

BOARD OF GOVERNORS  
OF THE  
FEDERAL RESERVE SYSTEM

# Office Correspondence

Date February 11, 1949

To Gov. Eccles

Subject: \_\_\_\_\_

From Mr. T. L. Smith

I have asked Mr. Merton Miller, the principal economist in this section working on problems of tax policy, to comment on the memorandum you received regarding undistributed profits tax.

To save time I am forwarding his comments although my own will be delayed until Monday.

Attachment



COMMENTS ON MEMORANDUM REGARDING THE UNDISTRIBUTED PROFITS TAX

The memorandum, as I read it, makes three major points: (1) that the problem of the undistributed profits tax is difficult and complicated; (2) that while we shall have to face up to the problem in connection with long-run tax reform, it is better to have no undistributed profits tax for the time being; and (3) that a start should be made toward the consideration of the longer-run tax policy problem. With these general conclusions I am in agreement, but I have some reservations about the content of the memorandum itself.

1. The memorandum tends to overstate the equity case in favor of the undistributed profits in general, but particularly insofar as the specific proposal under consideration is concerned. The praise bestowed upon the undistributed profits tax as a method of integrating corporate and personal income taxes has little relevance to a scheme which calls for the imposition of a penalty tax on undistributed profits on top of a substantial "unintegrated" basic corporate tax. The case for the undistributed profits tax on equity grounds has always rested on its being a substitute for all or part of the basic corporate income tax which at a top rate of 38 per cent puts a disproportionate burden on distributed income.

As far as the general approach itself is concerned, the memorandum does indicate some of the serious difficulties involved such as the problem of small business, the problem of the reorganization of the capital markets, and so on, but generally as qualifications and with far less emphasis than they merit. A particularly serious example of this is the inadequate reference to the capital gains tax which in many respects is really the major villain of the piece.

2. The most serious weakness, however, is the completely inadequate consideration given to the purely economic aspects of the tax program under consideration. It seems to be taken for granted that the undistributed profits tax (and/or the excess profits tax) would be achieving some useful purpose at the present time.

The fact is, that as long as the money supply is not under control, an undistributed profits tax is the least promising approach to stabilization during a serious inflation. Owing to the insistent investment demands in a boom period, imposition of an undistributed profits tax means little reduction in investment expenditures, but a larger proportion of investment financed directly or indirectly with bank credit. Under an open-end monetary situation the best approach is to levy taxes on those who can't borrow or draw down idle balances, which would seem to imply excises and other taxes on the lower income group and not taxes on those with the highest credit ratings. 1/ On the

1/ It may be, of course, that taxes on the lower income groups under such conditions would merely lead to demands for wage increases (i.e., the corporations would be forced to borrow), but if this happens then it will merely prove that no fiscal policy can stop the inflationary process as long as the money supply is completely elastic.

other hand, given control over the money supply and debt policies which are directed to mopping up excess liquidity, it would not matter very much for stabilization purposes where the taxes were placed. The decision could be made on other grounds, such as equity.

Whether the undistributed profits tax is more helpful in a depression (where demands for it usually have arisen) is still a debatable question. It might increase the level of consumption somewhat relative to alternative tax sources (assuming always that there are significant undistributed profits at all) <sup>2/</sup> but its quantitative effect is not likely to be very large. It is many times more important in terms of reflationary effect to have the correct level of Government deficit (financed by borrowing from the banks) than to strive for a tax system which maximizes the burden on saving.

As far as the excess-profits tax is concerned, there would hardly be room in a brief memorandum to deal with the case against this tax, which is the "first choice" of the memorandum. Perhaps it will be sufficient to consider the case made out for an excess-profits tax by the Economic Council, a case which the memorandum cites approvingly. The case as there presented rests on three factors: (1) that the tax will rapidly reduce its demands on taxpayers in the event of a recession, (2) that the tax will not have the effect of raising prices, and (3) that it would discourage wage increases.

