

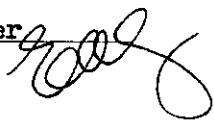
BOARD OF GOVERNORS  
OF THE  
FEDERAL RESERVE SYSTEM

# Office Correspondence

Date February 25, 1936

To Chairman Eccles

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

From Mr. Goldenweiser 

G P O 16-852

I am sending you a statement of your proposal for increasing Federal revenue. This statement represents an agreement between Mr. Currie, Miss Burr, and myself. A one-page summary for your use will be sent tomorrow.

February 26, 1936

OUTLINE OF PROPOSALS FOR INCREASING FEDERAL REVENUE

Federal Reserve's Interest in Fiscal Policy.

Fiscal policy has been chief factor

- (a) in increasing supply of money
- (b) in recovery

Government spending still necessary and new taxes should not be of a kind that impede recovery.

Excise taxes bad from this point of view.

Tax on undistributed corporate earnings would

1. Stop one way in which wealthy evade income tax (Ford, Mellon, etc.)
2. Help small investors
3. Discourage growth of uneconomic bigness (Berle & Means)
4. Weaken despotic control of managements
5. Aid effectiveness of monetary control
6. Aid in recovery
7. Raise considerable revenue (\$200-\$300 million)
8. Be popular

Objections

1. Against "sound" principles of corporate finance-  
Answer: Money can be borrowed or raised thru new stock issues if really needed.
2. Will prevent corporations from reducing indebtedness  
Answer: Provision can be made for reasonable debt retirements
3. Will penalize small businesses  
Answer: Exemption of \$25,000

Joint tax returns from husbands and wives

1. Would raise \$150 million mainly from upper brackets
2. Would come under heading of administrative change rather than raised rate
3. Would be equitable
4. Would not impede recovery

Objection

1. Hardship in case of two separate establishments.  
Answer: Exemption up to \$2,500 for additional separate establishment.

February 25, 1936.

PROPOSALS FOR INCREASING FEDERAL REVENUE

I. Federal Reserve System's interest in fiscal policy.

An adequate supply of money and its unobstructed flow through channels of production and distribution are necessary for business recovery and for the maintenance of stable business conditions. Government expenditures, borrowings, and taxation exert a powerful influence on the volume of money and on its use by the public. The Board of Governors of the Federal Reserve System, being charged with the responsibility for doing what it can to restore and maintain the volume of business, therefore, has a vital interest in the fiscal policies pursued by the Government. Credit and monetary policies alone can insure neither recovery nor stability, unless they are supported by appropriate fiscal policies.

It is for these reasons that certain observations and suggestions in regard to fiscal policy are here presented.

II. Progress toward recovery made to date.

(a) In the supply of money.

Fiscal policy since 1933 has been the principal cause of business recovery. By spending more money than it took in, the Government has increased the buying power of the people and, directly and indirectly, has raised the national income from a low point of \$38,000,000,000 in 1932 to \$55,000,000,000 in 1935.

The country's supply of currency and check deposits, which had declined from \$26,000,000,000 in 1929 to \$20,000,000,000 in 1933, has risen to nearly \$28,000,000,000 at the present time. The present

supply, if used as actively as it was in 1929, would be sufficient to finance a slightly larger volume of business. But population has increased since 1929 and more business is necessary to keep the people employed. A further growth in the supply of money of from \$2,000,000,000 to \$4,000,000,000 may, therefore, be desirable. This may be expected to arise from possible gold imports and from loans and investments by banks for trade and industry. No further growth from the purchase of Government securities by banks seems necessary.

It would, therefore, be good monetary policy to plan for balancing the budget in 1938. In view of the attitude of people toward deficits, which is carefully nurtured and exploited by the opposition, it would be advantageous from the psychological and political point of view as well to take steps which would indicate a balanced budget in 1938.

(b) In the recovery of business.

Business recovery in the past year has been substantial and sustained, and perhaps one-half of the road to complete recovery has been traversed. The process, however, is still incomplete. For one thing capital issues for productive use are still negligible, and much of the money created by Government spending has accumulated in the hands of large corporations, which can see no profitable use for their funds, since they still have productive capacity in excess of their needs. It would appear, therefore, inadvisable for the Government to reduce its expenditures in the fiscal year 1937 or to impose new taxes of a type that decrease private expenditures.

