March 11, 1936.

ANSWERS TO THE OBJECTIONS PUT FORTH IN THE ANNALIST, MARCH 6, 1936,

TO THE PROPOSED TAX ON UNDISTRIBUTED EARNINGS

1. "It would place many corporations in a difficult position in the event of another depression, because it would discourage the building up of surpluses in good years for the maintenance of dividends in bad years."

Answer:

Corporations cannot pay dividends out of surplus except in a very loose manner of speaking. Surplus is a proprietorship account and may be matched on the asset side by plant. What corporations can pay out is cash, either on hand or arising from sale of goods or investments. Properly speaking, "depression reserves" should take the form of cash or marketable investments. There is nothing in the proposed tax plan that would prevent a corporation from building up such reserves through new stock issues in good years. Actually, in the past depression, corporations entrenched very little on their reserves in this sense. For non-financial corporations from December 1929 to December 1932 holdings of cash and tax-exempt investments declined only from $10,859,000,000 to $9,070,000,000. In the same period their other investments increased $5,594,000,000.

2. "It would retard the growth of large corporations which have meant much to the industrial development of the country."

Answer:

It would only retard the growth of uneconomically large corporations. Large profitable corporations could easily raise new money through stock issues.

3. "It would discourage thrift."

Answer:

A stockholder cannot be said to be practicing thrift when his income is withheld from him. The disbursement of corporate earnings would give more opportunity for the practice of thrift.

4. "It would accentuate booms and depressions by compelling corporations to distribute larger dividends in good times, leaving little or no surplus to be distributed in bad times."

Answer:

It is the excessive expenditures on capital goods that characterize a boom. The payment of dividends would probably result in less money available for expenditure on capital goods and, hence, would be a moderating factor. Non-financial corporations reporting net earnings of $35,000,000,000 from 1926 to 1929 retained $13,700,000,000. From December 1926 to December 1929, however, their cash increased only $648,000,000, which indicates that withheld earnings were used in other ways.

As remarked above, "surplus" is a proprietorship account and cannot properly be said to be distributed. To distribute anything in a significant sense one must have liquid assets. Although for all non-financial corporations surplus and undivided profits decreased by $15,000,000,000 from December 1929 to December 1933, this did not represent disbursements to the factors of production. For the most part it merely represented charge-offs. Thus, for these four years, charges against earnings on account of bad debts, depreciation, depletion, and loss on the sale of capital assets, amounted to over $20,000,000,000. While, doubtless, some of the depreciation charge represented actual money expenditures there is reason to believe that much of it did not. Inventory and plant writedowns were other and additional factors causing a decline in surplus and yet did not represent payments to the factors of production. It is apparent, therefore, that the writing down of surplus did not operate to sustain the community's income, just as it is apparent that corporations as a whole entrenched very little upon their depression reserves properly so-called.

5. "It would lead to various forms of tax avoidance, such as putting earnings into unneeded plant and equipment, if ways could be found to charge such expenditures to expense accounts instead of to capital accounts."

Answer:

This objection also applies to the present tax assessed on net earnings.

6. "It would lead to a new series of court proceedings, because of the difficulty of writing an entirely constitutional law in conformity with the President's ideas."

Answer:

If no laws were passed because they might be contested in the courts we would have very few laws. Competent legal opinion is that the tax is perfectly constitutional.

7. "It would cause a decline in business activity by inducing corporations to curtail present plans for plant expansion. There would then be a renewed rise in unemployment."

Answer:

Corporations have larger liquid resources than they ever have had before. In addition, they can issue stock or borrow on favorable terms. So far from curtailing business activity at this time the tax would lead to larger incomes, larger demand for goods, more profits, and more expansion.

8. "It would give the large corporations, many of which have already accumulated substantial surpluses, an advantage over the small corporations, many of which are still struggling to accumulate adequate working capital. This would accentuate the so-called concentration of wealth about which many of the New Dealers profess alarm."

Answer:

There appears to be more merit in this objection than in the others. It is met in large part, however, by the graduated nature of the tax and by the fact that the present corporate income tax is being removed.

9. "It would further postpone a reopening of the capital market because investors would refuse to invest in companies which, in order to avoid heavy taxation, would be compelled to pay out a large proportion of future earnings in dividends."

Answer:

There has been no understanding in the past that any proportion of earnings would be undistributed and there is no indication that this factor has weighed with investors. Adequate depreciation reserves arrived at before the determination of net earnings maintain the margin of security of loans. If there is an adequate margin of security and earnings, corporations will have no difficulty in borrowing.

10. "Even if adopted in far less drastic form than suggested by the President, it would substitute the judgment of Congress and Treasury Department 'experts' for that of corporation officials as to what constitutes a safe and reasonable amount to be set aside each year for surplus. If there were only one thing on earth concerning which it would be impossible to lay down a fixed rule for all kinds and classes of business, this would be it."

Answer:

The whole question of the difficulty of deciding upon a "reasonable" amount of reserve funds becomes irrelevant in view of the fact that corporations can decide this matter for themselves and issue new stock accordingly.

11. "It would not be a strictly revenue measure but a new method of redistributing wealth."

Answer:

It is a strictly revenue measure based on the universally-accepted principle of taxing according to ability to pay. If this is called redistributing wealth then presumably the only tax system that would avoid this accusation would be one in which the same amount of revenue was paid by every person in the country regardless of his or her income.

12. "It would tend to stimulate corporate borrowing for working capital and would increase fixed charges so that in a depression many companies would be forced into bankruptcy."

Answer:

This objection is inconsistent with (7) and (9) above. Corporations in general have sufficient liquid resources to handle a volume of business in excess of 1929. Those that need more cash and do not want to borrow may issue new stock. After the removal of the present corporate income tax and the payment of additional personal income taxes, owners of small corporations will have approximately as much, if not more, to invest in their companies as they have under the present system.