As far as point three is concerned, it should be pointed out that the excess-profits tax because of its high marginal rate has normally been considered by economists as tending to encourage wage increases. As to the effect of an excess profits tax on prices, the only study which has been made of the question of the incidence of an excess profits tax will not support any such simple conclusions.<sup>1/</sup> That leaves only such comfort as can be obtained from knowing that an excess profits tax has the advantage of repealing itself in a depression (except for such industries and firms not so severely affected at first by the slump and around which the revival might be built); whereas other taxes are normally repealed (frequently retroactively) by act of Congress.

Furthermore, the positive case for a straight across-the-board increase in corporation income taxes as summarized by the Council in the same section consists entirely of the negative case against the excess profits tax. The fundamental issue of why the tax should be on corporations in the first place is never really faced at all.

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<sup>1/</sup> Gillim, The Incidence of Excess Profits Taxation, Columbia Univ., 1945

<sup>2/</sup> During the 30's, the "undistributed profits" of all corporations were negative (i.e., total dividends exceeded total net earnings) in every year until 1939. The undistributed profits tax was in effect only in 1936 and 1937.

T. L. Smith  
February 14, 1949

COMMENTS ON MEMORANDUM CONCERNING AN UNDISTRIBUTED PROFITS TAX

The memorandum favors immediate enactment of an excess profits tax. It seems to me that enactment of higher taxes will be undesirable for the time being until it becomes clear that there is not to be a recession lasting for possibly a year or more. Without attempting to forecast, a serious recession appears as likely as further inflation during the next year. Higher taxes could be decisive at a possible turning point in the business cycle, such as the present, when expenditure decisions hang in the balance. We no longer have as large a carry-over of unsatisfied demands, savings are increasing while investment is decreasing, and it is uncertain whether much of the accumulated liquid assets would be spent if prices fall and incomes decline. The budget is approximately balanced through the fiscal year 1950 so that it adds little either to deflationary or inflationary pressures.

The long-run prospect is inflationary, assuming a secular increase in Government expenditures, so that higher taxes are likely to be needed even though the present moment may not be propitious. Some recession now, but not a depression, might be desirable. It will be extremely difficult, if not impossible, to continue a stair-step inflation--short periods of stability in which readjustments are made, followed by further inflation--without an eventually disastrous inflation. It almost surely will be impossible to walk the tightrope of full employment for a long time with no cyclical swings, but the swings can be moderated.

The memorandum assumes without stating the case that higher corporate taxes are required. In general, the amount of taxation and the Treasury surplus are far more important in absorbing excess demand than the kind of taxation. However, the kind of taxation if in large enough amount has an important influence upon the allocation of resources. If in an inflation resources are insufficient to expand the production of both capital and consumer goods, I believe a case can be made for higher corporate taxes.

Under such circumstances, the choice in the short run is between curtailing expenditures for capital and other durable goods by taxation of corporate profits and the incomes of individuals in the higher brackets of income, or curtailing consumer expenditures by taxation falling principally upon individuals in the lower brackets. The choice is not between consumption now and consumption later since capital as well as consumer expenditures will be reduced in the long run if there is under-utilization of resources. The choice should be such as to minimize the swings in the cycle and keep the average utilization of resources high.

During an inflation at or near full employment, I believe that stability is more likely to be promoted by erring, if at all, on the side of curbing investment. This appears to be a value judgment which cannot easily be proved or disproved. I believe that proper allocation of resources through the price mechanism partially breaks down during inflation when profits even

of the inefficient are in excess of the amount needed to attract investment. I believe that exorbitant profits are an important cause of an excessive rise in investment and furnish an excuse for labor to ask for higher wages. The instability that arises from over-production of capital and durable goods relative to the effective demand may be particularly dangerous because expenditures for such goods are postponable.

A policy of damping investment is likely to cause a recession sooner than would otherwise be necessary in the hope of preventing a worse recession. Fiscal policy is a clumsy instrument at best for influencing the direction of output. We cannot forecast the business cycle accurately. It takes time to change the level and character of Government expenditures and receipts. The increase in corporate taxation would have to be large, except at turning points, and cannot be made sufficiently selective. Shifts to the production of consumer goods would be hampered by immobility of the factors of production and by lack of assurance of adequate demand to absorb increased output of consumer goods. Reduced production and income would result during the shift so that a program of Government expenditures to utilize temporarily idle resources and also to bolster consumer demand should be ready if the decline becomes serious. Even so, business anticipations would be adversely affected and it may be hard to stop the decline.

