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TAXATION AND MONETARY POLICY WITH SPECIAL REFERENCE TO A TAX ON UNDISTRIBUTED CORPORATE EARNINGS

A. Broad Statement of the Problem of Monetary Control.

In broad terms economic stability in an advancing economy depends upon a steadily increasing flow of goods and services and a steadily increasing flow of purchasing power from industry and public bodies. The flow of purchasing power should not only increase but should increase at a steady rate more or less corresponding with increasing productive capacity. All the factors which various writers stress as causes of the business cycle will show themselves eventually, if they are true causes, in an interruption or an acceleration of the flow of purchasing power.

In an advancing economy a larger amount, and possibly an increased proportion, of disbursements are made on durable and producers' goods, and a larger amount of income is derived from the making of durable and producers' goods. For various reasons the amplitude of the swings in the production of durable consumers' goods, such as houses, and producers' goods of all kinds, are very much wider than the swings in the production of less durable consumers' goods. In fact, the business cycle is largely a durable and producers' goods cycle. This is why highly industrialized countries may have worse depressions than less advanced countries, and why the severity of depressions may increase in the course of time.

The statement of the problem of securing more stable conditions may therefore be narrowed somewhat without losing anything essential. If the amount spent on durable producers' goods increases steadily and slightly more rapidly than the current savings of the community there will be increased income available to take off the steadily increasing flow of consumers' goods.

B. Possibilities and Limitations of Monetary Control.

Insofar as the Reserve Administration can create or extinguish purchasing power it can influence the supply of funds available for borrowers and hence influence interest rates and the availability of loans. To the extent that these factors influence the amount of money borrowed and spent on durable consumers' and producers' goods the Reserve Administration may influence the current and prospective volume of business disbursements and hence of incomes.

The possibilities of success in this direction rest in part on the existence of fairly stable conditions and the widespread expectation of their continuance. Only under these conditions will changes in the availability and the price of loans be effective in checking or stimulating a significant volume of construction and plant expenditures. This applies particularly to a downswing when after a certain time, falling interest rates appear to have little effect in stimulating expenditures. Possibilities of success also depend upon the human factor — upon proper forecasting, proper timing and proper magnitude of action. It is apparent that both the material and human conditions necessary for effective monetary control are difficult of attainment.

C. The Necessity of Coordinating Fiscal and Monetary Policies.

If conditions are such that changing the price and the availability of loans is ineffective in bringing about just the requisite increase in disbursements and incomes, recourse must be had to fiscal policy. Fiscal policy has two aspects— raising money and spending it. If private expenditures fall off the effect on income may be offset by increasing public expenditures without increasing taxes, or by maintaining public expenditures and reducing taxes which decrease buying power and imposing taxes that do not decrease buying power. If private expenditures increase at an excessive rate, this may be offset by decreasing public expenditures or by imposing taxes that decrease buying power. Since variations in public expenditure and taxes affect the total volume of disbursements and incomes, it is obvious that fiscal policy must be coordinated with monetary policy if relatively stable conditions are to be secured and maintained.

D. Present Phase of the Recovery Movement.

The annual national income has expanded by around $20 billion since 1932-1933. Various investigations which cannot be entered upon here point to the importance of the fiscal policy of the Government, in conjunction with excess reserves, in bringing about the degree of recovery experienced to date. The country as a whole has been receiving more from the Government than it has paid in taxes. In addition a portion at least of the corporate and personal income tax revenues did not decrease spending correspondingly but rather, in the conditions prevailing since 1933, represented a utilization of what would otherwise have been idle balances.

