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Innocents under the Gun. Walter Gordon Merritt is a writing lawyer with a special interest in the law and philosophy of labor relations.

Taxes for Revenue Are Obsolete. Beardsley Ruml, Chairman of the Federal Reserve Bank of New York, is an audacious thinker in the new world of social fiscal policy.

Gaunt Prophecy. John Rustgard's writings are increasingly brief and now almost entirely confined to private circulation. See note at the end of his article.

The Gentlewoman from Illinois. A speech by Jessie Sumner is an uncomfortable event in the House of Representatives.

Why We Can't Buy Full Employment. Bradford B. Smith is one of the brilliant young economists on the conservative side.

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American Affairs is a quarterly journal of thought and opinion. In that character it is obliged to touch many subjects that by nature are controversial. Its pages are intentionally open to views and ideas that provoke debate. By printing them the National Industrial Conference Board does not endorse them; it undertakes only to acknowledge the integrity of the contributors and the good faith of their work.

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Taxes for Revenue Are Obsolete

By Beardsley Ruml

Chairman of the Federal Reserve Bank of New York

Mr. Ruml read this paper before the American Bar Association during the last year of the war. It attracted then less attention than it deserved and is even more timely now, with the tax structure undergoing change for peacetime. His thesis is that given (1) control of a central banking system and (2) an inconvertible currency, a sovereign national government is finally free of money worries and need no longer levy taxes for the purpose of providing itself with revenue. All taxation, therefore, should be regarded from the point of view of social and economic consequences. The paragraph that embodies this idea will be found italicized in the text. Mr. Ruml does not say precisely how in that case the government would pay its own bills. One may assume that it would either shave its expenses out of the proceeds of taxes levied for social and economic ends or print the money it needs. The point may be academic. The latter end of his paper is devoted to an argument against taxing corporation profits. -EDITOR.

THE superior position of public government over private business is nowhere more clearly evident than in government's power to tax business. Business gets its many rule-making powers from public government. Public government sets the limits to the exercise of these rule-making powers of business and protects the freedom of business operations within this area of authority. Taxation is one of the limitations placed by government on the power of business to do what it pleases.

There is nothing reprehensible about this procedure. The business that is taxed is not a creature of flesh and blood, it is not a citizen. It has no voice in how it shall be governed-nor should it. The issues in the taxation of business are not moral issues, but are questions of practical effect: What will get the best results? How should business be taxed so that business will make its greatest contribution to the common good?

It is sometimes instructive when faced with alternatives to ask the underlying question. If we are to understand the problems involved in the taxation of business, we must first ask: "Why does the government need to tax at all?" This seems to be a simple question, but, as is the case with simple ques-

tions, the obvious answer is likely to be a superficial one. The obvious answer is, of course, that taxes provide the revenue which the government needs in order to pay its bills.

It Happened

If we look at the financial history of recent years it is apparent that nations have been able to pay their bills even though their tax revenues fell short of expenses. These countries whose expenses were greater than their receipts from taxes paid their bills by borrowing the necessary money. The borrowing of money, therefore, is an alternative which governments use to supplement the revenues from taxation in order to obtain the necessary means for the payment of their bills.

A government which depends on loans and on the refunding of its loans to get the money it requires for its operations is necessarily dependent on the sources from which the money can be obtained. In the past if a government persisted in borrowing heavily to cover its expenditures, interest rates would get higher and higher, and greater and greater inducements would have to be offered by the government to the lenders. These governments finally found that the only way they could maintain both their sovereign independence and their solvency was to tax heavily enough to meet a substantial part of their financial needs, and to be prepared-if placed under undue pressure-to tax to meet them all.

The necessity for a government to tax in order to maintain both its independence and its solvency is true for state and local governments, but it is not true for a national government. Two changes of the greatest consequence have occurred in the last twenty-five years which have substantially altered the position of the national state with respect to the financing of its current requirements.

The first of these changes is the gaining of vast new experience in the management of central banks.

The second change is the elimination, for domestic purposes, of the convertibility of the currency into gold.

Free of the Money Market

Final freedom from the domestic money market exists for every sovereign national state where there exists an institution which functions in the manner of a modern central bank, and whose currency is

not convertible into gold or into some other commodity.

