

April 4, 1938

RE LETTER OF MR. W. T. NARDIN

I. Simply as a general comment, the problem concerning the undistributed profits tax does not seem to be one of conflict between theory and practice. It appears more realistic to ask whether the theory is good or bad. If its theory is good, the undistributed profits tax will turn out, at least in the long run, to be the practical program to follow.

II. With regard to the more specific point, namely, the inclination of corporations to create debt, and the deflationary attitude of both borrowers and lenders as a result of the tax, the situation is by no means clear.

The year 1936 should be remembered. Under the impact of a high volume of consumer purchases, there was an expansion of new issues, bank loans, and capital investment at a pace quite as high as could be long sustained. Indeed, a good many of our capital-producing industries had reached their practical maximum capacity in spite of the tax. It is thus hardly reasonable to lay any considerable part of the deflationary development since that time on the tax when, despite the tax, investment and expansion had previously been going ahead at a rate that now appears to have been almost too rapid. Such an argument regarding the effect of the tax must be most carefully clarified in order to bring out the many additional factors in the situation. We are now aware, for instance, that huge inventories--to mention a single factor--had been piled up.

Actually, of course, the cost of the tax has been greatly exaggerated. Corporations can retain a substantial portion of their earnings before they get up to a total tax (including the corporation normal and the undistributed profits tax) equal, for instance, to the single flat-rate tax that British corporations pay. There is no evidence that the British tax crushed business.

Of course, it can be granted that any tax upon profits reduces a corporation's ability to support or add to its debt structure. That may be especially true with those corporations that, because of size or financial condition, are unable to make use of the capital markets. It may also be true when the capital market is unable to absorb issues. However, many points should be noted with regard to all this.

In the first place, it would be easily possible to exempt smaller corporations that do not have access to the capital markets. In the second place, it would be possible in behalf of all corporations to exempt earnings retained, in excess of depreciation, for the purpose of adding to equipment and capacity. It would be possible, on some scale, to exempt earnings used for the repayment of debts created for the same purposes: assessing simply a small rate of, say, 4 percent against funds so used. When these steps were taken, however, it would seem that practically all legitimate charges that the undistributed profits tax especially obstructs capital investment would be removed. After all, the ability of a company to create a debt is largely dependent upon its past, present, and prospective ratio of earnings to

investment, including borrowed and proprietorship capital. If its profit ratio is unsatisfactory, it will have little inclination and certainly little ability to create a substantial new indebtedness. If its profit ratio is satisfactory, it is difficult to see quite how a tax of the magnitude even of the present undistributed profits tax could prevent debt creation. For illustration, under the present tax a corporation can retain 40 percent of its earnings for a little over 13 percent. In short, as these figures work out, a corporation could liquidate a fixed indebtedness three and one-half times its annual earnings in about ten years at a cost of 13 percent; and, after liquidating its indebtedness, would have the capital available in perpetuity or for such a length of time as it desired. That refers to the present tax. If we permitted the repayment of debt created for physical expansion, not even that much cost would apply.

III. It is to be remembered in connection with bank deposits that the banking system does not lend deposits. As a general statement of the situation, it should be said that the banking system creates deposits for the purpose of lending; but only the owner of a deposit can put it in circulation. The simplest method of analyzing this is to assume that the entire banking system of the country consists of one bank, of which all individuals and businesses are customers. In that case, a corporation that builds up its deposit account does so by receiving deposits from those who purchase its goods or services. Thus, while the corporation's deposit account is building up, the deposit

accounts of its customers are being drawn down; and there is no change in the total deposits of the bank. If the corporation receiving deposits, then, does not utilize the deposits it receives, there is an impairment in the flow of money, and that impairment in the flow of money is deflationary in effect. The bank cannot possibly lend the unutilized deposits. In that way, a hoarding of deposits is deflationary, and a deflation will follow unless there are offsetting factors. For instance, if the bank has excess reserves, it can make loans, thereby creating additional deposits in the hands of those who will actually use them. Such additional deposits might offset the deflationary effect of deposit hoarding by others, but it would not change the fact that the hoarding of deposits is, of itself, deflationary.

IV. In general, it may be observed that the undistributed profits tax, like any other tax falling on funds that would otherwise be saved, alters in the long run the ratio of saving to consumption expenditure in the economy. The advisability of such a procedure, of course, is one that can be debated extensively. However, one point seems to be true: that is, an economy in which investment expenditure depends upon the decision of the individual is likely to be a more fluctuant economy if the proportion of saved income is higher than if the proportion of saved income is lower. The reason is that, when the proportion of saved income is higher, a decision of savers to hold funds rather than to invest them, means a greater immediate contraction of the national monetary income than a like decision of savers when the proportion of saved income is lower.

