

October 25, 1937.  
L. B. Currie  
Confidential

THE UNDISTRIBUTED EARNINGS TAX AND BUSINESS CONDITIONS

It is proposed to discuss three questions in this note. 1. To what extent, if at all, is the undistributed earnings tax responsible for the current recession? 2. Could it be amended in such a way as to stop the recession and bring about an upturn? 3. To what extent would proposed amendments constitute a departure from the objectives of the tax?

1. It is difficult to substantiate the claim that the undistributed earnings tax was responsible for the current recession. The downturn is in no way associated with a failure of industrial and mining plant and equipment expenditures to come up to expectations this year. According to preliminary estimates such expenditures this year increased by one third over last year and approximated the expenditures for 1928. Indeed, the accumulation of a large backlog of orders and the consequent delay in delivery in the machine tool and steel mill equipment industries make it doubtful if expenditures for an important type of industrial capital equipment could have been greater, at least up until very recently. The recent apparent slackening of orders for industrial equipment can be more reasonably explained in the light of past experience as being the resultant of the worsening in business prospects arising from other causes, rather than the inability to secure funds for expansion.

Public utility and railroad expenditures have not made so favorable a showing this year, although electric power outlays for capital purposes

may approximate 450 million dollars as contrasted with 300 millions in 1936. In both these industries, however, there is general agreement that the lag in capital expenditures is attributable to special circumstances connected with the industries.

In considering the source of funds for plant and equipment expenditures the importance of depreciation accounts is frequently overlooked. Annual depreciation and depletion charges for non-financial corporations amount to some \$4 billion. They are particularly important in the railroad and public utility industries. It should also be kept in mind that replacement of plant and equipment financed through depreciation accounts does not take the form of replacement of the original plant and equipment with their original productive capacity. The replacement takes the form of new plant and equipment, which is generally more efficient than the old. Hence, over a period of years, the industrial plant could be completely modernized with a resultant great increase in productive capacity if there were no borrowings, and all earnings were paid out.

A second, and quantitatively much less important source of funds for plant and equipment expenditures, is money raised through new security issues. The point is frequently made that this depends on the state of the capital markets, and that it is when this is a disturbed condition that the effect of the undistributed earnings tax is to retard industrial expenditures.

It is difficult to assess the validity of this contention. The difficulty consists in part of distinguishing between expenditures actually postponed because of the difficulty of raising new money and the expenditures postponed because of declining sales, but attributed to the state of the capital market and the undistributed earnings tax. It is only human nature to take advantage of a situation by attributing economically undesirable developments to a factor one may dislike or disapprove on other grounds. The broad point seems valid that favorable expectations will lead to increased plant and equipment expenditures out of both earnings and new money, and such favorable expectations will make conditions more favorable for raising money. Unfavorable expectations affect adversely both the security markets and the desire to make new plant expenditures.

A third source of funds for plant expenditures is retained earnings. From 1923-29 non-financial corporations reporting new income, paid out 57 percent of their earnings and retained 43 percent. Under the present law they can still retain 20 percent of their earnings, or about half the amount they actually retained in the Twenties, on the payment of a tax of  $9\frac{1}{2}$  percent (7 percent on the first 10 percent retained, 12 percent on the second 10 percent). They can retain 40 percent on the payment of an average tax of 13.2 percent.

2. The suggestion has been advanced that plant and equipment expenditures in excess of depreciation in the year 1938 be deducted from undistributed earnings for the years 1938-40 in determining undistributed earnings for tax purposes. It is expected that such an amendment would induce a considerable amount of industrial expansion next year and that this in turn would greatly help in converting the anticipated recession into an upswing.

In trying to arrive at some idea of the efficacy of this type of subsidy in stimulating expenditures that would not otherwise be made it is helpful to distinguish between a period of declining sales and profits and one of rising sales and profits. If business men do not expect sufficient demand in the near future to utilize profitably additional plant, they are reluctant to add to capacity. Judging from their behavior from 1933 to 1936, they would rather postpone new capacity until there is an actual demand for it, even if this entails higher costs and temporarily deficient capacity, than take advantage of lower construction costs at a time when there is plenty of capacity. They doubtless reason that the future must be uncertain and the penalty for a mistake in overexpansion can far outweigh a slight gain in lowered costs of construction or a remission of taxes.

If, on the other hand, sales, profits and production are increasing, the granting of a subsidy would be an added inducement to expand plant capacity.

It has frequently been remarked that measures proposed to meet one situation often lead to untoward consequences and necessitate further measures in turn. It is possible that the present proposal may be a case in point. It is quite possible that the year 1938 may include two different trends of business activity, at first down and then up. Indeed, the effect of this proposal would work in this direction. It would be natural for business men to refrain from taking advantage of the proposal in the first part of the year since they can always increase their expenditures in the latter part of the year and prospects will be clearer then. Consequently there is a danger that the proposal would not prove very efficacious when it is most needed, and might be too efficacious when it is not needed.