The United States is a national state which has a central banking system, the Federal Reserve System, and whose currency, for domestic purposes, is not convertible into any commodity. It follows that our Federal Government has final freedom from the money market in meeting its financial requirements. Accordingly, the inevitable social and economic consequences of any and all taxes have now become the prime consideration in the imposition of taxes. In general, it may be said that since all taxes have consequences of a social and economic character, the government should look to these consequences in formulating its tax policy. All federal taxes must meet the test of public policy and practical effect. The public purpose which is served should never be obscured in a tax program under the mask of raising revenue.

What Taxes Are Really For

Federal taxes can be made to serve four principal purposes of a social and economic character. These purposes are:

1. As an instrument of fiscal policy to help stabilize the purchasing power of the dollar;
- Q. To express public policy in the distribution of wealth and of income, as in the case of the progressive income and estate taxes;
3. To express public policy in subsidizing or in penalizing various industries and economic groups;
4. To isolate and assess directly the costs of certain national benefits, such as highways and social security.

In the recent past, we have used our federal tax program consciously for each of these purposes. In serving these purposes, the tax program is a means to an end. The purposes themselves are matters of basic national policy which should be established, in the first instance, independently of any national tax program.

Among the policy questions with which we have to deal are these:

Do we want a dollar with reasonably stable purchasing power over the years?

Do we want greater equality of wealth and of income than would result from economic forces working alone?

Do we want to subsidize certain industries and certain economic groups?

Do we want the beneficiaries of certain federal activities to be aware of what they cost?

These questions are not tax questions; they are questions as to the kind of country we want and the kind of life we want to lead. The tax program should be a means to an agreed end. The tax program should be devised as an instrument, and it should be judged by how well it serves its purpose.

By all odds, the most important single purpose to be served by the imposition of federal taxes is the

maintenance of a dollar which has stable purchasing power over the years. Sometimes this purpose is stated as "the avoidance of inflation"; and without the use of federal taxation all other means of stabilization, such as monetary policy and price controls and subsidies, are unavailing. All other means, in any case, must be integrated with federal tax policy if we are to have tomorrow a dollar which has a value near to what it has today.

The war has taught the government, and the government has taught the people, that federal taxation has much to do with inflation and deflation" with the prices which have to be paid for the things that are bought and sold. If federal taxes are insufficient or of the wrong kind, the purchasing power in the hands of the public is likely to be greater than the output of goods and services with which this purchasing demand can be satisfied. If the demand becomes too great, the result will be a rise in prices, and there will be no proportionate increase in the quantity of things for sale. This will mean that the dollar is worth less than it was before that is inflation. On the other hand, if federal taxes are too heavy or are of the wrong kind, effective purchasing power in the hands of the public will be insufficient to take from the producers of goods and services all the things these producers would like to make. This will mean widespread unemployment.

The dollars the government spends become purchasing power in the hands of the people who have received them. The dollars the government takes by taxes cannot be spent by the people, and, therefore, these dollars can no longer be used to acquire the things which are available for sale. Taxation is, therefore, an instrument of the first importance in the administration of any fiscal and monetary policy.

To Distribute the Wealth

The second principal purpose of federal taxes is to attain more equality of wealth and of income than would result from economic forces working alone. The taxes which are effective for this purpose are the progressive individual income tax, the progressive estate tax, and the gift tax. What these taxes should be depends on public policy with respect to the distribution of wealth and of income. It is important, here, to note that the estate and gift taxes have little or no significance, as tax measures, for stabilizing the value of the dollar. Their purpose is the social purpose of preventing what otherwise would be high concentration of wealth and income at a few points, as a result of investment and reinvestment of income not expended in meeting day-to-day consumption requirements. These taxes should be defended and attacked in terms of their effects on the character of American life, not as revenue measures.

The third reason for federal taxes is to provide a subsidy for some industrial or economic interest. The

most conspicuous example of these taxes is the tariffs on imports. Originally, taxes of this type were imposed to serve a double purpose since, a century and a half ago, the national government required revenues in order to pay its bills. Today, tariffs on imports are no longer needed for revenue. These taxes are nothing more than devices to provide subsidies to selected industries; their social purpose is to provide a price floor above which a domestic industry can compete with goods which can be produced abroad and sold in this country more cheaply except for the tariff protection. The subsidy is paid, not at the port of entry where the imported goods are taxed, but in the higher price level for all goods of the same type produced and sold at home.

