should disappear. As far as the end of 1946 and the beginning of 1947 are concerned, it is possible that demand in many areas may fall short of supplies.

With respect to tax policy, this means that it is difficult to apply a single prescription for the year 1946 as a whole. For the <u>early part</u> of the year, unemployment will be largely determined by non-demand factors, such as the speed of reconversion and demobilization of the armed forces. A higher level of consumers' demand secured by tax reductions would be helpful in this period only to the extent that it might increase the demand for nondurables. An increased demand for durables or plants and equipment would not help the employment situation but would increase inflationary pressures both by increasing available funds and giving a green light to increased spending and speculation. On the whole, therefore, tax reductions should be kept quite moderate for this period.

As far as the <u>end of the year</u> is concerned, predictions are more difficult. However, the most likely guess at this time is that unemployment will still be large, possibly around the five million mark. Also, it is likely that this unemployment will be due to deficient demand and not any more to reconversion difficulties. Hence, it might be desirable at that time to have lower tax rates which would somewhat retard the disappearance of the deficit, until a further and more drastic increase in private investment expenditures develops in 1947.

In short, the prescription for 1946 should be (1) to go easy with tax reductions; (2) reduce those taxes first which will result in an increased consumers' demand for nondurables; (3) retain those taxes, the reduction of which would result in increased demand for durables, inventory speculation, rise in capital values, and a generally bullish spirit; and (4) to make such changes only as will strengthen and not prejudice the chance for a good long run program, to go into effect in 1947.

Adjustment by Taxes

Excess Profits Tax. In the Treasury discussion, it appeared to be a foregone conclusion that E.P.T. would not remain on the books for 1947. Also, there was a general opinion that it would be most difficult to hold the E.P.T. for 1946; I think that this is unduly pessimistic. Blough, Colm, and others felt that since the E.P.T. would have to go eventually, it might be better to give it up gracefully now and in turn make sure that the regular corporation tax be retained at a high level, pending final reconsideration of the corporation tax structure next year. Thus, they tend to take the position as far as the Interim Bill is concerned that the E.P.T. should be given up but reductions in the 40 per cent rate be opposed.

I doubt whether the politics of this approach are sound, that is, whether giving up the E.P.T. will make it any easier to retain the 40 per cent rate. In some respects, this would be obviously inequitable since it would give all the benefit to the corporations which have excess profits and none to the others. In part, this could be met by reducing corporation tax rates on, say, the first $25 thousand of net income which would give relief to the small firms. While this would be good, it might not be sufficient.

Also, there are good economic reasons for retaining the E.P.T. at a reduced rate of, say, 60 or 65 per cent for the year 1946. Early repeal of the tax, like no other measure, would psychologically act as an invitation to inflation; certainly it would call for greatly increased wage demands. From the point of view of long run pricing policies, margins between gross receipts and net profits should be permitted to narrow down before the E.P.T. is removed. Also, a continued E.P.T. is needed as a check to speculation in short-run inventory profits which are a (if not, the) key factor in a potential inflation. At the same time, continued application of the E.P.T. would hardly dampen long-run investment expenditures. These are based on post-1946 profit prospects and it would be understood (and possibly, legislated) that the tax would be repealed as of January 1, 1947. Finally, the continuation of carryback provisions for one year will provide a helpful cushion to many firms which in turn would tend to oppose immediate repeal.

Conclusion: The E.P.T. should be retained at 60 per cent for 1946. It should be repealed, together with carrybacks for 1947. If desirable, advance legislation for such repeal may be passed now.

Corporation Income Tax. The treatment of the corporation income tax will undoubtedly be the major issue for the 1944 legislation. I think the Treasury is justified in feeling that its strategic position will be better in 1946 if the 40 per cent rate is not reduced too much in the Interim Bill. However, some reduction in the 40 per cent rate will probably be inevitable, certainly if the E.P.T. was repealed, and on equity grounds it will also seem desirable.

Conclusion: The top rate might be reduced from 40 to 35 per cent; rates applicable to the first $25 thousand of net income might be cut by perhaps as much as 50 per cent.

Capital Stock and Declared Value Excess Profits Tax. These taxes are generally recognized as a nuisance. They yield little over $100 million and might as well be repealed in the Interim Bill.

Personal Income Tax. Some reduction in the personal income tax will be inevitable. The 3 per cent normal rate is the obvious starting point. It can either be repealed (revenue loss of $2 billion) or it may be integrated with the personal income tax by applying regular personal income tax exemptions to it (revenue loss of $800 million). In either case, over ten million taxpayers would be dropped from the rolls. From the long run point of view, repeal of the normal tax is obviously desirable, on equity, economic and administrative grounds. In the short run, integration or repeal of the normal tax is also more desirable than any other income tax reduction, because it will release purchasing power to the lowest income groups. This is the group which is most likely to spend the released income on nondurables which will be in more ample supply and least likely to spend it on durables which will be scarce. For the same reason, reductions in surtax rates should be postponed until January 1, 1947. Mr. Stam and, I take it, Congressional circles are advocating a flat 10 or 20 per cent cut in all present income tax liabilities. This would give a much larger share of the benefit to the upper income groups and would be ill advised at this early date.

Conclusion: The normal tax should be integrated with the personal income tax. If pressures for further reduction prove great, the normal tax should be repealed. Surtax rates should be kept unchanged in the Interim Bill and be revised next year.

Excises. Wartime excise rates are scheduled to go off the books six months after termination of hostilities is declared. 1/ This will provide for a yield reduction of about $1 billion, which would still leave about $4.5 billion of excises for the calendar year 1946. Some further reduction in mass consumption excises (such as excises on liquor and tobacco but not on durables) might be desirable, particularly if OPA could see to it that prices would be reduced correspondingly. However,

1/ This declaration is for excise purposes only and distinct from the termination declaration applicable to other measures. Hence, the rates may be expected to go down early in 1946.

it would not seem feasible politically to substitute excise reductions for income tax reductions in the Interim Bill. To introduce some element of flexibility into the 1946 picture, it might be possible to provide for further excise reductions to be held in abeyance and to go into effect in the middle of the year if the general picture permits.

Further Outlook

The program here suggested would correspond with Plan B in Table II. It would seem to be the minimum practicable. It would lower receipts for the first half of 1947 to approximately $26 billion assuming a gross national product of about $168 billion. If it was proposed for the long run program to raise approximately $25 billion out of a full employment gross national product of, say, $190 billion, further reductions, especially of excises, could then be enacted in 1946, together with a more thorough reconsideration of the whole income tax-corporation tax problem.