TREASURY DEPARTMENT
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FEDERAL TAXATION IN THE POSTWAR PERIOD

It is an honor and a pleasure to be here in Buffalo today to speak to you on problems of postwar taxation. Taxation, like the weather, has perennial interest if only as a convenient excuse for the good old American custom of casual grumbling. But today the interest in taxation is greatly intensified, and so it should be. Public interest in public matters ought always to be commensurate with the importance of the problem. Surely few will deny that the adjustment of the wartime tax system to the transition and postwar periods is a national problem of the very first magnitude.

Wartime taxes and postwar planning

Not so long ago, we were confronted with another and less inviting tax problem--the expansion of the tax system to meet the vast needs of war. Some people forget at times that our present tax system is a far cry from the one in effect before the war. The gigantic increase in Federal tax revenues from $5,400,000,000 in the fiscal year 1940 to $44,100,000,000 in the fiscal year 1944 reflects, along with a rising national income, the great changes that were made in converting a prewar into a wartime tax system. Those changes were made not in one fell swoop, but in stages to which the expanding war economy could adjust without endangering its stability and productivity. Our wartime taxes are doing much more than financing a large proportion--currently almost half-- of the cost of the war. They are helping to distribute that cost equitably. They are reducing inflationary pressures growing out of a war economy operating under forced draft. They are capturing excessive war profits. They are supporting the price and wage stabilization program. They continue today, as they have been, an essential part of the war program.

We are still very much at war and must therefore continue to live with war taxes. But at the same time, we must plan our postwar taxes or run the risk of being caught unprepared for the eventual return to peace. With the cutbacks and shifts of production incident to the end of hostilities in Europe, the first impact of transition is already upon us. We are faced with the immediate question of what, if anything, should be done taxwise in the interim period between VE-Day and the final end of the war. Facing us in the future but not requiring immediate action are the basic problems of postwar taxation: what long-run changes in tax structure are desirable? How much can taxes be reduced? How should the reductions be distributed? In what order should changes be made? How soon should they begin? How rapidly should they proceed?

Even while focussing on war finance, the Treasury and the Congress have continuously kept the problems of postwar taxation in their field of vision. Although the wartime tax system will not serve and was never intended to serve as a postwar tax system, many of its provisions have a postwar orientation. Thus, to permit costs and losses which are properly chargeable against wartime income to be deducted from such income even though they are not incurred until after the end of the war, the Revenue Act of 1942 provided for a carryback of unused excess-profits credits and a carryback of business losses. Furthermore, that act set up a postwar credit or refund of 10 percent of the excess-profits tax, to be evidenced by noninterest-bearing bonds payable at certain designated times soon after the end of the war.

The postwar problems of the individual also loomed large in the minds of the Treasury and the Congress, especially in the 1943 legislation providing for withholding and current payment of income taxes. These measures removed the specter of overhanging tax liabilities which would otherwise plague millions of individuals when incomes shrink because of cutbacks to peacetime production.

<u>Congressional and Treasury tax studies</u>

Moreover, postwar tax studies have long been under way by both Congressional and Treasury tax staffs. Although a good deal of spade work had gone before, a resolution by the Congressional Joint Committee on Internal Revenue Taxation on June 15, 1944, marked the beginning of formal work on tax adjustments for the transition and postwar periods. The Committee, adding a member from the minority party in each House to achieve equal representation for both parties, constituted itself the Joint Committee on Internal Revenue Taxation for Postwar Taxation. Its resolution called on the Joint Committee staff and the Treasury tax staff to work as a unit on the study of postwar tax problems and to report their results and suggestions to the Committee.

The resolution of the Joint Committee was followed to the letter. The tax staffs of the Committee and the Treasury undertook a series of joint studies relating to various aspects of the transition and postwar tax problem. Representatives of business, labor, agriculture, and other groups, many of whom had undertaken their own postwar tax studies, were invited to Washington to present their views. Out of the many off-the-record conferences with these groups grew a body of information and suggestions that has proved extremely valuable in our postwar tax work. Together with the continuing studies of the Joint Committee and Treasury tax staffs, it has served as the background for a number of confidential reports submitted to the Joint Committee in meetings throughout this past winter.

The program for the interim period

The first formal results of this work are reflected in the report of the Joint Committee made public a week ago, recommending certain tax changes for the interim period between the end of the European war and the end of the war with Japan. These recommendations, while not calling for any reduction in tax rates, will materially improve the cash position of business in the reconversion period.