The fourth purpose served by federal taxes is to assess, directly and visibly, the costs of certain benefits. Such taxation is highly desirable in order to limit the benefits to amounts which the people who benefit are willing to pay. The most conspicuous examples of such measures are the social security benefits, old-age and unemployment insurance. The social purposes of giving such benefits and of assessing specific taxes to meet the costs are obvious. Unfortunately and unnecessarily, in both cases, the programs have involved staggering deflationary consequences as a result of the excess of current receipts over current disbursements.

The Bad Tax

The federal tax on corporation profits is the tax which is most important in its effect on business operations. There are other taxes which are of great concern to special classes of business. There are many problems of state and local taxation of business which become extremely urgent, particularly when a corporation has no profits at all. However, we shall confine our discussion to the federal corporation income tax, since it is in this way that business is principally taxed. We shall also confine our considerations to the problems of ordinary peacetime taxation since, during wartime, many tax measures, such as the excess-profits tax, have a special justification.

Taxes on corporation profits have three principal consequences—all of them bad. Briefly, the three bad effects of the corporation income tax are:

1. The money which is taken from the corporation in taxes must come in one of three ways. It must come from the people, in the higher prices they pay for the things they buy; from the corporation's own employees in wages that are lower than they otherwise would be; or from the corporation's stockholders, in lower rate of return on their investment. No matter from which source it comes, or in what proportion, this tax is harmful to production, to purchasing power, and to investment.

- Q. The tax on corporation profits is a distorting factor in managerial judgment, a factor which is prejudicial to clear engineering and economic analysis of what will

be best for the production and distribution of things for use. And, the larger the tax, the greater the distortion.

3. The corporation income tax is the cause of double taxation. The individual taxpayer is taxed once when his profit is earned by the corporation, and once again when he receives the profit as a dividend. This double taxation makes it more difficult to get people to invest their savings in business than if the profits of business were only taxed once. Furthermore, stockholders with small incomes bear as heavy a burden under the corporation income tax as do stockholders with large incomes.

Analysis

Let us examine these three bad effects of the tax on corporation profits more closely. The first effect we observed was that the corporation income tax results in either higher prices, lower wages, reduced return on investment, or all three in combination. When the corporation income tax was first imposed it may have been believed by some that an impersonal levy could be placed on the profits of a soulless corporation, a levy which would be neither a sales tax, a tax on wages, or a double tax on the stockholder. Obviously, this is impossible in any real sense. A corporation is nothing but a method of doing business which is embodied in words inscribed on a piece of paper. The tax must be paid by one or more of the people who are parties at interest in the business, either as customer, as employee, or as stockholder.

It is impossible to know exactly who pays how much of the tax on corporation profits. The stockholder pays some of it, to the extent that the return on his investment is less than it would be if there were no tax. But, it is equally certain that the stockholder does not pay all of the tax on corporate income—indeed, he may pay very little of it. After a period of time, the corporation income tax is figured as one of the costs of production and it gets passed on in higher prices charged for the company's goods and services, and in lower wages, including conditions of work which are inferior to what they otherwise might be.

The reasons why the corporation income tax is passed on, in some measure, must be clearly understood. In the operations of a company, the management of the business, directed by the profit motive, keeps its eyes on what is left over as profit for the stockholders. Since the corporation must pay its federal income taxes before it can pay dividends, the taxes are thought of—the same as any other uncontrollable expense—as an outlay to be covered by higher prices or lower costs, of which the principal cost is wages. Since all competition in the same line of business is thinking the same way, prices and costs will tend to stabilize at a point which will produce a profit, after taxes, sufficient to give the industry access to new capital at a reasonable price. When this finally happens, as it must if the industry

is to hold its own, the federal income tax on corporations will have been largely absorbed in higher prices and in lower wages. The effect of the corporation income tax is, therefore, to raise prices blindly and to lower wages by an undeterminable amount. Both tendencies are in the wrong direction and are harmful to the public welfare.

Where Would the Money Go?

Suppose the corporation income tax were removed, where would the money go that is now paid in taxes? That depends. If the industry is highly competitive, as is the case with retailing, a large share would go in lower prices, and a smaller share would go in higher wages and in higher yield on savings invested in the industry. If labor in the industry is strongly organized, as in the railroad, steel and automotive industries, the share going in higher wages would tend to increase. If the industry is neither competitive nor organized nor regulated-of which industries there are very few—a large share would go to the stockholders. In so far as the elimination of the present corporation income tax would result in lower prices, it would raise the standard of living for everyone.

