

BOARD OF GOVERNORS  
OF THE  
FEDERAL RESERVE SYSTEM**Office Correspondence**Date October 13, 1943.To Mr. Thurston

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

From Mr. Musgrave *R. N. M.*

I am attaching a brief summary of Mr. Rudick's memorandum together with a discussion of the corporate tax proposal which is to be considered at the New York meeting. The memorandum is somewhat longer than intended, but it is a rather technical and difficult problem.

If you do not want the N. P. A. memo for your own file, please return it to me.

Attachments

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# Office Correspondence

Date October 13, 1943.

To Mr. Thurston

Subject: N. P. A. memorandum on

From Mr. Musgrave

fiscal policy and taxation.

The preliminary memorandum of the National Planning Association outlines the first four chapters of a report on Fiscal Policy and Taxation, and presents a more detailed proposal for corporate taxation. In the following pages, the chapter outlines are summarized, and the corporation tax proposal, scheduled for discussion at the New York meeting, is examined briefly. I shall be glad to let you have a more detailed discussion if you want it.

The report offers an intelligent and constructive approach to the problem and may make a real contribution to obtaining business support for a forceful and effective fiscal policy. I feel that the group should be given all encouragement.

## Summary of N. P. A. Memorandum

Chapter I presents some General Considerations. The objective of fiscal and monetary policy is the maintenance of high employment under private enterprise. Our task is to find out what fiscal measures will aid in obtaining this, and at the same time be consistent with maintaining a reliable and stable monetary and financial system. It is of greatest importance that leaders of private enterprise should understand the policy and have confidence in it.

In Chapter II, the Federal Budget for the postwar period is considered. The basic policy problem is not "budgetary balance vs. spending", but the question whether public finances should be neutral with respect to aggregate demand or whether they should complement and supplement it, so as to assure a level of demand adequate to sustain high employment at prevailing prices. Clearly, the answer is in favor of the latter policy. This, of course, need not mean permanent deficits, and may at times imply debt retirement. More important, a stimulus might be provided through reduction of taxes as well as increased expenditures. Rather than to undertake use-less spending to generate additional demand, it would be much better to reduce taxes and maintain a given level of expenditures. Not too much should be expected from a public works program.

In Chapter III, a Tax Policy and Program are outlined. The program rests on two general propositions, namely, that taxes should be such as to balance the budget at a high level of employment only, and that a corpo-

rate management should be permitted to conduct its affairs free of Federal tax considerations. Taxes should be sufficient to balance the budget at income payments of 140 billion dollars in 1943 prices, or allowing for a 20 per cent price rise, about 170 billion dollars in postwar prices.<sup>1/</sup> At this level of income, the Federal budget is estimated at 16½ billion dollars and 18 billion dollars respectively, exclusive of Social Security. In times of depression, expenditures will be higher and taxation lower, and the opposite would hold in boom periods. The five specific tax proposals are as follows:

1. The Social Security program should be neutral with respect to its fiscal effects. Old age security should be financed on a contributory pay-as-you-go basis. There should be no old-age reserves, and reserves for unemployment insurance should be accumulated only in times of very high income.
2. The Federal income tax on corporations should be abolished, except for a small franchise tax. Steps should be taken to assure that personal income taxes are not evaded through non-distribution of corporate income. (See below.)
3. The Treasury should rely mainly on the graduated income tax as the fairest and most desirable tax source. To provide 13 billion dollars out of the total tax budget of 18 billion dollars, it is estimated that present rates could be reduced by one-third (assuming income payments of 170 billion dollars). The capital gains tax should be eliminated.
4. A Federal sales tax is undesirable, but the major existing excises should be maintained.
5. Closer coordination of the Federal, State and local tax systems is needed.

In Chapter IV, Public Disbursements, Public Works, and Public Loans are examined. (a) All disbursements should agree with expressed public policy. No expenditures should be made for the sake of spending only. Public expenditures must be efficient and flexible, and an effective administrative structure must be developed to make proper fiscal and monetary policies possible. (b) The objectives of public works policy should be modest. The construction industry cannot and should not be managed to maintain a high level of general employment, but only to maintain a stable level of public construction. (c) Public loans made or endorsed by the Federal Government are an important instrument of fiscal policy.

<sup>1/</sup> This level of income payments is estimated to result from the employment of 55 million people at 1940 working hours.

Four other chapters, not yet outlined, will deal with Savings and Investment, Foreign Investment and Lending, Open Market Policy, and Administrative Aspects of Fiscal and Monetary Policy.