There are now indications that business expenditures on plant and private expenditures on houses are increasing. A considerable expansion in the public debt has occurred, and the volume of deposits subject to check and outside currency has been built up to a figure in excess of 1929. In these circumstances the question naturally arises whether the Federal Government's contribution to the recovery movement can now be dispensed with. Data that would permit a precise answer to this question is lacking. There are, however, various considerations which suggest that the volume of expenditures on durable and producers' goods is not yet of sufficient magnitude to carry the load of recovery alone. There are various indications that the volume of current private saving is substantial, and it is known that business and home builders are currently borrowing only a small portion of these savings. There are also indications that many businesses are not disbursing the full proceeds of their sales in payments to wage earners, raw material producers, bond holders, and stock holders. Unspent savings, whether by business or individuals, constitute a drag on the recovery movement.

E. Proper Fiscal Policy now from the Monetary Point of View.

What is the proper fiscal policy in these circumstances? On the one hand various considerations suggest that the Government's contribution to the growth in the national income cannot as yet be safely lessened. On the other hand, other considerations point to the desirability of working toward a balanced budget. A satisfactory solution would appear to be the raising of additional revenue in such a way as not to decrease private spending.

While doubtless it is difficult to raise additional revenue in such a way as not to cause any decrease in private spending, it is obvious that different types of taxes differ widely in this particular. Increased taxes on the poor, for example, would almost certainly decrease private spending to a corresponding degree. Taxes on incomes, both business and private, that would otherwise be saved would, however, decrease business and individual spending very little. This is for the reason that in the present circumstances business is not disbursing all the proceeds of its sales, and is not borrowing and respending the savings of financial institutions and wealthy individuals. It would appear desirable, therefore, from the monetary point of view, to raise additional revenue at the present time from taxes on income that would otherwise be saved.

F. A Tax on Undistributed Earnings.

It has been recognized for a long period that a very substantial part of the savings of the community take the form of undistributed corporate earnings. By leaving earnings undistributed with corporations, wealthy stockholders are able to avoid the payment of high surtax rates, and save a large portion of their income. From 1923 to 1929 we find nearly $25 billion of undistributed earnings accumulated by corporations reporting net income, exclusive of financial corporations. It is apparent, therefore, that because of tax-exempt securities and the practice of retaining corporate earnings, high surtax rates are largely ineffective in taxing the income of the wealthy who contribute the bulk of the savings of the community. Various consequences flow from this fact. In the first place, savings which are not used constitute a drag on the recovery movement. In the second place, they represent funds that are available for use in the future and may be used at a time when expenditures are becoming excessive. The use of hitherto idle deposits is just as "inflationary" as the creation and use of new deposits.

In order, therefore, to raise additional revenue without dampening the recovery movement and also to guard against excessive expansion in the future, it is desirable to place a heavy tax on the undistributed earnings of corporations.

G. The Treasury Proposals Adopted by the House.

The bill passed by the House, which incorporated the Treasury's proposals, called for a repeal of all existing Federal taxes on corporations and the imposition of graduated rates according to the size of corporations and the proportion of earnings retained. A special rate of 22½ percent applied to earnings retained because of legal prohibitions or to retire certain types of debt. The exemption of dividends from the normal 4 percent personal income tax was repealed.

These proposals were open to several objections. The repeal of the existing corporate income tax would increase the per share earnings available for common stockholders and would constitute in effect a windfall gain for present holders of stocks. In the course of the Hearings it was brought out that many corporations and their stockholders would have their income increased without having to pay more taxes. Moreover, the repeal of the existing corporation tax forced the imposition of a tax on the undistributed earnings of the hundreds of thousands of small corporations, whose earnings amount only to a small portion of the total, to prevent their stockholders escaping all taxation. This not only complicated the tax but it would make its administration very difficult. Moreover, even with a lower graduated rate than was applicable to large corporations it was still unfair to small corporations who have not the access to the capital markets available to large corporations.

Another objection to the House bill is that it would have imposed a tax of 22½ percent on the earnings devoted to debt retirement, whereas other corporations in a position to pay out all earnings would not have had to pay anything. Finally, the rates proposed in the House bill were too low. From 1925 to 1929 non-financial corporations reporting net income paid out 57 percent of their earnings in dividends. Under the House schedules the tax on corporations that pay out 57 percent of adjusted net income in dividends would amount only to 14¾ percent of adjusted net income.

