BUSINESS TAXES AND INVESTMENT

A Thesis

by

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Introduction

World War II has come to a close, and the leading democracies of the world have started to reconvert towards a peace time economy. Many objectives have been put forward, and are in the process of accomplishment, but a Tax Policy which will effectively contribute towards these objectives is still lacking. Although taxation, and particularly business taxation, as a part of the Fiscal Policy program, has been the subject of much discussion, and several proposals have been advanced, much revision will have to be undertaken to incorporate the discussions and proposals in the Full Employment Peace Time Economy towards which we are striving.

An effective Postwar Tax Policy must be found, and if this paper makes some contribution towards this goal its writing has been warranted; if not it is hoped that future attempts on the subject may benefit from its mistakes.

The writer wishes to express his great obligation to Dr. B.H. Higgins without whose kind guidance and helpful suggestions this paper could not have been written. My thanks are also due to Miss Beatrice V. Simon, and the librarians of Purvis Hall and Redpath Libraries for their assistance in gathering material.

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CHAPTER I

Objective: Optimum Private Investment

While two wars were raging furiously in opposite corners of the earth, and when the very existence of what has now become the United Nations was threatened, at times voices were heard advocating measures for the future safeguarding of the domestic life of these threatened nations. Although military operations were occupying the minds of these peoples, the problem of reconstruction was forcing its way into the picture as one of national importance.

The appearance of prosperity, due to the enormous governmental war expenditures resulting in an accumulation of purchasing power, particularly in the hands of the working classes who had been the group hit hardest during the depression of the 1930's, started a wave of protest against the recurrence of such depressions. To-day everyone shares the opinion that such depressions must be prevented. People everywhere are united in the thought that we must solve the problem of depressions and its appendage of unemployment.

The governments of the United Nations have established certain goals which they intend to achieve, and in broad outlines the following representative phrases indicate the methods which they want to use in tackling the various problems:

United Nations Organization: "With a view to the creation of conditions of stability and well-being which are necessary for

peaceful and friendly relations among nations based on respect for the principle of equal rights and self-determination of peoples, the United Nations should promote:

a) Higher standards of living, full employment and conditions of economic and social progress and development;

b) solutions of international economic, social, health, and related problems, and international cultural and educational co-operation;

c) universal respect for, and observance of human rights and fundamental freedoms for all without distinction as to race, sex, language, or religion." [1]

International Labour Office: "It should be the responsibility of Governments to take all steps within their power, in collaboration with workers' and employers' organizations and industry generally, to establish such economic and financial (including fiscal) conditions as will facilitate the absorption into useful employment, at the highest practicable levels of remuneration, of all members of the population of working age, who are able to work and willing to accept such employment." [2]

In addition the individual governments of some of the leading countries have expressed similar views:

The United States of America: "To establish a national policy and program for assuring continuing employment and full production in a free competitive economy, through the concerted

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1) Wartime Information Board: "Text of the Charter of the United Nations including the Statute of the International Court of Justice", Chapter IX, Article 55, Ottawa, 1945.
2) International Labour Office: "International Labour Conference Provisional Record", 27th Session, Paris, 1945, No. 26, p. 15, par. 2 (1).

efforts of industry, agriculture, labor, state and local governments, and the Federal Government."[1]

The United Kingdom: "The government seeks to achieve both work for all and a progressive increase in the economic efficiency of the nation, as joint elements in a growing national power to produce, to earn, and to enjoy the fruits of increased well-being".[2]

Canada: "The government stated unequivocally its adoption of a high and stable level of employment and income, and thereby higher standards of living, as a major aim of Government policy. It has been made clear that, if it is to be achieved, the endeavour to achieve it must pervade all government economic policy. It must be wholeheartedly accepted by all economic groups and organizations as a great national objective, transcending in importance all sectional and group interests".[3]

Australia: "Full Employment is a fundamental aim of the Commonwealth Government. The Government believes that the people of Australia will demand and are entitled to expect Full Employment, and that for this purpose it will be able to count on the co-operation of servicemen's associations, trade-unions, employers' associations, and other groups".[4]

These representative statements by the governments of

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1) 79th Congress, 1st Session, House of Representatives: "Full Employment Act of 1945", S 380, Washington, 1945. p. 1
2) The Minister of Reconstruction: "Employment Policy", British Government, London 1944, p. 28.
3) The Minister of Reconstruction: "Employment and Income with special reference to the Initial Period of Reconstruction, Ottawa 1945, p. 23.
4) The Parliament of the Commonwealth of Australia: "Full Employment in Australia", Canberra 1945, p. 1.

the most highly developed nations on earth demand and strive for a postwar world in which mankind, particularly their own peoples, may live in an atmosphere of full employment and optimum production, and where they may enjoy the benefits of such a world in their leisure time.

It is intended to create these conditions within a framework closely ressembling the present political and economic organization of these nations. Nevertheless we must realize that the world is changing, and that it will continue to change. Any policies advocated must take this fact into account. Policy recommendations can only be applied if they can be integrated into the system. Without such an attitude any approach is worthless.

During the years of war the above mentioned representative nations, which we may take as the most suitable examples to examine an economic problem of this sort, lived in economies of full employment. It is assumed that they will successfully travel through the period of transition in which their war economies will change over to peacetime production, that at the end of this transition period, and at the beginning of the real postwar period they will have returned again to a full employment equilibrium. It is from that time on that our postwar world will need farsighted planning to maintain the economy at the desired level.

Under conditions of constant prices and wages and with a mobile labour supply, employment will be hampered if there is insufficient expenditure on the goods and services which might be produced. It is simple arithmetic, and a fact

recognized by everyone though often obscured by other considerations, that if more money is spent on goods and services, then more money will be paid out in wages, and more people will be employed. Our primary task therefore, in a policy of maintaining general employment, is to maintain an outlay, private and public, which will suffice to achieve and maintain this goal.

