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BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

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To Chairman Eccles

Subject: Fiscal Program

From Lauchlin Currie
L.C.

I am afraid that this is longer than I had anticipated. I felt, however, that you should have as many aspects of the matter as possible brought to your attention before you approached the Treasury. In particular I hope you will consider carefully the question of exempting debt retirements from the tax. It would be very helpful if you could find time to run over this and either mark the sections or make comments that will serve as a guide for the preparation of the short memorandum.

MEMORANDUM ON FISCAL POLICY

I - Bearing of Fiscal Program on Business Recovery.

The Board of Governors has a peculiar interest in and responsibility for general business conditions. Since the fiscal policy of the Government has such a direct and important bearing on general business conditions the Board of Governors has, perforce, a keen interest in the fiscal policy. During the past three years the Federal Government, by disbursing more in the form of income to people than it has collected from incomes in the form of taxes, has been increasing the national money income and has been the chief factor in bringing about the degree of recovery achieved to date. In the fiscal year 1933 we estimate the Government's net contribution to the national income at $2 billion; in fiscal 1934 at $2.5 billion; and fiscal 1935 at $3.3 billion. With the loss of processing taxes and the payment and partial spending of the bonus the contribution for fiscal 1936 will be the largest yet. These figures are minima. They do not include any secondary expenditures arising from Government expenditures, and all taxes, with the exception of estate taxes, have been deducted from expenditures in arriving at these figures, even tho there are good grounds for believing that much of the corporate and individual income tax revenue would <u>not</u> have been spent if it had been left in private hands.

There are numerous indications that the effect of the net income-increasing expenditures of the Federal Government are at last resulting in a stimulation of net income-increasing expenditures on private account. Expenditures for plant,equipment and construction are increasing. It is highly questionable, however, whether such expenditures are increasing at a sufficiently rapid rate to carry the whole load of recovery. Liquidation is still proceeding and the flow of money is still being obstructed by the piling up of idle cash in the accounts of large corporations. More specifically, it is doubtful if recovery would not be seriously impaired if the Federal Government balanced its budget in fiscal 1937 and made no contribution to the increase in the national income. On the other hand, the private net income-increasing expenditures have increased sufficiently to permit the Government to reduce its contribution. Thus, from the point of view of general business recovery the proper course would appear to be a reduction of the Federal deficit in fiscal 1937, and not a balanced budget. This should be achieved through an increase in revenues rather than a decrease in expenditures.

II - Budget Deficits and Inflation.

The argument most frequently urged against a continuance of a Federal deficit is that such a condition leads to "inflation". If inflation is characterized as a period when the monetary demand for goods and services of all kinds outstrips the community's ability to produce more so that costs and prices rise, it is obvious how a deficit at such a time would increase inflation. When, however, there is enormous slack in the productive machine as at present a deficit merely enables some of the slack to be taken up. From this point of view Federal borrowing and spending in a depression is very little different from private borrowing and spending. It is apparent, therefore, that it is not a deficit in depressed times that is to be feared but rather only in prosperous times. Since it appears beyond the bounds of probability that full productive capacity will be utilized in 1937, Government borrowing in that year would be no more inflationary than private borrowing.

It is often held that a deficit engenders further deficits. This, again, is only true at a time of rapidly rising prices. In a time of depression the reverse is true for two reasons. In the first place, a substantial part of the expenditures are attributable to the depression and will decrease as business revives. Secondly, by increasing the national income tax revenues are increased. The lag, which may be serious if Government costs are rising rapidly, is not serious when recovery is orderly and is characterized by the absence of rapid price rises.

One further point remains. A deficit entails borrowings and, in so far as banks subscribe for new bonds out of idle reserves, new deposits are created. It is conceivable that a volume of deposit currency may be built up in this way that will be excessive at a later date. The danger of this in the present circumstances does not appear great. So far the effect of Government financing has been to contribute to a restoration of the volume of means of payment wiped out in the course of the depression. In view of many factors which will not be entered upon here, a further expansion of three or four billion dollars of deposit currency should not prove to be excessive for a period of relatively full employment. Moreover, if necessary the volume of excess reserves can be cut down and the banks' portion of subscriptions to new issues be reduced.