H. The Senate Committee's Proposals.

The majority of the Senate Committee proposed to retain the capital stock and excess profit taxes and to raise the corporate income tax from a range of 12½, -- 15 percent to 15½ -- 18 percent; to impose a flat tax of 7 percent on undistributed earnings after various exemptions; to repeal the exemption of dividends from the 4 percent normal income tax; and to raise the surtax rates applicable to brackets from $6,000 to $50,000 by one percent.

From the monetary point of view two objections may be taken to these proposals. In the first place they provide for a higher percentage increase in the taxation of small corporations than of large, and for people of moderate means than for the wealthy. Apart from the social injustice of such a course it means that more of the additional revenue would have otherwise been spent than would be the case if the taxes had borne more heavily on the wealthy.

In the second place a rate of 7 percent on undistributed earnings would be totally ineffective in forcing out any more dividends. Since it was proposed to repeal the exemption of dividends from the 4 percent normal income tax, the additional incentive to pay out dividends as contrasted with existing law would be only 5 percent. When this rate is compared with surtax rates ranging up to 75 percent, it is obvious that it would be completely ineffective.

I. Chairman Eccles' Proposals.

Chairman Eccles proposed to retain the present corporate income tax rates of 12½ to 15 percent; to repeal the capital stock and excess profits taxes, and the exemption of dividends from the normal tax; to exempt retained earnings of $15,000 from the undistributed earnings tax; to tax earnings withheld because of legal prohibitions or used for the retirement of debt outstanding on March 3, 1936, at a 10 percent rate; and to tax the remaining undistributed earnings at high rates ranging up to 60 percent. All three proposals excepted banks and insurance companies from the undistributed earnings tax, although Chairman Eccles would limit this exemption to banks whose capital and surplus is less than 15 percent of deposits.

In essence Chairman Eccles proposed to confine the tax, after making provision for reasonable needs, to a few thousand big corporations. In 1933 only 14,815 corporation returns out of 446,842 returns for active corporations reported net earnings of $15,000 and over, and this small group of returns accounted for over 90 percent of corporate net income for that year. It is desirable to exempt small corporations since they already pay a high tax relative to individuals and partnerships, they have no access to the capital markets, and their inclusion would enormously complicate the administration of the tax.

A rate of 10 percent on earnings withheld to retire debt would not be unduly onerous for those corporations who could not raise money for this purpose in other ways, while it is sufficiently high to encourage recourse to other means of debt retirement if they are available.

The high rates on undistributed earnings are designed to be prohibitive rather than productive of revenue directly. The revenue would come from the surtax payments on the increased dividends of wealthy stockholders.

It is felt that these proposals would make for a simple and understandable tax, would be productive of revenue, would check the various social and economic abuses associated with the practice of retaining earnings, and would ensure that business income would be passed along either in debt repayments, taxes or dividends, and the current interruption in the monetary circulation arising from withheld earnings be thereby lessened.

J. Answers to Objections to a Tax on Undistributed Earnings.

In the course of the discussion of the various proposals, three main lines of criticism were developed. The first was that the proposal discriminated against small corporations with no access to the capital markets. There was force in this criticism when applied to the original Treasury proposals. It can easily be met, however, by exempting earnings of $15,000 from the tax. This would not only exempt all small corporations but it would permit corporations earning from $15,000 to $29,000 to retain more than 50 percent of their earnings without penalty.

The second type of criticism was that corporations had to retain earnings both for purposes of expansion and to provide for periods of depression and losses, and that they would be unable to do this if they had to pay out all earnings. The answer to this is simple. Insofar as corporations really need money for expansion or working capital purposes they may borrow, or, if they are adverse to this, they may issue rights to subscribe to new stock in good times. It is precisely at those times when corporations can retain the most earnings that conditions are most favorable for new stock issues.