Until recently taxes were levied for the sole purpose of collecting revenue for the government, but today taxes for revenue purposes only are less important than they used to be. Taxes, as any other factor, besides having the useful purpose of providing revenue, must first of all perform a useful task of primary importance in a world in which we want to live in peace and enjoy a high standard of living.[1] To provide full employment and a high standard of living is the primary objective of taxes, together with the prevention of inflation. In this sense the problem of maintaining sufficiently large expenditures directly concerns the problem of taxation as taxes or their absence may prevent or encourage expenditures. For this reason the effects of taxes in our economy must be studied more intensely, and it must be pointed out that the consideration of revenue implications must make way for a somewhat broader outlook on the problem. It is not intended to create an impression that deficit finance should become the accepted rule in our economy, but for purposes of analysis it may be wise to consider revenue collections as a secondary factor.

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1) Cf.: A.P. Lerner: "The Economics of Control", New York 1944, pp. 302-322.

In a money economy the full utilization of resources depends upon a high level of money expenditures, and to the extent that private enterprise does not create these expenditures government outlay financed by taxation or borrowing, must fill the gap caused by a lack of expenditures. Increases and reductions of these expenditures should preferably result in a change of the velocity of circulation of money, and affect the quantity of money as little as possible. The danger of inflation or deflation is likely to be less prevalent when the velocity of circulation is changed than when the quantity of money is manipulated and the velocity of circulation remains constant. We must note, however, that this should apply only as long as the limited quantity of money does not restrict any expenditures.[1] The desired level of expenditures is the outlay which is sufficient to maintain full employment, and enables the population to enjoy a satisfactory standard of living. It is a foregone conclusion that this level of outlay must be achieved by a certain amount of trial and error, but despite this uncertainty it should be possible to indicate a certain trend which could guide us.

Private or Free Enterprise will provide the Private Investment. The term Private Enterprise is used in the sense that it is the system where decisions are made by private individuals. Matters of consumption and production, of invest-

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1) In (M & M') V where M = Currency, M' = Bank Money (Credit) and V = Velocity of Circulation, a low (M & M') and a high V are preferable to a high (M & M') and a low V, as long as expenditures are not restricted because of a limited money supply.

ment and saving, are decided upon by private individuals, and these individuals will have free choice within the sphere of the economy. The area for private enterprise, as part of the national economy, should extend to the limit at which the ability of private individuals tends to serve the common good better than public enterprise. Beyond this limit government enterprise must serve that good.

Here we are particularly concerned with the creation of Private Investment. One should inquire which road we must travel to obtain the amount of private investment which is desirable for the maintenance of full employment. Private investment is motivated by profits, which subject will be more closely investigated in Chapter III. We may say that an increase in the rate of profit will induce additional investment.

In order to obtain an optimum amount of private investment, it is essential that private enterprise be enabled to examine all the possible channels of investment to the utmost, to ascertain and develop those fields which offer the best opportunities. Restrictions to private investment expenditure must be removed, but it does not mean that government competition should not be allowed. Among the restrictions tax barriers may be among the foremost; they also include patent laws, cartels, monopolies, etc., etc. This discussion will concern itself with business taxes, their purpose and their task, with particular emphasis on their relation to private investment. Neverthe-

less one must advocate the study and revision of any factor which blocks the road to optimum private investment. We must give private investment every chance, as we must maintain an adequate outlay at all times. If this opportunity is artificially obstructed then, as has been pointed out, public outlay must complete the gap. The greater the private outlay, the smaller the public outlay, and vice versa. In order to obtain an optimum amount of investment, profits must be at an optimum also. This optimum rate of profit will be the rate which will encourage an optimum rate of private investment, and the optimum rate of investment in turn will be the rate that will absorb all savings at full employment while the propensity to consume is at an optimum.

In times past booms in a purely private enterprise economy have never been able to perpetuate themselves. In booms we usually exploited to the full all available new developments which the progress of science and technology together with the growth of population had up to that point made economically possible, but available outlets for capital expansion had always become temporarily exhausted. It meant that profits had reached a level where additional investment would not yield a satisfactory return, and consequently the fuel supply for the economic machine had temporarily become exhausted. In a free enterprise society, we undoubtedly will not be able to prevent certain fluctuations which express themselves in economic cycles. It may not even be necessary to prevent these fluctuations as long

as they amount to slight deviations from the full employment trend. The crucial fact is that we safeguard against these fluctuations attaining too great a force which would carry the economy away from the full employment trend. The maintenance of sufficient expenditures in those fields which will contribute to the maintenance of full employment is a primary requisite of a sound economic structure. A farsighted investment policy in turn is one of the components of the expenditure program, whereas an incentive tax policy may be one of the pillars of this investment foundation.

CHAPTER II

The Problem of Investment Decisions

"An act of individual saving means - so to speak - a decision not to have dinner to-day. But it does not necessitate a decision to have dinner, or to buy a pair of boots a week hence or a year hence, or to consume any specified thing at any specified date. Thus it depresses the business of preparing to-day's dinner without stimulating the business of making ready for some future act of consumption. It is not a substitution of future consumption-demand for present consumption-demand, - it is a net diminution of such demand.....Since the expectation of consumption is the only raison d'être of employment, there should be nothing paradoxical in the conclusion that a diminished propensity to consume has cet.par. a depressing effect on employment."[1] The above quotation from Lord Keynes will have to be borne in mind in the discussion which follows. It impresses on us the necessity of continued investment, and the importance of a high propensity to consume. It also shows us that the amount of current investments, with reference to their income-generating effect, have to balance the deficiency caused by savings. Consequently our first task will be to find out where and how investment decisions are made. Then only will we be able to judge how inducements for investments can be created.

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1) J.M. Keynes: "The General Theory of Employment, Interest and Money," London 1942, p. 211.

