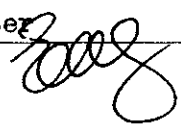


BOARD OF GOVERNORS  
OF THE  
FEDERAL RESERVE SYSTEM

## Office Correspondence

Date March 11, 1936To Chairman Eccles

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

From Mr. Goldenweiser 

G P O 16-852

Attached is a brief statement of the arguments for a tax on undistributed corporate earnings, and also a statement of the arguments against it that appeared in the Annalist, with replies to those arguments.

This material was prepared by Mr. Currie.

March 11, 1936.

ARGUMENTS FOR A TAX ON UNDISTRIBUTED CORPORATE EARNINGS

The proposed tax on undistributed corporate income would:

1. Close up one loophole through which the incomes of the wealthy have escaped the individual income tax. To the extent to which the incomes of the wealthy have been left undistributed with corporations our tax system has departed from the principle of taxing according to ability to pay. It is estimated that if all corporate earnings were distributed in 1936 additional income of nearly \$3,000,000,000, of 82,000 individuals having incomes of over \$25,000 per annum, would become subject to individual income tax rates.

2. Render more difficult the accumulation of enormous fortunes. If large incomes were really subject to taxation at the present high surtax rates it would be more difficult to amass a great fortune. One could, it is true, evade taxation by investing in tax-exempts, but it would be difficult to amass a fortune in this way.

3. Discourage growth of uneconomic bigness. It is at present advantageous for salaried executives and large shareholders to retain earnings in a corporation in order to make their position more secure and to evade taxes. There would be a closer calculation of probable costs and returns if shareholders were asked for new money before expansion was undertaken.

4. Discourage growth of monopolies. At present our tax system, by encouraging the retention of earnings by corporations, offers an inducement to use such funds to buy up other and competing concerns.

Moreover, in securing an interest in other corporations not purchased outright, encouragement is given to the adoption of policies that lessen competition.

5. Weaken despotic control by management and "insiders". The power to withhold earnings is a contributing factor to "insider" control. Without the power to withhold earnings ability to expand would depend upon the ability to borrow or issue new stock. With the publicity in connection with registering new stock issues with the S. E. C., stockholders would be in a position to learn much more about the operations of their corporations.

6. Benefit small investors by -- (a) virtue of the fact that the corporate income tax to be removed is higher than the normal income tax most individuals would have to pay on dividends, (b) having new expenditures of their corporations based on more economic grounds than at present, (c) enabling them to learn more about their corporations in connection with the more frequent new stock issues that would result.

7. Exercise a stabilizing effect on the general level of stock prices. Instead of a steady appreciation of stock prices in reflection of the growth of earnings resulting from investment of undistributed earnings, stock prices would be kept down through the frequent issue of new stock to finance expansion. Although the profitability of stockholders' investments would be very little affected, the psychological reaction is likely to be much more healthy if the general level of stock prices is thus kept down.

8. Aid in the effectiveness of monetary control. Judging from recent experience in the initial stages of recovery, corporations interpose a drag on recovery by building up cash holdings. At such times disbursement of full earnings would be constructive. In the later stages corporations spend the great bulk of retained earnings in plant and in purchase of other securities. This intensifies the upward movement. At such times disbursement of earnings and their subsequent partial recapture by the Federal Government for the purpose of retiring the national debt would be a restraining factor. In the initial downturn there is reason to believe that corporations increase their cash holdings. While the payment of unearned dividends in the later stages of depression is a moderating factor, it is probably of minor significance. For all non-financial corporations in the years 1930-1932 the payment of unearned dividends less undistributed earnings amounted only to \$2,734,000,000. Since part of this small amount went to other corporations and part was undoubtedly used by wealthy investors to retire debt, to purchase existing securities and to build up cash holdings, the net addition to the current demand for goods and services was very small. The bad effects at other times outweigh the good effect in a very bad depression and, indeed, help to bring about such a depression. If we have to choose it is better to choose something that tends to prevent a depression from developing rather than something which may operate to ameliorate a depression, particularly as the ameliorating

effects appear to have been of minor significance in the worst depression on record.

9. Aid recovery now. Since corporations have more cash than they have had before, a further retention of earnings now merely means further piling up of idle cash, or a further liquidation of indebtedness, both of which are dampening factors on the recovery movement.

10. Raise considerable revenue, particularly as recovery proceeds, and permit, first, a balanced budget and, later, substantial debt retirements. It does this, not by imposing new taxes but, rather, by making present tax rates effective.

11. Be superior to the alternative tax proposals suggested. The alternatives, for the most part, would tend to make our tax system more, rather than less, inequitable. One great merit of this tax is that the people who benefit most in money terms from the recovery would pay most of the cost, which is only fair. The tax would compensate for the rise in profits relative to wage rates.