This answer was not met by any of the critics of the proposed tax. George May, who gave the best reasoned testimony against the tax, could only say with reference to this point that it seemed unrealistic and academic. The United States Steel Corporation can hardly be accused of being unrealistic and academic and yet it issued new stock to pay off its bonds. Other instances could be cited indefinitely. If investors have not sufficient confidence in a corporation to take up rights and subscribe to new stock, the management should not have the power to force them to invest further in the corporation by retaining earnings.

Actually, corporations have little need of depression reserves. Losses must be very heavy before they need result in a reduction in cash, since a substantial part of costs need not represent actual out-of-pocket disbursements but, rather, bookkeeping items. These include depreciation and depletion allowances, bad debts, loss on sale of capital assets, inventory losses, and plant writedowns. From 1929 to 1933 all non-financial corporations, despite a reduction of $15 billion in the surplus account, actually increased their combined holdings of cash and investments by $3.8 billion. The explanation is that a substantial part of the costs that were not covered were bookkeeping costs that did not call for out-of-pocket disbursements. What corporations need are conservative ratios between their quick assets and current liabilities and between their net worth and their indebtedness. They can obtain such ratios as well by issuing new stock as by retaining earnings.

The third line of criticism was that the practice of retaining earnings operates to moderate cyclical swings and that to force out all earnings would intensify the swings in business activity. In answering this criticism it is convenient to consider different phases of business activity separately.

It is said that in the downswing corporations that were previously able to retain a large portion of earnings are in a position to maintain dividends and other disbursements, and this operates to maintain the purchasing power of the community. Fortunately, information is available with which to test the validity of this contention. From 1923 to 1929 non-financial corporationsrreporting net income retained $25 billion of earnings. From 1930 to 1933 the payment of unearned dividends by corporations reporting deficits amounted to only $3.8 billion. Moreover, during the same period non-financial corporations reporting net income withheld earnings amounting to $1 billion. This retention of earnings operated to counteract the increased buying power arising from the payment of unearned dividends. The net figure, therefore, was $2.7 billion. In 1930 the net figure was only $420 million and in 1933 retained earnings actually exceeded the payment of unearned dividends. When the figure of $2.7 billion is compared with the sum of the declines in the national income from the 1929 level for the years 1930-1933, - $120 billion - it will be seen that the sustaining effects due to the payment of unearned dividends were of an exceedingly minor character. It has already been noted that the decline in the surplus account did not arise from disbursements to the factors of production but from uncovered charge-offs and depreciation allowances.

The period of upswing may be divided into a period of recovery, which is desirable, and a period of boom, which is undesirable.

In a period of recovery such as we have been experiencing in recent years the retention of earnings by corporations operates as a restrictive factor. The bulk of the increase in deposits in recent years appears to have gone into business accounts and is explainable on the grounds that business has been disbursing less to the factors of production than it has been receiving in the sale of products to consumers. (See Report on the Large Deposit Study, pages 35-37). Had corporations disbursed all their earnings, buying power would have been increased, tax revenues would have been greater, and the Government would have had to borrow less. It may be said, therefore, that the practice of retaining earnings makes recovery more difficult and forces the Government to carry more of the load.

A boom is characterized not by excessive consumer purchases but by excessive plant investment. Expenditures on producers' goods increase much more rapidly than the current savings of the community. It seems obvious that the utilization by corporations of cash accumulated both out of previous and current retained earnings is an important contributory factor in excessive investment in producers' goods. How the paying out of earnings would moderate a boom is discussed in the next section.

K. A Tax on Undistributed Earnings Would Make for Greater Stability In the Future.

1. One of the factors many writers stress as a cause of a downturn in business is specific maladjustment. If certain industries are unduly expanded a sudden cessation of growth may be important enough to cause a net decline in business disbursements. Our present tax system, which offers an inducement to retain earnings to avoid taxes, tends to make for over-expansion in various lines. If earnings were paid out and expansion was financed through new stock issues closer calculations of probable costs and returns would result. This would lead to a better allocation of the community's savings.