Business functions for the purpose of attaining a profit, and provides an opportunity for the individuals comprising the community to invest their savings, i.e. that part of their incomes which is not used for the consumption of goods and services. This opportunity to invest, while generally promising a return, is accompanied by risk; not only the risk that the business itself may not prosper, but also the larger risks that will continue to exist in a world run by human beings. The above described form of investing is undertaken by individuals wanting to invest their savings, but in present times many of these individuals usually invest their savings on the many security markets, and then the only transaction that really occurs is the exchange of cash by one investor for the security investment of another investor who wants to realize on his investment. Consequently the purchase and sale of securities in the security markets does not directly put savings into business or take them out of business. Only when new corporate issues are distributed through the security markets will these savings find their way into actual business. Then the security markets perform the service of distribution, of bringing the place for real investment to the attention of the people who have savings to invest, and this has resulted in the present day prevailing separation of ownership and management. Consequently, although the citizens' savings may be used, management decides when and where this money is to be expended, and how much of it.

This situation did not always exist, because through the years the methods of financing business have changed considerably. At the beginning of this century small individual investors provided most of the investment and venture capital, and this was the generally accepted way of doing business. To-day conditions are different. The rise of the great modern corporation has profoundly affected both the channels through which savings flow, and the character of investment activity. Innovation, entrepreneurship, and real investment nowadays are largely carried on by corporations. Consequently savings in the form of depreciation and depletion allowances and of corporate surpluses are made available for the exploitation and development of new projects. In fact the method of financing capital expenditures by internal corporate resources including: 1) depreciation and depletion allowances, and 2) retained corporate earnings, is so well recognized by business executives that the overwhelming portion of corporate investment has often been financed by this method. In the United States during the period 1925-1929 these sources provided $7,889 millions for capital outlays on plant and equipment of non-financial enterprises, whereas productive issues from the capital market contributed $1,738 millions.[1] Despite the small portion of corporate

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1) These figures cited by Prof. Hansen cover a period of great prosperity and high profits. George Terborgh in "The Bogey of Economic Maturity", (Chicago 1945, p. 146), arrives at the following percentage figures to show a tendency towards a decline in internal financing by corporations. For the period 1923-1929 the savings of non-financial corporations averaged 73% of their net capital requirements compared with 54% for the period 1936-1941, a somewhat less profitable period from the point of view of business. It indicates that corporate internal financing fluctuates with profits, and supports the view that this source of corporate investment funds remains a very important one.

investment capital supplied through productive issues from the capital market, the public generally has not appreciated the influences of internal corporate investment financing on the economy as a whole. This method of investment financing is the more true when industrial corporations are concerned, and somewhat less with railroads, public utilities, and real estate corporations. The great industrial concerns are very largely self-sufficient with respect to their capital requirements.[1]

This change in the demand and supply of capital funds resulted in a tendency away from the absorption of savings into equities, and toward the use of fixed debt obligations. The resulting increasing ratio of debt to wealth creates a highly dangerous rigidity, and intensifies economic instability. It means that control of business remains unchanged, and under these circumstances it is difficult for new investors to exercise control over the management of existing corporations as the equity capital is tightly held. If expansion is desired the corporation has a first call on its internal reserves, and secondly on fixed debt obligations which it may issue. In this manner management does not need to change the equity capital, and consequently retains control of the corporation. Nevertheless reinvestment of corporate earnings is an important and desirable source of equity capital. It is unfortunate though, that during times of diminishing economic activity, corporations tend to retain a large part of their income in idle reserves.

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1) Cf.: Alvin H. Hansen: "Fiscal Policy and Business Cycles", New York 1941, pp. 384-385.

As mentioned above, undistributed corporate earnings form a very important, if not the most important, part of capital available for investment purposes. When discussing the investment tendencies of corporations we therefore will be considering a most important influence on private investment expenditures. It is clear that corporate earnings fluctuate, and with them changes the amount of investment funds supplied through internal financing by corporations. Consequently in boom times, corporations are likely to supply a relatively larger portion of corporate investment funds than they will supply in depressions when earnings are low, and they will be forced to call on the capital market to provide a larger percentage of investment funds necessary to replace expended capital investments and for the creation of new investments assets. In any case it cannot be denied that corporations will first call upon their own savings, as they are likely to invest these funds with less hesitation than they would invest borrowed funds which may be subject to withdrawal or will have to be repaid at some future date. When management considers the investment of reserve or surplus funds, the actual investment opportunity will be the deciding issue. The prevailing interest rate may be of some consequence as a capitalization factor,[1] but in the case of reserve and surplus funds the interest rate will be of lesser importance than with loan funds, as the reinvestment of undistributed earnings does not entail the same pressure

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1) Cf.: Friedrich A. Lutz: "The Interest Rate and Investment in a Dynamic Economy", The American Economic Review, December 1945, pp. 814-815.

from owners of the funds for a return as is the case when new securities are issued. When reserve or surplus funds are invested, the entire risk, as well as the entire return, will be borne by the equity capital. Where funds supplied by loans, bond and debenture issues, and certain preferred stock issues are invested, the equity stocks bear almost the entire risk, but the income of the corporation, and consequently of the equity stockholders, is reduced by the interest or dividend charges. When new equity stock is issued, these funds will share in the risk, but they also will participate in the profits. In companies where surplus or reserve funds are available for investment, the investor and lender are represented by one body, the management of the corporation, whereas if investment funds will have to be procured from outside sources the investor and lender will be separate personages. Consequently under the latter circumstances not only the investor must be convinced that his prospective investment is attractive, but the lender supplying the funds to the investor must also be convinced that the investor will be able to fulfil his commitments with regard to the loan. Surplus or reserve funds therefore, will leave greater freedom to corporate executives to embark on new projects, than is the case when funds have to be obtained from outside sources, and they constitute the source of eventual investment funds upon which management is most likely to call in order to create investment assets. This source of funds consequently encourages investment to a larger extent than other sources supplying capital funds. Naturally a corporation

must have had some time of operation before a significant surplus or reserve has been built up. In some fields this time of prior operation may be short, in other branches of business it may be long, but the fact remains that some time of operation is essential. Other methods of investment finance must therefore, be available to assist those enterprises which cannot dispose of corporate savings.