More specifically, one of the dangers in a recession at this time consists of laying the groundwork for a too rapid advance in costs and prices later. The more prices recede and inventories are reduced, the more likely that there will be a concerted rush to cover by purchasing agents if anything happens to change the outlook. If the proposal under discussion were adopted and the present trend of business activity and expectations should not change direction until some time well into 1938, the natural upswing would be reinforced by the desire to crowd capital expenditures which would be undertaken within, say, the next twelve months, into the remaining months of

the year. This danger might be avoided by limiting the application of the proposal to the first half of 1938. A limitation of this nature, however, would be difficult to secure from Congress.

3. To what extent would the proposed amendment constitute a departure from the objective of the tax?

Broadly speaking, the objective of the tax was twofold. The first was to close up a loophole in our tax system and make the surtax rates effective on large incomes. The second was to aid in the recovery and the maintenance of prosperity by increasing consumer buying and removing one of the incentives for the building up of corporation cash holdings. The second objective rested broadly on the view that the increase in consumer demand was a far more potent factor in stimulating capital expenditures than the ease of securing funds for expansion. It was observed that industrial plant and equipment expenditures were heavy in such years as 1919 and 1929, when money rates were very tight, and low in years of depression and in the period 1933-1935, when there was a superabundance of funds available for investment.

The proposed amendment would, of course, involve a departure from the first objective. The greater the amount of new business capital expenditures in 1938, the less effective would be the surtax rates on individuals for the years 1938-40, and the more the Government would lose in revenues.

Although this conclusion must be granted, it could be argued that the community at large is obtaining an offsetting advantage in comparison with the privilege of retaining earnings that existed up until 1936, since it would be only insofar as a corporation actually spent money and increased incomes that it could retain earnings without incurring a tax liability. This, however, is only partly true. Insofar as corporations would have made net capital expenditures in any case in 1938, the Government is granting a subsidy with no compensating advantages. It is only on the capital expenditures induced by the subsidy that there is an offsetting gain. Hence, if the proposal should be ineffective in accomplishing its objective it would still cost the Federal Government some loss in revenue and result in the reintroduction of a form of inequity in our tax system.

It is difficult to arrive at a clear answer as to whether the proposed amendment would entail a departure from the second and cyclical objective of the undistributed earnings tax. Should a substantial volume of net capital expenditures occur next year, as might very well happen if the low point of the recession occurs in the first half year, corporations would be enabled to retain a substantial volume of earnings in the years 1938-1940. Intermediate income brackets and indirect taxes would have to be higher than they otherwise would be to retire the same amount of Federal debt, and dividends would be lower than they otherwise would be. This might be desirable or undesirable, depending upon the rate of recovery.

In an earlier part of this note it was pointed out that the operation of the amendment, in conjunction with other circumstances, might easily make for increased instability in 1938-39. Should, on the other hand, the amendment induce a considerable amount of expenditures that would not otherwise have occurred while business is receding, and very little more than would otherwise have occurred when business is advancing, the net effect would be stabilizing. This, however, appears unlikely. If it is effective in a downswing it should be even more effective in an upswing, particularly if the upswing corresponds with the approach to a date line.

A major danger to both objectives would lie in the political difficulty of reversion to the present system after a year. There is intense opposition to the tax and it would appear well-nigh fatal to its continuance to concede by implication that it discourages capital expansion. Moreover, there are always those who believe that we can never have too much capital expansion and they will want to continue this subsidy. The next step will be the extension of the privilege to the retirement of debt and the tax would then be entirely lost. While these may be hypothetical dangers, they are none the less very real. We have all observed the difficulties attendant upon the repeal of temporary expedients, if a very large and powerful group benefits from the expedient. Finally, there is the difficulty, with which we are again familiar, of getting a piece of legislation through Congress in the form originally proposed.

Since the undistributed profits tax is bitterly opposed by a powerful group, there is no telling what form amendments would take if the matter is thrown into the legislative hopper.

In view of the uncertain nature of the advantages in comparison with the very definite dangers inherent in the proposed amendment, it would appear that one's position on the matter should be determined largely by the nature of the alternatives. If, for example, one felt the situation to be extremely serious and the possibilities of remedial action in other directions remote, the attitude toward the proposal might be favorable. If, on the other hand, there exists a good chance that really effective measures will be taken to stimulate building, for example, our attitude toward the proposal might be considerably modified. On general grounds, if a question of a Federal subsidy is at issue, it would appear preferable from every point of view to attempt to apply it to home building. It would be more likely to be effective, it would benefit a more deserving class in the community, and it would lessen the chances of a disastrous building boom at some time in the future.