2. Many writers have stressed the fact that one of the reasons the past depression was so severe is that our system is losing much of its flexibility. Monopolies and agreements between a few big corporations in an industry often result in increased price inflexibility. While it is true that many factors have contributed to the growth of monopoly, and large-scale units, it cannot be doubted that this process has been encouraged by our tax system. Both the interests of wealthy stockholders and of managements are served by the retention of earnings for the purpose of expansion either directly or by buying up smaller competing concerns.

3. An important factor contributing to instability is speculation. While corporations are no longer permitted to make loans to brokers, the retention of earnings encourages security speculation in another way. If expansion of plant is financed through retained earnings, earnings per share will be increased and the price of stocks will rise in reflection of this. If, however, expansion is financed through new stock issues, the price of individual shares will be kept down. The profitability of the investment for an individual stockholder will not differ in the two cases, but there is an important psychological difference between a stock doubling or tripling in price and one whose price remains relatively stable because of frequent new issues. Moreover, earnings retained beyond the needs of a business may be used to buy publicly listed securities, real estate, or other companies outright, thus contributing to a general bidding up of values.

4. In the previous section it was argued that a boom was characterized by excessive investment in producers' goods and that retained earnings, both current and previously accumulated, facilitate such over-investment. If the earnings were distributed in dividends a portion of them would be spent, and less money would be available for investment and interest rates would be higher. This would operate as a check on over-investment.

5. In order to evade the payment of personal income taxes a corporation's owners may let cash accumulate far beyond the current needs of the business, and far beyond the amount that

would be carried if new stock issues had to be resorted to. This not only interrupts the monetary circulation but in addition it causes difficulty in our banking system on the downswing. It is believed that a major part of the difficulties of banks in smaller cities in 1930-1933 rose from a shift of large corporate balances into metropolitan banks.

6. If corporate earnings were distributed as earned there would be more assurance of maintaining a period of widely diffused prosperity with relatively full employment. One of the difficulties in maintaining such a period lies in finding outlets for a rapidly-increasing volume of savings on the part of corporations and wealthy individuals, and hence in maintaining an increasing monetary circulation and the demand for consumer goods. It would appear that the distribution of corporate earnings would retard the increase in savings and would increase the buying power of the masses in different ways. In the first place, a portion of the increased dividends that would result would be spent by the dividend receivers rather than saved. Secondly, if Federal revenues were derived more largely from taxes on the incomes of the wealthy this would permit a lowering of taxes on the poor and in this way increase

the demand for consumer goods. Insofar as the Government retired its debt through taxes on the wealthy this would not increase the volume of savings in the community to any extent, since the funds put into the hands of holders of Government securities would be offset by the reduction of funds in the hands of individuals who save less because of tax payments. If, however, the Government retires its debt through taxes on the poor, this increases the savings of the community. The funds put into the hands of holders of Government securities would be available for investment; the taxpayers' demand for consumers' goods would be decreased below what it would otherwise be.

It is clear that the timing, character, and magnitude of Government revenues and expenditures exercise a profound influence on general business conditions. It follows, therefore, that if the Reserve Administration is going to assume any responsibility for securing more stable business conditions, it must be vitally interested in and concerned with the Government's fiscal policies.

In the present instance it is desirable, in the light of the long-term objective of monetary policy, to increase

Federal revenues without decreasing the community's expenditures. It is also desirable to check, so far as possible, the rapid accumulation of business balances which may become a source of danger in the future. Both these aims will be served by a prohibitive tax on the undistributed earnings of big corporations. In general, it would appear that a reform of our tax system in the direction of forcing the distribution of current corporate earnings and raising a larger portion of Federal revenues from taxes on the wealthy, would make conditions more favorable for the successful exercise of monetary control.

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