It is true that existing businesses supply a large part of original venture capital, but a considerable portion of venture capital still must be supplied by individuals from their own savings. These savings, from the point of view of the individual are not greatly affected by the prevailing interest rate, and consequently form an easier source of investment funds for supplying venture capital than borrowed funds. Besides, if part or all of the funds should be lost, individual savings, invested by the same individual, are a direct claim against himself alone, and do not affect other parties, whereas borrowed funds, if lost, always form a final liability on the entrepreneur, and may become a source of misery for many years ahead. We must note however, that not all people are willing to supply individual savings for venture capital. In the first place the large majority of any population is not able to save very much, and the small portion of their income which they manage to save they are generally not willing to risk; it is usually saved in the form of institutional savings, such as life insurance, saving deposit accounts, etc. This group of individuals will use its savings mainly to guarantee a certain standard of living

for the rest of their lives. They are not in a position to risk a certain part of their savings at the prospect of greater wealth, because a loss on the undertaking may result in a cut of future income which would drop them into dire poverty. The group that is able to supply venture capital are those individuals whose income and fortune allow them to risk their savings with the knowledge that even if they should not succeed, the likelihood of being able to continue on a fairly decent standard of living is rather certain. This group probably includes the upper-middle class, as well as the upper-classes considered from an income point of view. It is therefore, apparent that any cut in the incomes of these groups will affect savings, and particularly savings which may be destined to become venture capital, and a cut in income of the lower income classes will result in an immediate or future cut in consumption. In order to encourage savings which may become venture capital, two roads lie open to us. One is to cut incomes as little as possible, and the second is to guarantee a minimum standard of living to the entire population so that lower income groups will be enabled to lead their savings into riskier channels.

It must be noted that the decision to save is not the crucial problem; it is the decision to invest that counts. Consequently those savings which are likely to be the first to be ear-marked for actual investments, must be encouraged. From the above we may conclude that corporate savings, as well as those individual savings which may not be necessary to guarantee a certain standard of living, are the most likely

choice for this category. Other sources of investment funds usually concern at least two parties, the borrower and the lender, both of which must be sufficiently attracted to undertake the transaction. The borrower consequently incurs additional costs, costs which practically speaking are not calculated when the borrower and lender are one and the same person, as is the case with corporate savings, and individual savings invested by the individual.

Investments are made to realize a return, and insofar as the inducement to the individual to save depends on the future return which he expects, we may say that the inducement to corporate management to invest depends on the future return they expect, and we must emphasize the term future or prospective return as it is not merely on the current return. When reaching the stage of discussing the prospective yield of an investment, we automatically tread on uncertain grounds. This uncertain feeling is expressed in the risk we take when making the investment. To surmount this, management is likely to assemble facts on a prospective investment; if they have made similar investments before, they may rely on past experiences; if on the other hand they are conquering new territories they may make estimates, and act according to their judgment of the trend of prices, wages, volume of business, and the other varied items which govern the receipts and expenditures of a business undertaking. In these cases they assume the role of business forecaster as far as the particular investment is concerned, and in addition this business planning must include a certain judgment as far

as it is affected by economic conditions as a whole; that is, by circumstances outside of the business itself. This forecasting is necessary to success, because every intelligent businessman recognizes that success or failure depends on circumstances beyond his own control, as well as on those which he does control; it means a purely objective study of economic trends, trends which the businessman cannot personally control, but to which he may adapt his policy, and if he can estimate them accurately his success should be so much greater.

The entire field which the businessman must cover with his forecast contains the risk that the forecast may not come true. It is rather usual, for example, that the facts of the existing situation enter, in a sense disproportionally, into the formation of our long-term expectation. The usual practice is to take the existing situation and project it into the future, modifying it only to the extent that we have more or less definite reasons for expecting a change. The fact that we pay disproportionate attention to the present when forming our expectations, stems out of the reasoning that it would be foolish to attach great weight to matters which are very uncertain. We are often guided by facts which are less relevant to the issue than other facts about which our knowledge is vague, and of which we feel less confident. Although our decisions are based on the state of long-term expectation, they may not be based on the most probable forecast we could make, as it also depends on the confidence with which we make this forecast. The attitude with which we look

at our own forecast in itself influences the economy as a whole; we may say that the link between the cause - high current profits - and the effect - increased employment - is plausibly provided by high expected profits. This is the more significant as we know that in our uncertain world nobody can be sure of earning in a given future year from a given investment or industrial venture, a perfectly fixed and exact amount. We suppose that the world is made of factors, which under the same circumstances, always behave in the same way. By combining this forecasting of the future with the conviction of our own decisions, we reach the moment at which the decision to invest is made. Whether this decision will be positive or negative in the first place depends on the forecast, and this forecast, if considered positive, again will be exposed to the scrutiny of the second factor, the confidence related to this forecast.

Since there is a need to create conditions which are favourable for investment decisions, it will be our task to consider the problem from two angles, 1) we will have to make conditions favourable for positive forecasting to take place, and 2) it will be necessary that conditions are sufficiently attractive in order to warrant the confidence which is required to turn the positive forecast into a positive investment decision.

CHAPTER III

Profit and Risk

The decision to invest constitutes the crucial link between the undistributed earnings of a firm, as well as savings of individuals, and the flow of funds into actual investment. Emphasis must therefore, be shifted to the discussion of the effects of taxation on the investment of undistributed profits and individual savings, particularly with regard to the various degrees of risk involved in investments. Our goal is not simply to obtain sufficient funds for investment; these funds must also find their way into actual investment before their task is accomplished.