As opposed to these arguments, however, must be set the psychological one. If people believe that a succession of deficits is inflationary then it cannot be doubted that they furnish a background against which a succession of inflationary incidents may precipitate a runaway situation. This danger might be lessened if it were clear that progress toward a balanced budget was being steadily made.

III - Estimates of Federal receipts and expenditures, fiscal 1937.

For the fiscal year 1937 receipts, exclusive of processing and social security taxes, are estimated to amount to $4.4 billion. This represents a conservative estimate and probably underestimates the revenue. It seems probable that social security taxes will be the object of litigation and if paid will be held in escrow pending a Supreme Court decision. On the expenditure side the picture is not clear. If benefit payments of $577 million, social security payments of $500 million, and relief payments of $1.1 billion are included and debt retirements are excluded, the expenditure would amount to $6.2 billion, or a deficit of $1.8 billion. It seems logical that benefit payments or their equivalent will not aggregate such a high figure on a revised basis, since for one thing farm prices and farm incomes have increased substantially from their low points. It is also possible that an adverse Supreme Court decision would lead to no payments on social security account. In any case it is unlikely that social security payments would continue to be made unless specific and earmarked taxes are paid. If, therefore, we deduct social insurance payments the deficit will be $1.3 billion.

Provision for relief, on the other hand, is unquestionably too low at $1.1 billion. In fiscal 1935 the amount spent on ordinary and drought relief aggregated $1.9 billion. Taking into account the intervening period of recovery, it would appear reasonable to assume the cost of relief in fiscal 1937 will be no greater than in fiscal 1935. If, therefore, we add an additional $800 million to relief payments, our estimated deficit would then become $2.1 billion. Of the anticipated expenditures of $6.5 billion, receipts would amount to $4.4 billion, or 68 per cent. If these guesses are approximately accurate the budget could be balanced in the succeeding year or years by an increase in receipts of $1 billion and a reduction of relief expenditures of $1 billion.

Although time has not been available to make a careful estimate, such work as we have been able to do indicates that on the basis of a national income of $80 billion the present tax rates would yield at least $5½ billion dollars. Probably the yield would be larger. This figure excludes any revenues from processing taxes or their equivalent, social security taxes, or payments under the Guffey Act. It also excludes the revenue from miscellaneous taxes which is estimated will amount to $160 million in fiscal 1937, and takes no account of repayments to RFC or other Government lending agencies whose activities enter directly into the budget. Since, with the national income at $80 billion the cost of relief should be at least cut down by $1 billion from our estimated $2 billion for fiscal 1937, it would seem a conservative guess that over $1 billion would be available for debt retirement.

One factor that should be kept in mind in discussing fiscal policy in an upswing of business activity is the lag in Government revenues. Thus in any fiscal year returns from individual and corporate income taxes arise from incomes earned from six months to a year previously.

IV - Are additional taxes necessary or advisable?

Taking into account on the one hand the new taxes imposed during the depression, increased rates of taxes, various administrative changes relating to depreciation allowances and capital losses, and repayments to the RFC, etc.; and on the other hand, the probable decreased need for expenditures, it appears fairly certain that a continuance of recovery and a rise in the national income to levels approximating the late Twenties would bring about not only a balanced budget but also permit substantial retirement of debt, even if no new taxes are imposed.

As opposed to this line of argument it may be urged that it is based largely on guess work and in addition ignores important psychological factors. It may be years before the national income increases to $80 billion. Expenditures instead of diminishing may increase. The psychological effects of a long-continued series of deficits may be very bad.

On the whole it would appear advisable to take a middle course. Introduce some new taxes which would not constitute too great a drag on the recovery movement in 1937 and yet would have a reassuring effect and would provide against possible unfavorable developments in expenditures and receipts not given proper weight above.