### Corporate Taxation

The memorandum proposes a thorough reform of the taxation of corporate income. The corporation net income tax is held objectionable on two grounds: (1) It results in an inequitable distribution of the tax burden. If corporate income is distributed, it is taxed twice, first to the corporation as net income and then to the shareholder as dividends. If it is not distributed, it escapes individual taxation altogether and only pays the corporate rate which may be much lower than the rate applicable to the shareholder. The basic point is that the corporation is only a thoroughfare for income finally received by the shareholder. Its income should thus be taxed as a part of individual incomes, neither more nor less. (2) The corporation income tax hampers corporate policy by introducing tax considerations into business planning. In particular, this is important with respect to the distribution or retention of profits. Under the present system, there is a strong incentive for the corporation to retain profits and thus reduce taxes payable by the shareholder.

The simplest method of eliminating the influence of taxes on corporate policy might seem to be an outright repeal of the corporation income tax. But this would result in an inequitable situation, since it would leave undistributed corporate income entirely tax free. To obtain equity in the treatment of income from corporations, one might simply repeal the corporation income tax and impose a prohibitive undistributed profits tax, thus forcing the distribution of corporate incomes. But again, this method is not acceptable, since it would involve drastic interference with corporate finances. A solution which would meet both objectives would be to let the corporation assign shares in undistributed profits to individual stockholders which would be counted as personal income. For closely held corporations, these shares could be assigned as in the case of a partnership, and in other cases, information certificates could be used. The disadvantage of this method would be that the individual taxpayer would be asked to pay taxes on income which actually he did not receive, and would thus have to rely on other sources for obtaining the cash needed to pay the tax. Thus, the problem is one of developing a method which will result in an equitable taxation of incomes from corporations, be neutral with respect to corporate policies, and protect the individual against having to pay taxes on income which he has not received in cash form.

The method presented in the N. P. A. memorandum is as follows:  
Repeal the corporation income tax, impose a prohibitive undistributed profits

tax, but permit the corporation to count as distributed income not only regular dividends, but also a new form of scrip much similar to an information certificate. Let the individual count his regular dividends as well as the scrip which he received as a part of his income for purposes of computing his tax, and permit him to use the scrip in payment of his taxes to the extent that they reflect dividend income. The Treasury will then redeem for cash from the issuing corporation the scrip which is received by the Treasury from the taxpayer. The stockholder will return the scrip not used for tax purposes to the corporation in exchange for additional shares of stock. In essence, this procedure amounts to having the corporation distribute its entire income to the individual in the form of cash and stock dividends, with the amount of cash being at least sufficient to pay the taxes on the cash and stock dividends. The more roundabout procedure is needed merely because the corporation does not know the tax rate applicable to the individual shareholder.

This method is completely satisfactory in obtaining equitable treatment of income from corporations. It also protects the taxpayer against having to obtain cash for paying taxes on income not received in cash form. I doubt, however, whether the method succeeds in neutralizing the effects of the tax law upon corporate policies. It seems to imply the compulsory distribution of stock dividends, which affects the capital structure of the corporation and binds its dividend policy. <sup>1/</sup>

An alternative method, applied in Great Britain, provides for the collection from the corporation of an amount of tax reflecting, perhaps, the average rate at which dividends are taxable to the individual stockholders. When dividends are distributed, the corporation would attach to each dollar of dividends a tax receipt for, say, 50 cents (assuming a 50% corporate rate), and the individual income receiver would include the entire \$1.50 in his net income. After computing his tax, he would be permitted to pay 50 cents worth of tax in the form of the tax receipt, and if his taxes are less than that amount, he would obtain a refund. This method would not be quite as effective with respect to tax equity as that proposed by the N. P. A., since the final adjustment of tax would occur only when the corporate income is actually distributed. On the other hand, it would be more neutral with respect to its effects upon the financial structure of the corporation and its dividend policy. Also, this method would appear to be somewhat simpler on the administrative side. Possibly, this method could be applied without a constitutional amendment (relating to the taxation of stock dividends) which would be needed for the first plan.

<sup>1/</sup> It is not quite clear from the memorandum whether it is necessary that the entire scrip not used for tax purposes be converted into additional stock, but for administrative reasons, this would seem to be the case.

The problem here considered is a rather complex technical matter and cannot be dealt with satisfactorily in the form of a brief memorandum. It should be pointed out, however, that under either of the two methods (as well as other methods), the corporation would still be required to file a tax return showing its net income on which the amount of source collection would be based or from which the amounts distributed would have to be deducted to compute undistributed profits. Most of the technical problems relating to the definition of corporate net income would thus stay with us. This is a point which the N. P. A. memorandum seems to overlook completely. I am inclined to think the most important aspects of the corporate tax reform relate to problems connected with the definition of net income, problems which are rather distinct from those here considered. In particular, the treatment of losses in corporate net income is of the most vital importance. I suggest that problems of this kind should also be considered at the New York Conference.

Q. A. W.