This paper is mainly concerned with business taxes, and therefore, we will pay attention primarily to the investment of undistributed earnings. It has been established that the bulk of business investments is financed out of undistributed surpluses and reserves when these are available. Consequently we will be considering the most important available source of investment funds. We may emphasize here that "investment" constitutes investment in tangible assets, and does not include monetary transactions which really form an act of saving. It is the utilization of funds for the exploitation of resources and the production of wealth with which we are concerned. These investments will be undertaken by business, and in this paper the terms business, firm, investor, company, or corporation will have the same meaning, whether they are incorporated by law or not. These words will be

used in the sense of business or firm, and one individual in business for himself will be considered in the same light as a company or partnership, incorporated by law and having many stockholders or partners. We are assuming that any business firm in the economy is incorporated by law as a limited liability company, and that the ownership of the business is represented by capital stock in the form of common shares. In this way we will be able to treat each business in a uniform manner, and we will not have to discriminate among various forms of business organization.

We had come to the conclusion that investment decisions depend primarily on the forecast of, and confidence in, the prospective investment. Forecasts must be encouraging to result in investment decisions. This would mean that the probability of profits must outweigh the chance of loss when speaking of the average investor. When taxes are imposed on profits resulting from a successful investment, it is evident that these taxes reduce the return, and decrease the inducement to invest. Little attention has been paid to the manner in which taxes influence the risk factor. It is our intention to go into this latter question.

The risk factor in investment policy has become of the utmost importance because the failure to consider risk in the tax policy of the government, established the Tax Collector as a partner in the profits, but left the investor to carry all the losses. Consequently profits,

whether they arose out of returns on investments, or out of capital appreciation, had to be shared with the tax collecting authority, whereas the risk had to be borne entirely by the corporation. Risk in our discussion will be a very broad abstract concept which may show its effect in physical form, and will include the chance of loss, the probability of greater loss, the probability of greater gain, the probability of a smaller than the expected return, the consideration of personal wealth, the concept of liquidity,[1] for that matter any other factor or combination of factors which may cause a loss of whatever nature directly or indirectly connected with the investment transaction.

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1) The inclusion of liquidity may be explained as follows: Lord Keynes stated that the individual's, and that also applies to a firm's, desire to hold cash depends on several motives, the Income (and Business), the Precautionary, and the Speculative Motives. Domar and Musgrave go into this question in relation to their probability distribution schedule and positive and negative returns, and as their risk concept is rather similar to ours it will also apply here. The Income (and Business) Motive concerns the fact that not all cash is invested by an investor because of need of money for current expenditures at an early date, so that the investment of the last portion of his funds would almost certainly result in a net loss, since investment expenses would be large relative to gross yield, and a rush sale would probably be necessary. The Precautionary Motive is concerned with the possibility of a loss due to the unavailability of cash at some future date, and the Speculative Motive refers to possible losses due to changes in the interest rate. All these motives consequently represent a fear of loss, and thus form part of our risk concept. Cf.: E.D. Domar and R.A. Musgrave: "Personal Income Taxation and Risk-Taking," in the Quarterly Journal of Economics, May 1944, p. 398, and J.M. Keynes, op.cit., Chapters 13 and 15.

Profit on the other hand, will mean the net return on the transaction. When making his investment decision this expected return may not be an exact figure in the mind of the investor, but it is likely that the investor thinks of a particular profit or a range within which the profit is expected to be located. This profit will be the profit net of taxes, as it is the net return that will influence the decisions of the investor. Although it may be true that entrepreneurs are not greatly interested in taxes when starting a new enterprise, it must be admitted that as soon as taxes become sufficiently significant in the future operations of the business, management will shape its policies in accordance with these taxes.[1]

Profit and Risk determine investment. Their relationship in the mind of the prospective investor induces or deters the investment decision. When profits are large and the risk is small it is rather likely that most investors will undertake investments. The problem is to determine how large profits must be to outweigh the deterring influence of the risk factor. If we consider an investment offer which gives us an odd chance, i.e. for example an investment of $100.00 with the possibility of earning $20.00 or losing $50.00, it is unlikely that it would be considered attractive by the average investor. There always will be

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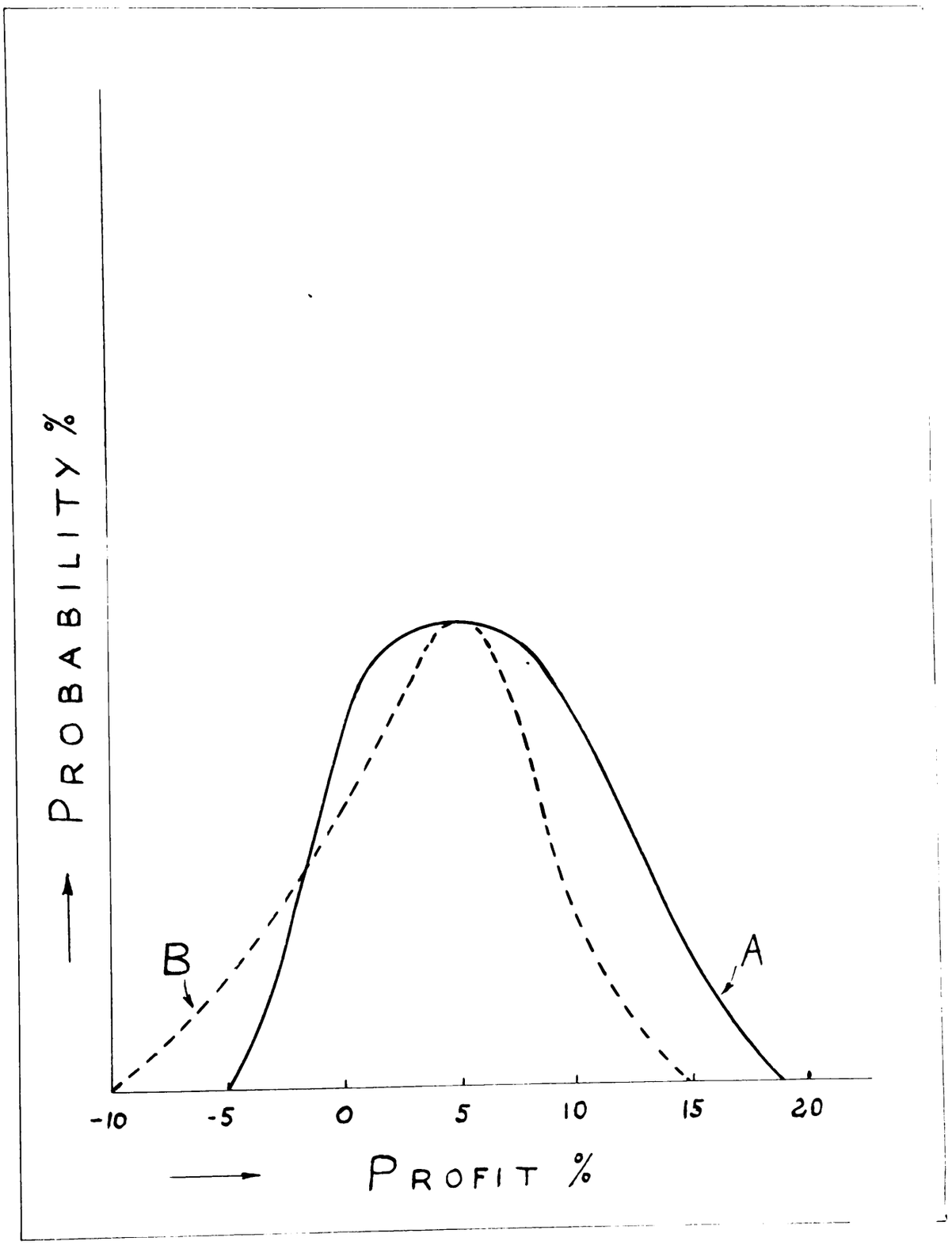
1) Cf.: J. Keith Butters and John Lintner: "Effect of Federal Taxes on Growing Enterprises", Boston 1945, pp. 15-16.

