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BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date August 26, 1940

To Chairman Eccles

From Martin Krost

MK

Subject: "Capital Goods Industries and Federal Income Taxation"

Summary of pamphlet

The argument of this pamphlet is that the present assessment of corporation income taxes on an annual basis is unfair to corporations with unstable incomes. In particular, restriction of loss carry-over to two years is unfair to corporations in the capital goods industries, which frequently must operate at a loss for several years. A special study of a large sample of companies shows that for the period 1929-38 income taxes amounted to 19.4 per cent of net profits for capital goods companies, as compared with 14.7 per cent for consumption goods companies. This difference was not compensated for by higher average earnings on the part of the capital goods companies, for over the sixteen years 1923-1938, they earned only 6.1 per cent on net worth, as compared with 9.5 per cent for consumption goods companies.

A six year operating loss carry-over is proposed, in accordance with British practice. A carry-over of this length would have permitted about two-thirds of the capital goods companies studied to make a complete offset of losses against profits over the period 1929-38. Under the two year carry-over permitted in the present statute only 19 per cent of these companies would have been able fully to offset losses.

Comment

Under the present law two corporations with the same net income over a ten year period may pay widely different amounts of tax because of differences in the way their incomes are distributed over the period. Any proposal that would lessen this inequality strongly recommends itself on grounds of tax justice. In determining the extent of the present discrimination and the appropriate length of loss carry-over, the following points deserve more extended treatment than they receive in the Machinery Institute's pamphlet:

1. One aspect of the extreme instability of net income in the capital goods industries is that a single year of exceptionally high earnings may compensate for many years of losses or subnormal profits. The sixteen year period on which the Institute bases its conclusion that profits in the capital goods industries fall short of

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profits in the consumption goods industries does not include the years 1917-18 or the years 1939-40. Some of our work in connection with the excess profits tax shows that profits ranging from 30 to 60 per cent will be earned in 1940 by many companies producing capital goods. This contrasts sharply with the 13 per cent average return for 1929 shown by the Institute's sample. The period 1929-38, used to show the necessity for a long loss carry-over, includes a depression unprecedented for severity and duration in American industrial history.

2. The capital goods industries suffer from the violent instability of demand for their products much more severely than from the burden of their taxes or other costs. A program designed to lessen the instability of the economy as a whole promises greater benefits to these industries than any possible measures of tax relief.

3. Industries subject to an abnormally high degree of risk need not earn an average rate of return equal to the return on capital in industry generally in order to attract investment funds. It is necessary only for a few producers to earn abnormally high profits. This observation applies to many of the capital goods industries. It would be more equitable if the industry as a whole earned satisfactory profits, but it is not necessary in order to maintain the capacity of the industry.

4. The corporation income tax is a rough but effective method of taxing savings. An appreciable part of any reduction in its yield, such as would result from the lengthening the period of loss carry-over, would be an addition to savings, individual or corporate. In order to prevent deflationary consequences, the Government would be forced to increase borrowing or to find new tax revenue from sources not likely to restrict consumption. This necessity could be avoided only if the capital goods industries responded to the stimulus of tax relief by expanding their own investment expenditures or by lowering prices and thus encouraging other industries to expand investment expenditures. The record seems to show that in recent years industry generally makes major changes in investment and price policy only as a result of changes in demand, not as a result of changes in costs.

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