



Business Trends

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TAXING EXCESS PROFITS

Under an economic system which looks to the profit motive to induce many of the changes and increases in output necessary for the maintenance of a large, well-equipped military force, war wealth is bound to arise. War wealth presents a problem, both moral and economic. Excess profits are a special part of this general problem, and in the twentieth century have been singled out for special tax treatment.

No one will deny that special taxes are dangerous expedients in so far as they check the economic incentive to efficiency. But they may prove very useful expedients if they succeed in reducing the costs of obtaining that efficiency, and in distributing the economic burden of war in a more equitable manner.

Excess profits taxes may be examined first of all from the standpoints of *revenue* and *administration*. The Treasury recently estimated that the World War II tax brought in \$16 billion more than would have come from the regular corporation tax alone. Obviously, an excess profits tax can raise considerable sums of money, particularly under inflationary conditions.

Against this welcome revenue, the administrative difficulties and expense must be considered. Even if the tax is confined to corporations, ex-

amination of applications for relief may be a costly process, both in terms of the wage-bill of the Bureau of Internal Revenue and in the time and frictions involved for businesses. Between 1942 and 1949, a total of 54,000 claims were filed for a reduction of over \$6 billion in the taxes due under the World War II tax. On June 30, 1949, 22,000 claims totaling nearly \$5 billion were still pending. However, if a generous allowance is made for normal profits; if the rate of tax is not too high; and if a minimum credit or a specific exemption is allowed which excludes many small corporations from the tax, the administrative burden of an excess profits tax can be minimized.

The next major problem is to assess the general *economic* effects of an excess profits tax. There is a strong tendency for such a tax, which falls heavily on the margin of effort, to restrict the economic incentive to efficiency and greater production, particularly if it is levied at a high rate. Control over costs is relaxed. Waste and extravagant expenditures are stimulated, with the attitude that such spending is "on the Government".

Tax evasion may take such form as advertising campaigns for products not yet available; and the camouflaging powers of expense accounts

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may prove quite remarkable. If businesses are allowed only a meager margin on Government contracts, which they consider purely temporary, they may be inclined to give preferential treatment to private orders, in the interest of assuring a market in the postwar future. Furthermore, in the absence of a wage freeze, wage increases will be granted more readily as a means of keeping labor forces intact. This is a particularly serious defect because, from the standpoint of inflation, an increase in profits is probably less dangerous than an increase in wages. A higher proportion of a gain in profits is likely to be saved than in the case of a wage increase. Another economic disadvantage lies in the fact that a high excess profits tax makes it difficult for businesses to retain an adequate proportion of their earnings. Yet under the inflationary conditions which usually accompany heavy defense expenditures, an increase in retained earnings is necessary if properties are to be maintained in efficient working condition. Accordingly, a high tax becomes in effect a capital levy.

On the other side of the economic ledger we may list the anti-inflationary potentialities of an excess profits tax. Like other taxes, it reduces disposable income, and so tends to curtail private spending. It may well restrain business expansion, at least until a successful end of the war is in sight. In addition, if the base period selected for the computation of normal profits is generous enough to allow some expansion of profits before liability is incurred, and if the tax is not levied at a confiscatory rate, the damage to economic incentive may not be too serious.

The third question which must be asked of an excess profits tax concerns its *equitability*. The principle to be followed in this respect is to determine as precisely as possible that the profits taxed have arisen from the war emergency, and not from other causes.

It is necessary, therefore, to select a peacetime period on which to base a computation of normal prewar profits. It is then assumed that profits in excess of this amount are war profits, on which the special tax can justifiably be levied. Accordingly, the base period used to determine

normal profits should be as close as possible to the war, and should include an adequate number of years of general prosperity. Nevertheless, the tax will discriminate against new and growing firms, and against firms whose profits fluctuate widely and were not in line with the profit level of business in general during the base period. Some allowance for this can be made by permitting firms to calculate their normal profits on the basis of a percentage of their invested capital. This percentage standard, however, should not be so high that it provides exemption for heavily capitalized industries with a normally low rate of return. Further assistance can be provided for firms whose expansion is necessary for the armament program, by allowing credit for new capital.

Companies with heavy borrowing, whose rate of return on equity capital is frequently subject to wide fluctuations, will obtain relief if they are permitted to include part of their fixed debt in their invested capital, or if credit is allowed for part of their fixed interests costs. And administrative flexibility should facilitate the fair treatment of cases of special hardship.

There remains the question of possible alternatives to an excess profits tax. Only one of these is pertinent to this discussion, namely, an increase in the flat rate corporation tax. In considering this, it must be borne in mind that the relative shifts in corporate profits under rearmament are more important than absolute gains in wealth, from the standpoint of equity. A boost in the flat rate corporate tax tends to accentuate the uneven effects of the defense program, and does not attempt to strike at war profits alone. Furthermore, if an already high corporation tax rate were raised still further, it would become prone to similar economic disadvantages as an excess profits tax.

It appears, therefore, that there is no *a priori* case for or against excess profits taxes in general. Any specific tax must be considered on its own merits. Valuation of the various factors discussed here must rest largely on the attendant circumstances, and will vary greatly according to the severity or ease of the existing tax structure, and the overall financing policy of the government.

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