some people who would undertake the above illustrated investment, and there may even be some to whom the risk factor is of lesser importance, and who would take $10.00 as an expected return even if the risk would remain at its former level. Nevertheless one may be inclined to say that the return on an investment must outweigh the risk factor, and mainly the chance of loss. From this we may conclude that a reduction in risk will be of greater inducement to investment than a proportionate increase in profits.

What will move the submarginal prospective investor to become a marginal investor is rather difficult to determine. One may be inclined to believe, according to our definition, that the profit factor will be a fairly exact concept in the mind of the prospective investor, and that he knows fairly well what he may expect as a return if the investment succeeds. We are not assuming that the investor believes that his prediction of future events is infallible, but we are assuming that the investor thinks he knows the probabilities of future events. Of course this attitude varies with every investment, and probably with every investor. It may be argued that even if the expected profits do not materialize, but a return still should be shown on the investment, the investor would not feel as unhappy about his venture as when a loss would be shown on the transaction. An investor is likely not to fear a change in the expected profit, as long as he makes a profit, to the extent that he fears a loss of whatever magnitude.

FIGURE I



It is the risk factor, and particularly the chance of loss, which is the big question mark in the mind of the investor, and it depends on the size of this factor which the mind of the prospective investor will create, that the investment decision hinges on to a great extent. One would be inclined to say that fear of possible loss is often more important in business decisions involving large uncertainties than the hope of profit. It is this point which was often not fully recognized by the legislative and executive branches of government, as well as by the economic analyst. Our concept of profit and risk may be graphically represented in Figure I. We are considering two hypothetical investments A and B. The most probable return on both investments is 5 percent, which would correspond to our concept of profit, but the other probabilities, which correspond to our concept of risk, differ. The probabilities of B are less attractive than those of A, and consequently A must be considered a more attractive investment.

Investments take place at all times but their volume fluctuates continuously. Sometimes there is an investment boom, sometimes there is a dearth of investment. Investments are undertaken to earn a return, but they are made only when this return, or expected return, compensates the investor for the risk he is taking. We may express these investments as various points $(x^1, y^1), (x^2, y^2) \ldots\ldots\ldots (x^n, y^n)$ between the X-and Y-axes (Figure II). These locations may differ for the same investment undertaken by the same investor at different moments of time, and they may also differ