V - Possible new taxes.

1. Excise taxes, particularly on food stuffs. The arguments that can be urged against such taxes are as follows:

(a) They are regressive and inequitable. They bear most heavily on the urban populations, which in many cases are worse off than the farmers. Moreover, the poorer a person is the larger a proportion of his income that is spent on the necessities of life. If such necessities are taxed, the heavier, proportionately, are taxes on the poor than on the rich.

(b) A tax on the necessities of life is a political liability. No matter how small it is it gives opponents a fine talking point and becomes a scapegoat for any rise in prices.

(c) Excise taxes, of all taxes, have the most dampening effect on business recovery. In so far as the Government raises money by excise taxes it is almost certainly decreasing private expenditures by nearly the same amount. The same is not so true of corporate taxes or taxes on the wealthy since, in a time of sub-normal business activity, there is more probability that the money would not have been spent if it had not been paid in taxes.

2. Increased income tax rates. Income tax rates on the very wealthy are probably as high as they can be made. People with incomes from $5,000

to $50,000 could very well pay higher rates but doubtless the imposition of additional taxes on such people would not be politically feasible at present.

<u>3. The means which are here recommended to raise additional revenue are a tax on the undistributed earnings of corporations and the abolition of separate income tax returns for husband and wife.</u> There are three main arguments to be urged in favor of a tax on undistributed earnings. In the first place, many wealthy individuals can cut down the amount of their tax payments by leaving a substantial portion of their income with the corporations they control. A tax would either force them to disburse more of their income in the form of dividends and thus subject them to the payment of higher individual income taxes or, if they did not follow this policy, their uncollected income would be subject to a higher tax than at present. By means of such a tax the people who are benefitting the most from the recovery would pay more of the necessary cost.

The second argument in favor of this proposal is that it would discourage to some extent the uneconomic allocation of the community's productive resources. Salaried executives may, in many cases, be more interested in increasing the <u>absolute</u> gross and net return than in increasing the <u>rate</u> of return on invested capital. It is at present excessively easy for them to do this by holding back a substantial portion of the earnings of the year, reinvesting them in plant facilities. There would be a much closer calculation of probable costs and returns on any new investment if managements were confronted with the alternatives of either paying much heavier taxes or asking the stockholders directly for new money, or borrowing.

In the third place, if through the imposition of a graduated tax on undistributed earnings corporations regularly disbursed a greater proportion of their earnings in the form of dividends or taxes, one source of disturbance in general business conditions might 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 it is a reasonable assumption that they would be more reluctant to acquire balances in such ways than by holding back earnings.

The argument that would be urged against such a tax is that it would militate against sound principles of business finance. It will be said that a "properly" run business should not disburse all its earnings but should hold back some in the good years so that it will be in a strong position to meet adverse conditions when they arise.

This argument may be met in various ways. In the first place, it rests in part on an analogy to individual finance, where it is obvious that if all income is currently disbursed on consumer goods no capital accumulation will be possible. A corporation, however, is not an individual but rather an instrument by means of which a group of individuals engage in a productive enterprise. The importance of the distinction from the present point of view is that if more money can be profitably utilized by a corporation its owners can be asked to put it up. Admittedly this does not apply so well to a privately-owned business, since a heavy tax on undistributed earnings or on large individual incomes would leave less money available for investment in the business. This, however, is an individual and not a social disadvantage. If the business is very profitable the individual can either borrow or admit new stockholders by selling stock. It would be most unrealistic to assume that if Henry Ford had had to pay much heavier taxes the community would not have been supplied with automobiles as good and as cheap as they are at present. There is, in other words, no more reason for exempting incomes from taxation which are not disbursed by corporations but which are directly reinvested in plant or marketable securities than there is for exempting incomes disbursed but used for the purchase of stocks or the building of houses.

In the second place it is not the existence of a bookkeeping surplus that enables a company to withstand adverse conditions but rather its liquid position and the smallness of its indebtedness in relation to the equity. A corporation can retire indebtedness and put itself in a liquid position by issuing stock as well as by holding back earnings.