### III. What kind of taxes would be desirable?

Viewing the present situation as a whole, it would seem desirable to provide for additional revenue. But new taxes should not be the kind that would tend to retard recovery. They should not be excise taxes, because such taxes fall heaviest on the poor, and because, by levying on money spent for current consumption by the public, they decrease private spending by as much as they provide for public spending. These taxes are unpopular and unjust, and harmful. They tend to counteract the Government's efforts for recovery.

Instead of excise taxes, it is proposed here to raise additional revenue by (a) taxing undistributed earnings of corporations, and (b) requiring joint income tax returns by husbands and wives.

### IV. A tax on undistributed corporate earnings.

The first great advantage of such a tax would be that it would close an avenue through which the incomes of the rich can escape the taxes imposed on large incomes. By keeping corporate earnings undistributed the rich can escape the high surtax rates which they would have to pay if the money were paid to them as dividends, and can get by with paying the low tax rates imposed on corporations.

That this has been a common practice is indicated by the fact that from 1926 to 1929 thirty-six of the largest industrial corporations held back \$2,200,000,000 of their earnings, or nearly one-half of what was available for the common stockholders. Three companies controlled by Andrew Mellon--Gulf Oil, American Aluminum, and the Union Trust Company--retained \$117,000,000 of their earnings of \$146,000,000 in the years

1927-1929, or 80 percent. The great bulk of Henry Ford's income in the past has been subject only to the comparatively low corporate income tax. It is evident that our present high surtax rates can have little effect in preventing the growth of great fortunes.

For the small investors the policy of holding back earnings is not profitable, since if they had received dividends, which are exempt from the normal tax, this would have increased their incomes but not their income taxes.

But, vastly more important than that, is the fact that the accumulation of earnings has contributed to the growth of huge aggregations of capital. Numberless corporations have used funds held back from the stockholders to extend their plant beyond all economic requirements, to buy up competing concerns and to build up huge holdings of cash. According to Berle and Means the annual rate of growth of the 200 largest corporations from 1924 to 1928 was 7.7 percent as contrasted with only 2.6 percent for all other corporations. They estimate that if this rate of growth were maintained for the next twenty years, 85 percent of corporate wealth would be held by 200 huge units. It cannot be doubted that the retention of earnings facilitates this tendency and thus contributed to diminished competition and the growth of monopoly.

This shows that it would be in the interests of equity and sound economic and social policy to impose a prohibitive tax on undistributed earnings of corporations. It would also be desirable from the monetary point of view.

Analysis of corporate reports shows that during the depression the larger corporations reduced their debt and at the same time maintained their cash position. A study of the balance sheets of some 274 corporations indicates that their cash holdings, which comprised 7.6 percent

of the total supply of deposit currency in 1929, constituted 11.8 percent of the total at the end of 1932. Since that date a substantial part of the new money created through Government financing has gone into the hands of corporations and has not been disbursed by them. Individual and corporate demand deposits in New York and Chicago are 42% higher than they were in 1929, although total individual and corporate demand deposits are still below the 1929 figure. This piling up of idle deposits has not only constituted a serious drag on the recovery movement but it is also an impediment to monetary control in the future since it permits heavy corporate expenditures without recourse to the banks or the capital markets.

Large holdings of cash also enable the management of corporations to embark on undertakings now or in the future without being obliged to consult the wishes or the interests of the stockholders or of prospective investors. It enables the directors of corporations who may represent a negligible proportion of the stockholders to manage the financial and economic policy of the undertakings without let or hindrance from the numerous investors who are the real owners. It seems impossible to force the money accumulated to date into circulation, but the imposition of a prohibitive tax on undistributed earnings would prevent further accumulation. In this way a large part of the money flowing to the corporations from now on will be made to come back into use either through expenditures by those who receive it as dividends or by the Government which will take it in the form of taxes.

Opposition to the tax from big corporations, which have used undistributed earnings to expand their power, is to be expected. They will claim that it is an interference with sound corporate financial policies.