FIGURE II

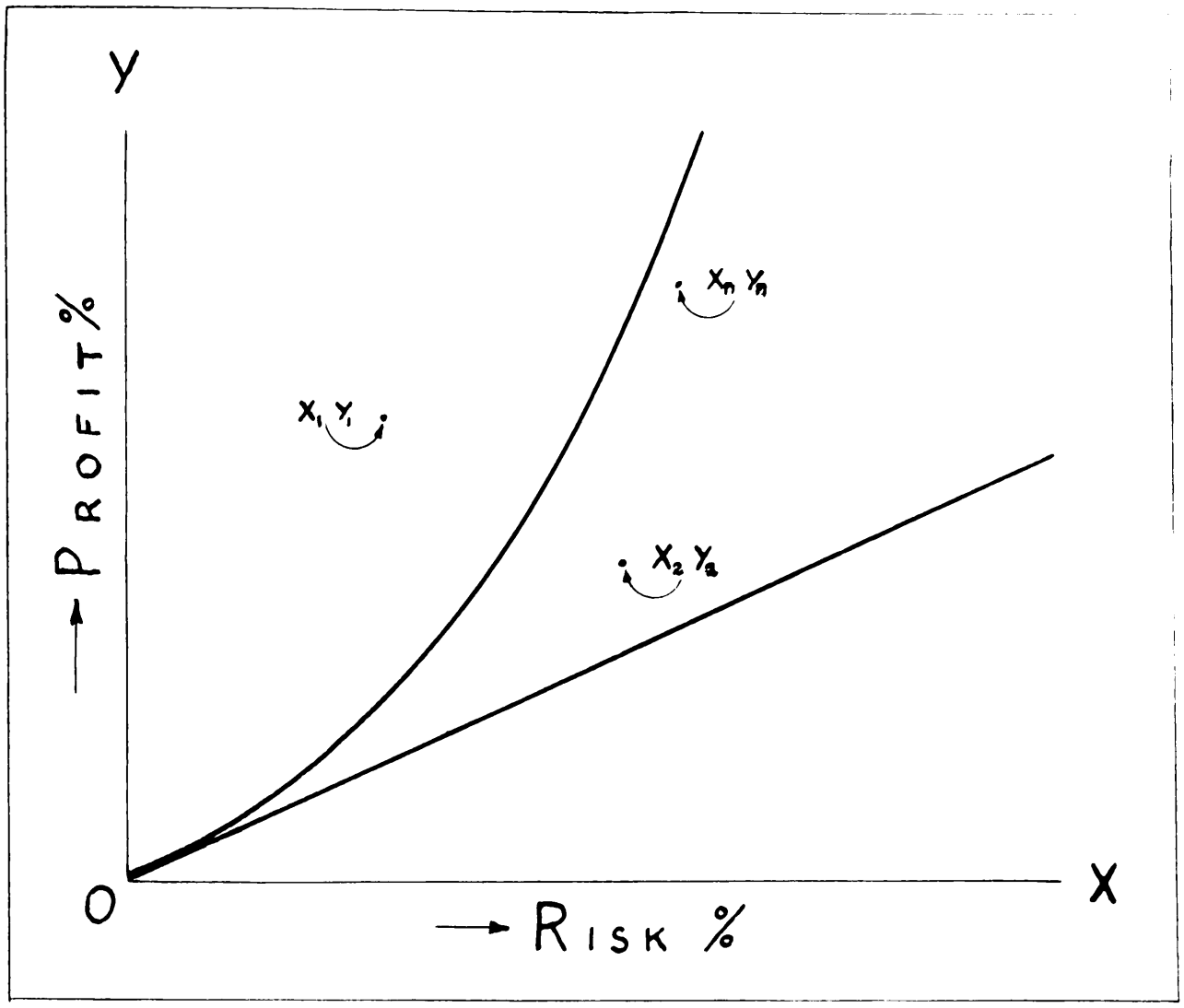
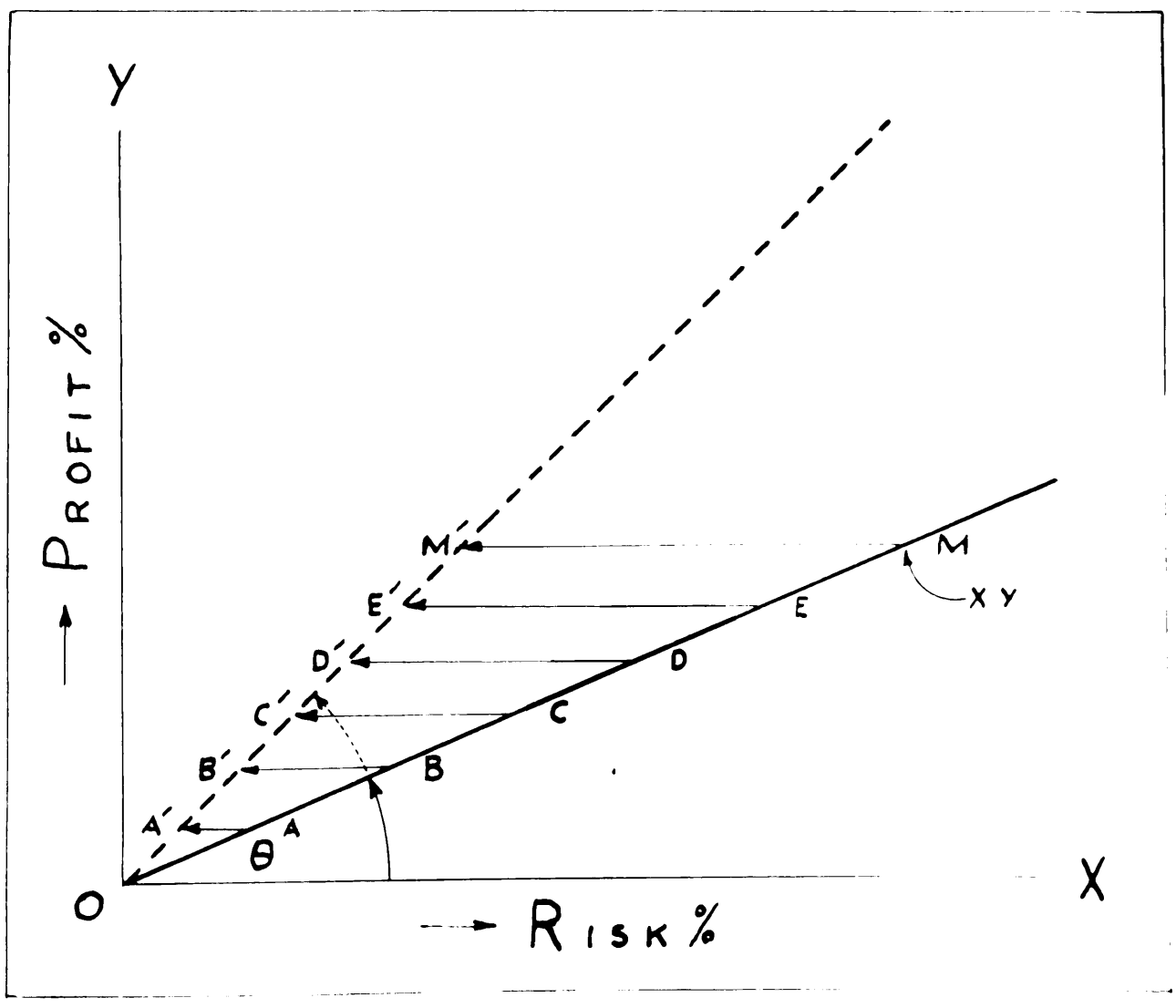


FIGURE III



for the same investment if made by different investors at one moment of time. Any location between the X-and Y-axes may represent an investment, or prospective investment, and the attitude of the investor towards these investments may be expressed by curves drawn from O which may vary for each individual investor at various moments of time, but will be the same curve for any one investor at any one moment of time. From this we may deduce that the individual investor will be inclined to undertake any investment which graphically represented, would be located between the Y-axis and "His" indifference curve through the origin O, which we may call his "Marginal Curve." In other words, any investment or investment opportunity located on the indifference curve representing the attitude of the particular investor will be a marginal investment for that particular investor. If the profit expectation is increased or the risk factor reduced, the investment or investment opportunity will be located above the marginal curve, whereas if the profit expectation is reduced or the risk expectation is increased, the investment will become submarginal.

