There are several candidates for the unwelcome job of procuring the $4 billion of additional revenue requested by the President in his recent Budget Message. The President has simply suggested in gneral terms "that the principal source ***should be additional taxes upon corporate profits," without any further specification of the kind of tax he preferred. The Council of Economic Advisors has discussed briefly in its recent report the relative merits of an excess profits tax as compared with an increase in the regular corporate income tax. These two, the excess profits tax and an increase in the regular corporate income tax, are the leading candidates for the job. Governor Marriner Eccles has recently put forward a third candidate, namely, an undistributed profits tax.

Believing, as I do, that 1949 legislation should be prompt, even though it may be painful, I favor an excess profits tax for immediate enactment and temporary service in the present fiscal emergency. Governor Eccles favors an excess profits tax in preference to an increase in the present corporate rate. But even more he prefers a special tax on corporate earnings which are not paid out as dividends. Mr. Eccles thinks that a 15 percent tax on corporate earnings retained would yield the Government about $2 billion if thdse earnings continue at the 1948 level. Mr. Eccles could quote in support of his proposal a report issued in 1939, after two years' study by a special committee of the National Tax Association, which included some of the outstanding tax experts of the country. The report unanimously stated:

> "By its action in 1939 allowing the undistributed profits tax to lapse, Congress merely retreated from this problem without solving it . . . To exempt (undistributed profits) would not only be grossly unfair to those using other forms of saving but would also provide a broad avenue for evasion . . ."

This statement is more true today than it was ten years ago when it was made. Profits after taxes were $5 billion in 1939, of which $1.2 billion, or 24 percent, were retained. In 1948 profits after taxes were $20.8 billion, of which $13.2 billion, or 63.5 percent, were retained.

It is an undeniable fact that there exists a gross disparity between the taxes imposed on profits distributed as dividends and profits retained by corporations. Profits distributed and profits retained are both subject to a tax of 38 percent (or a somewhat lower tax in the case of small corporations). Profits distributed are not subject to an additional tax in the hands of very low bracket stockholders, but they are subject to individual taxes ranging up to about 82 percent in the hands of high bracket stockholders. This discrimination in favor of undistributed corporate profits has developed out of our system of improvised, haphazard tax legislation to meet emergencies, and has no foundation in reason or fact for its continued existence today.

Economically corporate profits, whether distributed or not, benefit the stockholder. The stockholder has dividends separated from the corporation when corporate profits are distributed. But unseparated undistributed profits increase the value of stock, though the increase in value, for a number of reasons, may not be in the same amount as the accumulated profits. The stockholder may allow the increase to stand as unrealized appreciation in value of stock, which is not taxed as income, or he may realize the profit through the sale of the stock, in which event his gain is subject only to the relatively low capital gains tax. This we need to remember in offset to the frequent complaint that corporations and their stockholders are oppressed by "double" taxation. Except for the special penalty tax imposed for accumulating profits beyond the reasonable needs of the business, whatever "double" taxation there may be reaches only distributed corporate profits; it does not touch undistributed profits unless stock is sold, and then the second tax is at the favorable capital gain rate.

It is far from my intention to suggest that tax avoidance is the only motive for failure to distribute corporate profits. It certainly cannot be fairly said that the 63.5 percent of corporate profits remaining accumulated in 1948 -- a total of $13.2 -- were retained only to prevent the imposition of the personal income tax upon shareholders. To a large degree these profits are retained to finance plant expansion and to add to working capital. Across the board industry now does between 65 and 70 percent of its financing out of retained earnings and depreciation reserves without resort to the outside capital market; retained corporate profits have become the principal available risk capital. On the other hand, a substantial amount of corporate profits remain undistributed, even at the risk of the $27\frac{1}{2}$ to 38 percent penalty tax on unreasonable corporate accumulations, because of a purpose to avoid the high surtax which would be imposed upon individual stockholders if the profits were distributed.

We will do well not to endanger a substantial source of venture capital until we have found an alternative source. However, it is a legitimate question whether the Federal government should subsidize through tax preference one particular form of savings as compared with other ways of obtaining funds for business expansion. A subsidy of this character is perhaps justified if we take the view once announced by former President Herbert Hoover that capital is invested by corporate insiders "to much more reproductive purpose than if it remained in the hands of the idiots who parted with it." It is not justified if we accept the philosophy of many others that corporate management should consult its stockholders about any substantial new investment, or expansion program, or departure from previous channels of activity.

In spite of these arguments in support of the Eccles suggestion, I am reluctantly driven to the conclusion that we should be content for the time being with a moderate profits tax for immediate delivery. On the other hand, for the long run we should be less than content with a stop-gap expedient. We should not allow ourselves to be caught unprepared a second time. What is urgently needed is a thorough exploration of the relationship of personal and corporate income taxation for the purpose of having a program ready when a happier fiscal day makes feasible some reduction in the present tax load. There could be many undesirable effects of a hastily contribed undistributed profits tax which is not sufficiently combined with other desirable changes in the corporate and personal income tax structure. Furthermore, we cannot ignore the necessity of improvements in our capital market institutions if we more generally adopt the theory that management's decisions on questions of corporate expansion should be screened through the capital market. It is better to have no undistributed profits tax for the time being than a tax which may, like that of 1936, discredit for a long time the principle of undistributed profits taxation.

The undistributed profits tax of 1936, with its many vitues, was an attempted, and probably misguided, solution of the whole problem of corporate taxation. Various methods of taxing undistributed profits are now available. One proposal would not necessarily involve any actual distribution of corporate profits; it would provide merely that the corporation retaining its earnings be required to give the stockholder an information certificate so that he could include in his return his appropriate share of undistributed profits. Another proposal provides for a prohibitive tax on undistributed earnings which forces full distribution and taxation to the individual stockholder; the corporation would then be forced to appeal to stockholders for the funds it wished to recoup for expansion. A third type of proposal provides for a compensatory tax roughly equivalent to the tax paid by the average stockholder. Still another type of proposal provides for a tax credit for corporation or stockholder on account of distributed earnings. Finally, various proposals for incentive taxation allow not only for the deduction of dividends, but also for the deduction of that part of corporate profits which have invested in certain specified types of business expansion. This last proposal could be made sufficiently flexible so that the tax would aid in ironing out fluctuations in business investments.

The problem is difficult and complicated. It basically affects investment policies, the financial opportunities of large and small business, and relationships between stockholders and management. It would be highly desirable for the appropriate Congressional Committees and the Executive Departments to tackle this problem of revising the whole corporate tax structure so that it will be geared not only to temporary boom conditions, but also to conditions arising in periods when the maintenance of full employment is the country's major concern.