It has come as a surprise to some observers that, after several years of substantial war profits, there should be official concern over the cash position of business in the period just ahead. It is true that business, taken as a whole, appears to have enough cash and working capital to finance reconversion and to carry on into peacetime production. There are firms, however, many of them small businesses, which are not in this fortunate position. Some of them, because of the termination of war contracts and the extraordinary expenses and adjustments involved in reconverting to peacetime production, will experience financial difficulties and at least temporary shortages of cash and working capital. The program which the Joint Committee has outlined in its first report is designed primarily to aid reconversion by easing the financial problems of these firms.

The recommendations involve a five-point program. First, the specific exemption for the excess-profits tax, which was raised from $5,000 to $10,000 in 1943, would be raised to $25,000 for 1946 and subsequent years. This would relieve 12,000 small corporations from the burden of the excess-profits tax, leaving only 19,000 larger corporations still subject to this tax. Small corporations have found the excess-profits tax to be particularly burdensome, and the Committee felt it advisable to lift this burden during the critical reconversion years and thereby to give small business every opportunity to reestablish itself. Of the several recommendations made for the interim period, this relief to small corporations is the only one involving any ultimate revenue loss. Even here, the net loss will be only about $160,000,000 annually, or less than 2 percent of total Federal corporate taxes.

The other four recommendations for the interim period are designed to speed up the payment of certain tax refunds and credits to which businesses are entitled under existing tax laws. They would make available more promptly cash which would in any event ultimately have to be paid out by the Government.

Two recommendations deal with the postwar credit under the excess-profits tax. You will recall that 10 percent of the excess-profits tax is in the form of a postwar credit to be returned to the taxpayer from two to six years after hostilities cease, the length of time depending upon the year for which bonds evidencing this credit were issued. The bonds issued for 1942 are estimated to run to $480,000,000 and those for 1943 to $820,000,000, a total of about $1,300,000,000 for the two years. The Committee proposes that the maturity date of these bonds be advanced to January 1, 1946, and that cash payments would be substituted for bonds which had been certified but not yet issued with respect to these two years. It is estimated that postwar credit bonds applicable to 1944 liabilities will total about $830,000,000, and to 1945 liabilities, about $710,000,000. Under the Committee program, these postwar credits would be taken currently in the form of reduced tax payments. The effect would be to lower the gross excess-profits tax rate of 95 percent to a net rate of 85½ percent after postwar credit.

The fourth recommendation would accelerate the refunds resulting from carrybacks of net operating losses and unused excess-profits credit. Normally, these refunds would be payable over an indefinite period from 1947 to 1950. But this may not be soon enough. After the cut-back of war production, many corporations face falling incomes or extraordinary expenditures, or both. Their incomes may shrink below the level of normal profits or even turn into losses. At the same time, many corporations in these circumstances may have tax liabilities for the preceding year hanging over them. In extreme cases, their financial solvency might be imperiled, while others would hesitate to go forward boldly with their plans for reconversion. Under the Committee program, taxpayers anticipating carryback refunds arising out of current year operations would be permitted to postpone payment of a corresponding amount of their taxes currently due on prior year income. Thus the benefit of the carrybacks would accrue to them almost immediately. Refunds with respect to the years 1943, 1944 and 1945 would be made available during 1946 and 1947. In addition to granting this privilege of deferring payment of taxes currently due, the Committee program provides for speedier settlement and payment of refund claims filed by taxpayers at the close of the taxable year. It has been estimated that the refunds resulting from losses and unused credits for 1945 and 1946 will amount to perhaps $1,000,000,000.

The fifth and final recommendation of the Committee is to speed up the refunds which result from recomputing amortization on war facilities. Under present tax law, emergency facilities certified as necessary for national defense may be amortized over a 5-year period. But if the emergency ends before such a facility has been fully amortized, the taxpayer may elect to have the amortization deductions recomputed on the basis of the shorter amortization period. Shortening the period gives rise to tax refunds. In the normal course of audit and administration, such refunds would be spread over many months, with a little being paid in 1946 and the bulk being paid during the years 1947 to 1950. Adoption of the Committee proposal would speed up these refunds arising from recomputed amortization to such an extent that an estimated $1,700,000,000 of overpayments of tax for the years 1941 to 1945, inclusive, would be repaid in 1945 and 1946.

As stated, this interim program for the period between VE-Day and VJ-Day will not for the most part reduce ultimate tax liabilities. But it will materially strengthen the cash and working capital position of businesses by speedier return of moneys due them under wartime tax laws. The Committee felt that to defer such settlements might jeopardize chances of sustaining a high level of business activity and employment during the difficult transition years just ahead.

The program would seem to be noncontroversial. It is to be hoped that the Congress will find it practicable to enact it speedily. If this is done, I believe that businessmen will go ahead with their production schedules and plans for the future, reassured that their special problems will receive every consideration consistent with the country's needs.

