

Office Correspondence

FEDERAL RESERVE
BOARD

Date July 23, 1955.

To Governor Eccles

Subject: The proposed graduated

From Lauchlin Currie

corporation tax.

L.C.

••• 16-852

Attached is a memorandum which you requested last week,
criticizing the proposed graduated corporation tax and proposing
a tax on the undistributed earnings of corporations.

THE PROPOSED GRADUATED CORPORATION TAX

The recent tax proposals of the Administration include a recommendation that the principle of graduation or progression be applied to the corporation tax. It is proposed in this memorandum to discuss briefly the arguments for and against the adoption of this principle and to offer an alternative suggestion.

Arguments for the Proposal. The theory underlying a graduated corporation tax is that of taxing according to ability to pay and according to benefits received. It is claimed that the larger the corporation, the better able is it to pay and the more protection and advantages it receives. Mere size gives the corporation an advantage over a smaller concern, particularly in times of depression. Just as incomes and states are subject to different tax rates according to size, so also should be the incomes of corporations. Moreover, the larger the corporation, the more it engages in interstate commerce and the less subject it is to state taxation and regulation. The differences in competitive power arising from differences in the size of corporations should be compensated for by differences in tax rates or net incomes. On general social grounds "bigness" should be discouraged. Size begets monopoly and concentrates vast economic power in a few hands. It is believed that both on social and economic grounds it is desirable to discourage "bigness" and to encourage the perpetuation and growth of small concerns.

Arguments against the Proposal. Although the arguments for progressive corporation tax appear plausible, they will not stand up under analysis. Let us first consider the ability to pay argument. The weakness here lies in the assumed identity of the income or property of a wealthy individual and the income of a large corporation. The income of a wealthy individual is available for use by him. The income of a large corporation, however, represents the income of very many people, some wealthy, some well-to-do, and some comparatively poor. A small corporation, on the other hand, may be owned by wealthy individuals. To tax the income accruing to the wealthy at a low rate and the income of the lower middle-class at a higher rate is obviously the reverse of taxing according to ability to pay. In order to tax according to real ability to pay, recourse should be had to the income tax and to the estate tax.

The argument that a large corporation has special advantages which justify a higher tax rate is likewise weak. Insofar as the advantages are those arising from the economies of large-scale production they offer no justification for special taxation. In fact, if a tax prevented utilization of such economies, it would result in an impoverishment of the whole community. There would be justification for higher taxation of profits arising from monopoly and unfair trade practices, but the tax proposal under consideration makes no attempt to discriminate between profits arising from efficiency, from monopoly, or from the mere magnitude of the capital assets of the corporation. The fact, of course, that profits are large absolutely is no indication of the profitability of money invested in the concern.

A net income of twenty million dollars may represent a return of one percent on capital, or a return of fifty percent.

It is sometimes said that a large corporation engaged mainly in interstate commerce is protected to a considerable extent from the tax and regulatory powers of the States. There does not appear to be much substance in this contention. A state may tax the real property of a corporation doing business within its borders, and also that portion of income which is derived from operations within the state. Out-of-state corporations must also conform to the state industrial, health and labor laws. It is quite true that corporations in some states are subject to less taxation and regulation than corporations in other states. But this is due to differences in state laws and not to differences in size of corporations.

The social and economic benefits to a country arising from a large number of smaller corporations is a matter of some dispute. Many writers maintain that, on the whole, large corporations are better employers, and are easier to deal with and regulate, than small corporations.

Alternative Suggestion. In place of the graduated corporation tax it is proposed that the present tax be applied solely to net income which is undistributed in the form of dividends. The theory underlying this proposal is as follows:

Taxations should as far as possible be levied on individuals according to ability to pay. The income of corporations is really the income of the owners of the corporations, or in other words the

stockholders. Hence, to tax the income of corporations by the corporation tax, and the dividends paid its stockholders by the surtax, means taxing incomes twice with little reference to ability to pay. This may be avoided by exempting from the corporation tax the income of corporations paid out in dividends. The income which is not paid out in dividends likewise belongs to the owners of the corporations. Theoretically, it should be included in the total income reported by individuals, and taxed accordingly. This, however, is difficult administratively. It is proposed, therefore, that a flat rate of taxation, say twenty percent, be levied on undistributed earnings of corporations. This, admittedly, would be more than most, and less than a few, stockholders pay on their received incomes. It is expected, however, that this form of inequality will be minimized by the incentive for corporations to pay out a larger proportion of their income in the form of dividends. Some wealthy individuals who control corporations now pay only $13\frac{3}{4}$ percent on the large part of their income which is left with the corporations. Under the proposed changes the rate on undistributed earnings could be comparatively high. In this way the tax burden would be distributed more equitably. Three companies controlled by Mellon, -- Gulf Oil, American Aluminum, and the Union Trust Company, -- retained \$117 million of their earnings of \$146 million in the years 1927-29, or 80 percent. The bulk of Ford's income in the past has probably been subject only to the comparatively low corporation tax.

Not only would the adoption of this proposal work toward greater justice in taxation, but it would also afford other advantages. In the first place, it should lead to a better allocation of the community's capital resources. Although legally the corporation belongs to its stockholders who are represented by elected directors, actually the management and people in control may be motivated by considerations other than those of serving the best interests of the owners. Salaried executives, for example, may be more interested in increasing the absolute gross and net return than in increasing the rate of return on invested capital. It is very easy for them to do this by holding back a substantial portion of the earnings every year and by reinvesting them in plant facilities. There would be a much closer calculation of probable costs and returns on any new investment if the management had always to borrow or to ask the stockholders directly for new money. Similarly, the separation of ownership and control facilitates the building up of large liquid resources, particularly in the form of cash. The imposition of a fairly high tax on undistributed earnings would discourage uneconomic "bigness" resulting from the excessive ease of reinvesting earnings and would also discourage the accumulation of large idle balances and of large surplus accounts. From 1926 to 1929 thirty-six of the largest industrial corporations held back \$2.2 billion of their earnings. This amounted to 42 percent of the earnings available for the common stockholders. The undistributed earnings of all corporations from 1924 to 1929 amounted to nearly

\$13 billion. This was 25 percent of the earnings available for preferred and common stockholders.

It is often urged that the practice of distributing only a portion of earnings permits steadiness in the dividend rate, which is considered desirable. There are, however, objections to a steady rate of return on equities. Experienced investors realize, of course, that the current and prospective earnings are the important things in appraising the worth of a stock. Inexperienced investors, however, may be misled into giving too much weight to the dividend rather than the earnings. If dividends were varied frequently in accordance with variations in earnings, the importance of the trend of earnings would be more generally appreciated. This, incidentally, is the usual practice in England.

If corporations regularly disbursed their earnings in the form of dividends, one source of disturbance to general business conditions would be lessened. It is probable that the flow of money would be more regular and there would be fewer obstructions to that flow due to the lessened variability in cash balances that might be expected to follow the penalizing of undistributed earnings. Corporations could, it is true, still build up large cash holdings by borrowing, by the issue of stock, and by not using depreciation reserves for repairs and new equipment, but they would be more reluctant to acquire balances in such ways than by holding back earnings.

At the present time the removal of taxes on distributed earnings and the imposition of a tax on undistributed earnings would

aid in the process of recovery, since it would probably lead to the declaration of higher dividends and thus discourage the piling up of large idle corporation balances that has been taking place since 1933. The net effect would be a desirable increase in spending.

Since the restriction of the corporation tax to undistributed earnings would be in the nature of an unexpected windfall to present stockholders, it is suggested that not only should dividends cease to be exempt from the normal tax but that the surtax be higher than originally contemplated.

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