On the matter of sound corporate financial policy, Dewing, one of the leading authorities in the field, takes a middle ground on the question of reinvesting earnings. On the one hand he points out the advantages of this procedure to a young and comparatively unknown company and mentions that an uninterrupted dividend record enables a corporation to borrow at lower rates. On the other hand, he discusses the danger of uneconomic overinvestment and points out the possible injustice to stockholders arising from this fact. He cites a study of a number of cotton mills, half of whom depended on earnings for new money and half expanded by issuing new stock and bonds. In twenty-one years the market price of the stock of the latter group appreciated considerably more than that of the former.

Still another argument that might be urged against the tax proposal under discussion is the inequality of the burden it would impose on different types of companies. On the one hand are those very large companies which already have large holdings of cash and securities and have in addition ready access to stock and bond markets for new money if needed. On the other hand are those smaller companies whose resources have been severely strained by the depression, whose stock has a small market, who find it difficult to borrow, and hence who have to rely heavily on undistributed earnings to reduce loans and build up their liquid resources. A tax on undistributed earnings would penalize such companies relative to the financially strong companies.

This objection, which appears to be a legitimate one, might be met at least in part by graduating the tax according to the absolute amount of undistributed earnings rather than according to the percentage of net earnings undistributed. For example, the first hundred thousand dollars of undistributed earnings could be exempt or subject to a lower tax and progression could proceed rapidly thereafter.

It would appear that a graduated tax has several arguments in its favor. In the first place it would compensate for the greater difficulty the small man has in raising new money for expansion. Secondly it would make the tax politically more popular while diminishing very little its effectiveness. As opposed to this is the fact that graduation would make the tax more complex and difficult to administer. This objection is not as strong as it would be if the principle of graduation were not applied to so many other taxes, including the corporate income tax itself.

VI - Should the tax be initially levied on undistributed corporate incomes for the calendar year 1935 or for the calendar year 1936?

To levy it on undistributed income in 1935 would be to make it retroactive, which is always unpopular. This, however, could be avoided in part by levying the tax on the earnings of 1935 which were undistributed by the end of 1936. This, however, would entail further difficulties. If repayments of debt were included in distributed income certain companies which had retired debt would gain. There would also be inducement to retire further debt in the latter part of 1936. If debt retirements were not included in distributed income there would again be inequality of treatment in the case of companies that retired debt but would not have done so if the tax had been in force.

<u>VII - Should earnings devoted to repayment of debt (in existence when the tax is initially imposed) be exempted from a tax on undistributed earnings?</u>

<u>1. Arguments for:</u>

a. By encouraging the reduction of indebtedness one of the factors contributing to the violence of a depression would be diminished. A heavy volume of indebtedness contributes to the violence of a depression in two different ways. In the first place it means a correspondingly heavy volume of fixed charges, which in turn entails an inability to reduce costs as prices and volume fall. In the second place, a heavy volume of indebtedness forces the adoption of very conservative policies on a downswing. Efforts are made to accumulate cash to meet maturities and all expenditures that can be are postponed.

b. Sound financial policy calls for the retirement of debt out of earnings. Unless debt is retired out of earnings it is doubtful whether it will ever be retired. An adequate depreciation policy merely maintains the property intact. It does not enable the property to be kept intact and also pay off the indebtedness outstanding against it. Unless provision is made for retirement of debt the corporation cannot borrow on as advantageous terms and may even find it difficult to borrow at all.