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 position to meet adverse conditions when they arise. But this argument is inconclusive. It is not the existence of a bookkeeping surplus that enables a corporation to withstand adverse conditions, but rather its liquid position and the smallness of the indebtedness in relation to the equity. In the imposition of the proposed tax, provision can be made to exempt undistributed earnings used to retire debt up to a reasonable amount, equivalent, say, to customary sinking fund requirements, and also to meet preferred stock retirement provisions, back taxes, etc. Moreover, a corporation may retire indebtedness and put itself in a liquid position by issuing new stock, as well as by holding back earnings. The difference will be that corporations will estimate their needs much more exactly if they have to ask stockholders for new money than if they can hold back earnings.

The case of small corporations that may find it more difficult to pay off debt or secure money for expansion can be met by exempting undistributed earnings up to \$25,000 from the prohibitive tax. Such an exemption would meet a legitimate objection, would interfere very little with the purposes of the tax, and would avoid opposition by small corporations which are in number vastly more important. Only some 30,000 corporation returns in 1929 and 10,000 in 1933, out of 450,000 corporation returns showed statutory net incomes in excess of \$25,000.

It is difficult to estimate the additional revenue which such a tax would bring in, particularly in view of the proposed exemptions. For the calendar year 1937, however, assuming a 50 percent rate and making allowances for exemptions and various assumptions as to the additional amount of earnings



that will be distributed and the surtax rates to which they will be subject, the tax may produce as much as \$200,000,000 - \$300,000,000.

V. Joint tax returns from all husbands and wives.

If husbands and wives were all required to file joint individual income tax returns, as much as \$150,000,000 of additional revenue would be raised during the calendar year 1937. This revenue would come almost entirely from individuals with net incomes in excess of \$10,000. About \$90,000,000 would come from individuals with net incomes of \$50,000 and over and, of the balance, less than \$10,000,000 would come from individuals with net incomes under \$10,000.

This increase in revenue would not require an upward revision in normal and surtax rates applied to individual incomes nor a change in personal exemptions and credits. Unless there are unusual legal difficulties the increase in revenues would depend on an appropriate change in the law affecting the administration of returns, either by eliminating the option now given husbands and wives of filing separate returns, or by making use of the privilege subject to special penalty tax rates.

From the point of view of ability to pay taxes, there is no reason why this change should not be made. The ability of married individuals to pay taxes depends on their combined net income rather than on the fact that income may come from sources belonging legally to two individuals.

It may be suggested that such a revision in the income tax law would cause hardship in cases where separate establishments are maintained by husband and wife. In so far as this criticism has a justifiable bearing on the ability to pay income taxes, it might be met by broadening the provisions for personal exemptions applying to a "head of a family".

The law now includes a personal exemption of \$2,500 for an individual who actually supports or maintains in one household one or more individuals closely related to him. This could be extended to provide a larger exemption, not more than \$5,000, in the case of separate establishments maintained by husbands and wives.

To raise additional revenue by means of this proposed additional charge would impose little restraining effect on recovery since it would affect mainly the wealthy whose incomes are not all spent on consumers' goods or at the present time invested for the making of producers' goods. To cut down savings at the present time would be no impediment to recovery since there is a superabundance of idle funds seeking investment.

Thus there is much to be said for this proposal from the point of view of recovery, of yield, of equity, and of popularity.

Summary of advantages of the two proposals.

From the point of view of business recovery it would seem desirable to raise a moderate amount of revenue in the fiscal year 1937. Such taxes should be of such a nature as to decrease private expenditures as little as possible. It is strongly recommended, therefore, that serious consideration be given to the two proposals discussed above, rather than to additional excise taxes. If business recovery continues as anticipated serious consideration should be given to the possibility of balancing the budget in the fiscal year 1938.

The two proposals here made would tend toward greater justice in our tax system. Two important gaps or loopholes that now help to make the present high surtax rates ineffective - undistributed earnings, and separate returns for husbands and wives - would be stopped by the proposals.

Politically the proposed changes would be popular. They would affect only the wealthy and would not increase tax rates, but only amend administrative procedure. Corporations need not pay the tax if they disburse their earnings. The tax exempt income of small investors will actually be increased.

From the point of view of general economic and social policy, the distribution of corporate earnings would tend to curb excessive bigness, would lead to more equitable treatment of small investors, would encourage a more thoroughly considered planning of new capital equipment, would tend to make more difficult the accumulation of great fortunes, and would aid the monetary authorities in their endeavor to promote more stable economic conditions.