The memorandum states a preference for an excess profits tax, with which I am in agreement. This form of corporate taxation is probably the most effective in discouraging investment, particularly risky investment, which is probably the least desirable use of resources when the limit of resources has been reached. An excess profits tax is self-repealing in a recession when under-utilization of resources makes encouragement of investment desirable. If set at a flat rate which is nearly confiscatory, it induces wasteful expenditures and needless wage increases by eliminating the incentive to hold down marginal costs. To overcome this objection without reducing the over-all size of the tax increase, the rates could be graduated and applied to a larger portion of profits.

At one point, the memorandum suggests that criticism of double taxation of dividends and profits on the ground of equity is overdone. I think that this is true. The share price paid by individuals reflects anticipated dividends received and capital appreciation, and I see no basis in equity for treating dividends and capital gains differently from other personal income. Other forms of savings are no longer discriminated against by a low tax rate on corporate profits. Special tax rates on capital gains and tax credits for dividends received and dividends paid shift the burden of needed tax receipts to other taxpayers and forms of income, with no apparent gain in equity.

The memorandum gives qualified approval of an undistributed profits tax but reluctantly concludes that we should be content with a moderate profits tax for immediate delivery. It feels that improvement in the capital market structure is a prerequisite to undistributed profits taxation and that the whole corporate tax structure should first be made adaptable to all business conditions.

These two arguments are not in themselves sufficient grounds to postpone an undistributed profits tax, although an excess profits tax may be superior in the current inflation. A structure of corporate taxation to fit all business conditions probably cannot be devised. Thus, an undistributed profits tax is most useful during periods of underemployment of resources. An excess profits tax appears to give the greatest built-in flexibility.

Imperfections in the capital market are an obstacle to investment when corporations need funds for expansion during periods of under-utilization of resources. They make it particularly difficult for small and less well-established corporations to obtain equity funds. The channeling of savings of lower-bracket individuals into institutions, primarily life insurance companies, and the preference of wealthy individuals for tax-exempt bonds, Treasury bonds, and only the highest-grade corporate obligations are impediments. Also, the deductibility of interest for tax purposes makes it advantageous for business to seek loan rather than equity funds.

However, if corporations hold earnings idle in the form of excessive cash or investments in Government securities to avoid taxation on distributed profits or simply to maintain unreasonable liquidity, imperfections in the capital market are not a sufficient objection to an undistributed profits tax. On the other hand, in periods of excess demand, retention of earnings to avoid taxes is probably not a serious problem for two reasons. Corporations have use for their funds, and the tax rate on dividends has been much reduced by the new income tax provision providing for the splitting of incomes. The average tax<sup>rate</sup>/on dividends is probably less than on profits and would be considerably less if profits taxes were increased.

Federal excise tax collections, fiscal year 1949  
(In millions of dollars)

Liquor		2,211
Tobacco		1,322
Stamp		73
<b>Manufacturers'</b>		
Related to automobiles	504	
Gasoline	504	
Passenger automobiles and motorcycles	333	
Tires and tubes	151	
Auto trucks and busses	137	
Parts and accessories	120	
Lubricating oil	82	
Total related to automobiles		1,327
Electrical energy		1,349
Electric, gas, and oil appliances	81	
Electric light bulbs and tubes	26	
Radio sets, phonographs, etc.	49	
Phonograph records and musical instruments	16	
Mechanical refrigerators, air conditioners, etc.	78	
Business and store machines	33	
Photographic apparatus	43	
Sporting goods	20	
Firearms, shells, pistols, etc.	11	
Matches	8	
Total, manufacturers		1,772
<b>Retailers</b>		
Furs	62	
Jewelry	211	
Luggage	83	
Toilet preparations	94	
Total, retailers		449
<b>Miscellaneous</b>		
Admissions to theaters, concerts, etc.	388	
Admissions to cabarets, roof gardens, etc.	49	
Transportation of property	337	
Transportation of persons	252	
Telephone, telegraph, radio, etc.	311	
Local telephone service	225	
Sugar tax	76	
Other	116	
Total miscellaneous		1,753
Total excise tax collections		7,580