> <u>Comment:</u> If the property is being fully maintained presumably there is no impairment in the security of the debt. If the debt is retired out of net earnings the stockholders are increasing their equity just as though they had used net earnings to

extend plant. Since equity is being increased in both cases earnings should be subject to the same tax. If a corporation's business is declining so that it does not need as much capital plant it can devote its depreciation allowances to the reduction of debt. If a corporation can use all the plant it has but no more it can ask its stockholders for new money if it wishes to reduce its debt rather than take the stockholders' undistributed earnings for this purpose. In the case of holding companies where there are no depreciation allowances, and stockholders wish to increase their equity by retiring corporate debt out of earnings, such earnings should be subject to the same tax as if they had been distributed and used by the stockholders to pay off personal security loans. In both cases stockholders' equity has been increased. Since the debt in both cases was incurred for the purchase of stocks it can be liquidated in both cases by the sale of stocks.

c. If repayments of debt are taxed it may discourage borrowing. At present an investment will be undertaken if it promises to pay bond interest and amortization plus something for the owner of the equity. If repayments of debt out of incomewere taxed, amortized investments would have to yield enough to pay interest and the tax as well as the amortization of the loan itself, or else enough to enable it to be financed by the sale of stock. A large volume of savings is restricted by law or custom to investment in high-grade bonds. A considerable portion of these funds is now uninvested because of the scarcity of such bonds. If the supply of such investments were further reduced it would mean that an even larger portion of such savings would remain uninvested.

(d) In the case of outstanding bond issues whose indentures call for sinking fund provisions injustice would be done by not exempting earnings devoted to this purpose.

<u>Comment</u>: The objections raised in c. and d. might be avoided if the corporation distributed in dividends all of its net earnings and then raised new money for sinking fund purposes by issuing stock. The stockholders' equity would be increased along with the issue of the new stock.

<u>1. Arguments against</u>.

a. Encourages liquidation and militates against full recovery. Exemption of earnings used for debt retirement from the undistributed earnings tax would encourage liquidation. Wealthy individuals could add much more to their equity by causing corporations to retire their debt in this way than by using earnings for the purpose of expansion. Disbursements of corporations on wages and materials must increase very greatly if we are to achieve full recovery and yet such an exemption as is here discussed would militate against such an increase in disbursements. It may very well be the case that our chief difficulty in the future will be to get people to borrow enough to absorb current savings. A very large portion of savings can only be invested in fixed-income yielding securities but the number of issuers of such securities may steadily decline. Even in the '20's most business corporations were retiring rather than increasing indebtedness. In a few years the Federal Government will doubtless be retiring rather than increasing debt. Many States and municipalities have reached their debt limits or are in other ways prohibited from borrowing. After the experience of recent years utilities may very well rely more on stock issues than bond issues for new money. There will be many more obstacles in the way of an increase in security loans than existed in the past. At the present moment it would appear that the one big field for an expansion of borrowings is in construction, and it is doubtful whether the demand will be sufficient to absorb the steadily increasing supply of savings. The eventual solution of this condition if it should arise would be the continuance of very low interest rates which would both encourage borrowing and cut down savings. It will take some time, however, before lenders become reconciled to low interest rates and they may hold idle cash and wait for a rise. Although doubtless the transition can be made it will take time and in the meantime no additional incentive is necessary or should be provided to encourage business to reduce indebtedness. If earnings are taxed heavily when held in the business or disbursed to individuals there is a better chance that such earnings will be spent on current goods and services than if they are turned over to investors in a lump sum in repayment of debt.

b. An exemption for retirement of debt would be inequitable. It would enable those individuals who own shares in companies at present heavily indebted to increase their equity and, hence their principal, to a much greater degree than if they were in companies having no indebtedness. It is true that on the downswing the existence of heavy indebtedness meant greater losses. On the upswing, however, the existence of heavy indebtedness constitutes a leverage factor which should make the net earnings of such corporations increase more rapidly than those having no debt. Thus investors in heavily indebted corporations will gain on two counts in the upswing. In the first place, their net earnings will increase more rapidly and, in the second place, more of their income will be available for increasing their equity. In effect the exemption would penalize companies which have been conservative in the past and give a bounty to those which have gone heavily into debt.

c. If retirements of debt were exempted from a tax on undistributed earnings this would reduce the resultant increase of Government revenues to a negligible amount. Instead of paying out earnings in the form of dividends which would be subject to surtax, corporations would simply retire debt whenever they could do so.

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