With regard to savings, it is also appropriate to quote from Income and Economic Progress by Harold G. Moulton of the Brookings Institution:

"As to income distribution and its results, we found in the second division of our study the proceeds of the nation's productive efforts going in disproportionate and increasing measure to a small percentage of the population--in 1929 as much as 23 per cent of the national income to 1 per cent of the people. We found the unsatisfied wants--needs according to any good social standard--of the 92 per cent of all families who are now below the level of \$5,000 annual income sufficient to absorb the product of all our unused capacity under present conditions of productivity and still demand much more from such unexplored potentialities as might thereafter be opened up. We found the incomes of the rich going in large proportion to savings and these savings strongly augmented by others impounded at the source by corporations through the practice of accumulating corporate surplus. These savings, after providing for such increase of capital goods as could be profitably employed, we found spilling over into less fruitful or positively harmful uses, ranging from foreign loans (bad as well as good) to the artificial bidding up of prices of domestic properties, notably corporate securities.

"Thus, we began to discern the answer to our question whether the basic defect in our economic system, not discovered in the technical processes of production, is to be found in the way in which we conduct the distribution of income. The answer is affirmative: this is the place at which we do find basic maladjustment.

"The magnitude of the disorder and its significance in terms of national well-being is, however, not fully measured by the amount of the loss in income at any given moment of time. We found from our measurements of productive capacity that we were able to operate in good times at about four-fifths capacity and on the average over such a period as that from 1922 to 1933 at only about two-thirds capacity. But this is only a part of the story. The answer thus far is in relatively static terms, whereas we should think in dynamic terms of a society marching forward at as brisk a tempo as the progress of its knowledge and invention

makes attainable. In a society in which consumptive demand lags behind productive capacity we have not only unutilized capacity but also a retardation of the rate of new capital development."

V. Finally, it is not to be overlooked that the application of the undistributed profits tax does not in general, as most persons have assumed, create a new tax pressure but offsets a very great tax pressure that existed prior to the enactment of the undistributed profits tax. Some aspects of the foregoing point may be set forth briefly.

The development of income taxation in the United States has chiefly involved the levy of a flat-rate tax on the income of corporations and a progressive tax on the received income of individuals. The accrued income of individuals, however, in contrast to their received income, has not been taxable if the accrual took the form of undistributed, corporate earnings. This situation has meant, then, that the constituent, individual owners of corporate retained income, have found their income from corporate sources subject to one or two income-tax deductions, the result being dependent upon corporate policy with respect to the retention or distribution of corporate earnings. If such earnings are distributed to their owners, they are reduced by the amount of the corporate net income tax and the individual net income tax; if such earnings are not distributed to their owners, they are reduced by the amount of the corporate income tax only.

The foregoing unequal application of the revenue laws necessarily produces unequal effects. In the first place, there is created a kind

of tax-exemption subsidy for investment expenditure in contrast to consumption expenditure. In the second place, so far as investment itself is concerned, the subsidy is not proportionate for all income groups; it inures in the main to the advantage of the upper income brackets to whom the greatest percentage of dividends is typically paid and for whom, of course, retained earnings chiefly accrue.

Indeed, quite aside from the consideration of all income groups, the progressive rate schedule of the individual income tax means that the subsidy to corporate reinvestment is individually disproportionate even among corporate investors themselves. In the third place, for persons whose individual tax rates would exceed the corporate flat rate, the subsidy constitutes, moreover, a premium on the corporate form of business organization as against the individual proprietorship or partnership, in which undistributed income is treated as if distributed. A corollary effect in this connection is that, in the fourth place, surtaxes on individual income are made partially inoperative, which means that certain taxpayers are favored by the exemption of their saved income at the cost of other taxpayers (including corporate investors whose individual tax rate would be lower than the corporate flat rate) who must in the long run be penalized by the necessity of paying levies greater than would be required of them if the revenue laws were evenly applicable.

It has been clear to students of taxation for more than a decade that these grossly unequal and unfair aspects of the tax system need

to be corrected. The final result was that Congress adopted the undistributed profits tax. With regard to that tax, no one would contend that it was perfectly drafted or perfect in effect. In fact, it may even be true that some other form of tax would eventually prove necessary to correct the unequal treatment of saved income; but the proper procedure would appear to be to derive a workable and equitable tax by amendment and change, not a junking of the whole measure. That is especially true at a time when the surtax rates on received, individual incomes are at their highest point in history; and to believe that these differentials will not vitally affect corporate policy with respect to the declaration of dividends, causing them to retain huge amounts purely and simply because of the tax advantages we grant to such retention--to believe that is to credit the incredible.