The second bad effect of the corporation income tax is that it is a distorting factor in management judgment, entering into every decision, and causing actions to be taken which would not have been taken on business grounds alone. The tax consequences of every important commitment have to be appraised. Sometimes, some action which ought to be taken cannot be taken because the tax results make the transaction valueless, or worse. Sometimes, apparently senseless actions are fully warranted because of tax benefits. The results of this tax thinking is to destroy the integrity of business judgment, and to set up a business structure and tradition which does not hang together in terms of the compulsion of inner economic or engineering efficiency.

Premium on Debt

The most conspicuous illustration of the bad effect of tax consideration on business judgment is seen in the preferred position that debt financing has over equity financing. This preferred position is due to the fact that interest and rents, paid on capital used in a business, are deductible as expense; whereas dividends paid are not. The result weighs the scales always in favor of debt financing, since no income tax is paid on the deductible costs of this form of capital. This tendency goes on, although it is universally agreed that business and the country generally would be in a stronger position if a much larger proportion of all investment were in common stocks and equities, and a smaller proportion in mortgages and bonds.

It must be conceded that, in many cases, a high corporation income tax induces management to

make expenditures which prudent judgment would avoid. This is particularly true if a long-term benefit may result, a benefit which cannot or need not be capitalized. The long-term expense is shared involuntarily by government with business, and, under these circumstances, a long chance is often well worth taking. Scientific research and institutional advertising are favorite vehicles for the use of these cheap dollars. Since these expenses reduce profits they reduce taxes at the same time; and the cost to the business is only the margin of the expenditure that would have remained after the taxes had been paid—the government pays the rest. Admitting that a certain amount of venturesome expenditure does result from this tax inducement, it is an unhealthy form of unregulated subsidy which, in the end, will soften the fibre of management and will result in excess timidity when the risk must be carried by the business alone.

The third unfortunate consequence of the corporation income tax is that the same earnings are taxed twice, once when they are earned and once when they are distributed. This double taxation causes the original profit margin to carry a tremendous burden of tax, making it difficult to justify equity investment in a new and growing business. It also works contrary to the principles of the progressive income tax, since the small stockholder with a small income, pays the same rate of corporation tax on his share of the earnings as does the stockholder whose total income falls in the highest brackets. This defect of double taxation is serious, both as it affects equity in the total tax structure, and as a handicap to the investment of savings in business.

Shortly, an Evil

Any one of these three bad effects of the corporation income tax would be enough to put it severely on the defensive. The three effects, taken together, make an overwhelming case against this tax. The corporation income tax is an evil tax and it should be abolished.

The corporation income tax cannot be abolished until some method is found to keep the corporate form from being used as a refuge from the individual income tax and as a means of accumulating unneeded, uninvested surpluses. Some way must be devised whereby the corporation earnings, which inure to the individual stockholders, are adequately taxed as income of these individuals.

The weaknesses and dangers of the corporation income tax have been known for years, and an ill-fated attempt to abolish it was made in 1936 in a proposed undistributed profits tax. This tax, as it was imposed by Congress, had four weaknesses which soon drove it from the books. First, the income tax on corporations was not eliminated in the final legislation, but the undistributed profits tax

was added on top of it. Second, it was never made absolutely clear, by regulation or by statute, just what form of distributed capitalization of withheld and reinvested earnings would be taxable to the stockholders and not to the corporation. Third, the Securities and Exchange Commission did not set forth special and simple regulations covering securities issued to capitalize withheld earnings. Fourth, the earnings of a corporation were frozen to a particular fiscal year, with none of the flexibility of the carry-forward, carry-back provisions of the present law.

Granted that the corporation income tax must go, it will not be easy to devise protective measures which will be entirely satisfactory. The difficulties are not merely difficulties of technique and of avoiding the pitfalls of a perfect solution impossible to administer, but are questions of principle that raise

issues as to the proper locus of power over new capital investment.

Can the government afford to give up the corporation income tax? This really is not the question. The question is this: Is it a favorable way of assessing taxes on the people-on the consumer, the workers and investors-who after all are the only real taxpayers? It is clear from any point of view that the effects of the corporation income tax are bad effects. The public purposes to be served by taxation are not thereby well served. The tax is uncertain in its effect with respect to the stabilization of the dollar, and it is inequitable as part of a progressive levy on individual income. It tends to raise the prices of goods and services. It tends to keep wages lower than they otherwise might be. It reduces the yield on investment and obstructs the flow of savings into business enterprise.