It has been pointed out that the recommendations of the Joint Committee do not encompass any reduction in tax rates. Moreover, the Administration has taken the position that taxes should not be lowered until the end of the war with Japan. There are strong grounds for this position. The Joint Committee, in explaining why they do not recommend that existing tax rates be reduced at the present time, make the following statement in their report:

"1. Federal expenditures can be expected to remain at a high level after victory in Europe, and thus the need for revenue will not be greatly lessened. With the war continuing on one front, it has been estimated that the Federal Government will spend for war alone at the annual rate of about $70,000,000,000.

"2. It appears unlikely that there will be any serious general unemployment during the period of the Pacific war. This period can be expected to be one of reasonably full employment, since the pent-up demand for goods and services is expected to offset the anticipated cut-back in war production. Such unemployment as may exist will largely be caused by unavoidable delays in the reconversion of plants to peacetime production. It is likely to be limited to a few areas in which large cut-backs in war production will be made. General tax reductions could do little to help these isolated areas.

"3. Inflation will continue to be a danger during the period of the Pacific war. Tax reductions at this time might be an important factor in starting a runaway inflation, since they might increase the demand for civilian goods and services which is already in excess of limited production. Furthermore, tax reductions at this time might weaken other anti-inflationary controls.

"4. The armed forces are still called upon to endure personal and economic hardships."

We are still engaged in a bitter and costly war with Japan. Federal expenditures are continuing at levels never thought possible before the war. A large sector of our economy is still devoted to production for war instead of turning out the goods and services normally consumed in peace. As long as these conditions prevail, I believe it is generally accepted that no program of tax reduction could be undertaken without risking serious inflation and endangering morale on both the home front and the war front.

Basic problems of postwar taxation

On the principle of first things first, I have thus far been discussing the interim period, its tax problems, and the proposals for solving them. But these proposals are recognized by all concerned as only the opening chapter of postwar taxation. The basic problems of tax revision and tax reduction for the postwar period still remain. You will note that I bracket the problem of revision of the tax structure with the problem of tax reduction. I am sure you have also noted that all of the postwar tax plans thus far advanced by private groups,

e. g., the Twin Cities Plan, the Ruml-Sonne Plan, the Committee for Economic Development Plan, and the CIO Plan, have coupled structural changes in the tax system with downward revision of tax rates. Tax reduction serves as an effective lubricant for tax readjustment. The goal towards which people both inside and outside the Government are working is thus not only lower taxes, but better taxes.

Let me hasten to add that although the direction of tax rates will clearly be downward, how far down they will go is not yet apparent. However, any realistic appraisal of the Federal Government's postwar revenue requirements makes it clear that reductions will be far less than many people have allowed themselves to believe. Estimates of these requirements almost universally run three and four times as high as our prewar Federal tax yield. If we are to avoid a large and chronic Federal deficit, we will have to retain a strong and productive tax system after the war. Taxes can and will be reduced, but the reductions will have to be selective and will have to be made with an eye to maintaining a high level of business activity and employment. The limited scope of possible tax reductions makes it all the more important that every reduction be carefully geared into a tax program designed to strengthen the postwar economy.

Questions of the level and shape of taxes to come are receiving the full attention of the Treasury and the Joint Committee tax staffs. The level of postwar taxes will, of course, depend on the volume of Government expenditures and on changing economic conditions. With the final revenue goal unknown, study and planning as to tax levels must proceed in terms of alternatives -- alternative rate schedules, exemptions, and the like -- to meet the various situations which may develop. On the other hand, past experience in taxation provides a number of guide posts as to the structure of future taxes. Hence, advance planning as to the kinds of taxes suited to our postwar needs can more readily go forward in concrete terms. You may be interested in an account of some of the problems the tax staffs are studying and some of the considerations they are taking into account in their search for solutions.

From our many conferences and extensive correspondence with taxpayers, certain impressions emerge as to which problems are uppermost in the minds of the taxpaying public. Probably the major concern of businessmen is whether -- and when -- the excess-profits tax will be repealed. Businessmen have generally expressed the belief that they could not live with this tax as a continuing postwar measure. In this connection, one may observe that the tax was adopted solely as a tax on excessive war profits and that there is no evidence of any intention to continue it after war profits disappear.

The so-called double taxation of corporation dividends is another major concern of taxpayers who are looking at the shape of the postwar tax structure. As you know, it is claimed that the imposition of one tax on the corporate income and another tax on the dividends received by the stockholder results in unfair double taxation. This assumes, of course, that the stockholder bears the final burden of the corporation income tax as well as of the tax on the dividends. To the extent that this assumption is correct, double taxation is a real problem. But to the extent that the corporation tax is shifted away from the stockholders in the form of higher prices to consumers or lower wages to employees, double taxation is more apparent than real. This question of who, in the last analysis, bears the burden of the corporation income tax cannot be ignored in grappling with the double taxation problem.

Numerous alternative methods of treating corporate income have been suggested. Some would virtually abolish the present corporation taxes. Others propose tax credits under the individual income tax with respect to dividends received. Still others would subtract from the corporation's taxable income the amount of dividend payments made to stockholders. These different approaches reflect more than merely the personal idiosyncrasies of their proponents. They flow from sharp differences of opinion regarding three basic questions, namely, (1) whether or not it is proper and desirable to tax income to corporations at all, (2) who bears the final burden of the corporate tax, and (3) how difficult it would be to administer and comply with the various proposed solutions.

If corporations could always be counted on to distribute all of their income, the same final tax result could be achieved by any one of several methods. It would be immaterial, for example, whether we simply abolished the corporation tax, or converted it into a withholding tax, or allowed dividends, like interest, to be deducted in computing corporate taxable income. But in fact, corporations do not, and cannot be expected to pay out all of their earnings. The setting aside of reserves for contingencies has long been a recognized procedure, and the reinvestment of earnings serves as the principal methof of financing the growth of new, expanding enterprises. Any attempt to eliminate double taxation thus raises the vexing problem of what tax treatment should be applied to retained earnings.

Another major tax problem is that of devising a scheme of taxing small business which will help preserve a growing, competitive economy. The objective of smoothing the tax road for small businesses is widely accepted, but there is no general agreement on a precise method of achieving this end.

An aspect of business taxation which is not concerned with tax rates but has fully as great an impact on business incentives is that of averaging income for tax purposes. The adverse effect of taxes on the willingness to incur risks can be materially reduced by allowing businesses to offset their net losses in one year against their net profits in other years. A 5- or 6-year carry-forward of net losses has many proponents. Reduction of the risks of business by more liberal loss offsets may be a more effective means of stimulating business investment than a decrease in the rate of tax on profits. Moreover, especially at high rates of taxation, businesses with widely fluctuating incomes must be given the protection of loss carry-forwards or carry-backs, or both, if taxes intended as levies on income are not to eat into capital.

With these complex questions in view, it is almost with a sense of relief that one turns to the capital stock tax and declared-value excess-profits tax. For here is one tax, or perhaps I should call it a dual tax, on which a concensus can truly be said to exist. All are agreed that this tax should be repealed, and only the question of timing remains.

I have talked principally of business taxes, both because they raise the issues which concern this audience most immediately and because they constitute such a crucial part of the postwar tax program. But it goes without saying that they are by no means the whole problem. The rates and exemptions of the individual income tax and the composition and rates of our excise taxes, for example, play an equally important role in the postwar tax picture. They affect the entire population and have a direct impact on consumer purchasing power and markets. To strike the proper balance between the various types of taxes requires that each be appraised, not in a vacuum, but as an integral part of an overall tax system.

Underlying considerations in tax planning

In approaching the task of reducing and adjusting taxes for the postwar period, certain broad considerations appropriately control most of the basic decisions. These considerations are well-known, but they bear repetition in the present context.

We have already noted that postwar tax levels will need to be high to meet the revenue needs of Government. The primary concern in postwar tax planning is to raise the necessary revenues with the minimum restrictive effect on production and employment. High levels of business investment and consumer spending are required to ensure a healthy, full-employment economy. This consideration calls for appraising the impact of each tax or tax change upon business incentive on one hand and consumer purchasing power on the other.

Although the economic effects of taxation are of first importance, the demands of equity and fairness must at the same time be satisfied. Accordingly, the revenues needed to finance Government should be raised according to the long-established principle of ability to pay. This principle underlies Federal tax policy of the pre-war and wartime years and remains the standard for the future.

Ease of administration and compliance is also a vital consideration in devising postwar taxes. Simple and uniform laws are the best bulwark against expensive administration and costly and irritating compliance burdens. Much progress has been made in the direction of simplification, but much remains to be done. In attempting simplification, however, one is forcibly reminded that the demands of equity in the tax system set a limit beyond which simplification cannot go. Thus, one criterion of a well-designed tax system may clash with another, and the tax designer is charged with the task of reconciling the two.

Stability in the postwar tax system is another widely desired end. But it is important to distinguish between stability in structure and stability in rates. The tax system should be responsive to changes in economic conditions. Taxation is an instrument designed to serve organized society. If it is to be of maximum service, it must be adapted to the changing economic and social needs of that society.

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