Just as any investor has his "marginal curve" at any moment of time, so the economy as a whole and its inclination towards investment may be represented by a curve at any moment of time. This investment curve will be an aggregate of all the various investment functions of the individual investors.

Leaving marginal investment curves we must consider the assets which may be investments or investment opportunities,

and we will have to determine the point at which the investment opportunities will be transformed into actual investments. In Figure III we are considering the investment market, and the area between the X- and Y-axes will be covered with points, each representing an asset which may already have been converted into an actual investment, or which may be in the form of an investment opportunity. We may then take any point M (x,y), and draw a straight line from the origin (O) to M. On this line, M represents one asset which may be an investment of some investor, or it may be an asset which, as yet, has not attracted an investor. On OM other points, representing assets, may be located (A,B,C,D,E, etc.), but for this analysis one point M (x,y) will suffice.[1] In Figure III $\frac{y}{x} = \tan \Theta$. As we want to maximize private investment, the most favourable condition for investment will be when $\frac{y}{x}$ is at a maximum. Since $\frac{y}{x} = \tan \Theta$, this condition will be satisfied when tan Θ = Infinity. When tan Θ reaches infinity, the value of the angle Θ will be 90^{o}, and private investment will be maximized at that value. It is evident that all investors cannot take advantage of riskless investments which offer high yields, as these investment opportunities are very limited. Therefore, investment opportunities offering higher returns will generally contain a higher element of risk, and

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1) This considers only a range of assets which may be expressed on a straight line, and profits of which vary directly with risk, i.e. simple straight line functions. Often this is not the case, and more complicated functions will represent the various investment curves, but this method of analysis will suffice here, as the conclusion will be the same.

consequently will be located at a distance from the Y-axis, automatically limiting the maximum size the angle θ can attain. The most undesirable condition with positive values for investment will be when $\frac{y}{x} = 0$, i.e., when $\tan \theta = 0$. This condition is satisfied when the angle $\theta = 0^{o}$. Consequently investment varies with the size of the angle θ, and it shows that by changing the angle θ one can increase or reduce the volume of investment. This change in the angle θ can be effected by increasing or decreasing y, or decreasing or increasing x. This increase or decrease of the angle θ will shift the assets, constituting investments and investment opportunities accordingly, and when the angle θ is increased, assets which up to now had been outside the reach of various investors, will be brought within their "marginal curves". Investment consequently is increased as these investment opportunities have been transformed into actual investments. The same applies to a decrease in the angle θ which would mean a reduction in investment, and disinvestment would likely take place. In other words investment can be increased by increasing the expectation for profit, or by reducing the risk factor, and investment can be reduced by decreasing the expectation for profit or increasing the risk factor.

The case may arise where the increase in the investor's portfolio, and the consequent reduction in cash holdings, will result in an increased marginal utility of cash. This will be expressed as a change in liquidity. By defini-

tion liquidity preference is included in the concept of risk, and by reducing liquidity the investor increases his concept of risk in any subsequent investment opportunity. This becomes of particular importance when several marginal investment opportunities may be available. In such a case the act of investment in any one marginal asset increases the investor's portfolio, and if the subsequent reduction in his cash holdings should result in a change in his liquidity preference, the remaining marginal investment opportunities will again have become submarginal assets due to the increase in the investor's concept of risk, with regard to these subsequent investment opportunities.

With the above facts at hand it will be our task to obtain such a set of circumstances under which private investment is at an optimum. It may be said that the maximum private investment that can take place without infringing on the private enterprise characteristics of the investment, is the investment that is not influenced by the imposition of taxes. Although tax collections are not our primary objective, the problem of taxation cannot be ignored by stating that if taxes are abolished the maximum private investment possible under the circumstances will be undertaken, and besides inducements for further investment will be lacking. It does not provide for the investment of undistributed earnings, and it must be recognized that the lack of taxes would not necessarily mean that an optimum amount of private investment will be undertaken. Our task therefore, is twofold. It is to reduce the basis of investment deci-

sions as far as possible to the level at which taxes are not levied, and to see that the funds available for investment are utilized.

If taxes are levied, and we want to reduce the basis of investment decisions to a level at which taxes are not levied, we must reduce the risk factor in relation to the reduction in profits caused by the taxes. Most of the available methods of risk reduction are based on the loss offset idea, and an inquiry into loss offset clauses may be desirable with regard to the actual methods to be adopted for our purpose.

Full loss offset means that whenever the investor suffers a loss, the government reimburses him for a fraction of the loss equal to the tax rate. Consequently whenever a loss should occur this loss could be charged against any profit or income accrued from other sources, and a tax is not levied on this portion of the income of the firm which had been offset against the loss incurred. Methods vary with regard to the income that may be employed for this purpose but it may constitute a combination of past, present and future income, or any one or two of these. Partial loss offset reimburses the investor for less than the fraction of the loss equal to the tax rate, and the reimbursement depends on the degree of partial loss offset. Full loss offset is one extreme, and no loss offset is the other. Any loss offset effective between these two limits is a partial loss offset, and this partial loss offset will be more beneficial to the investor the closer it approaches the full loss

offset limit. The method of loss offsetting[1] will shift some of the risk upon the shoulders of the tax collecting authority as long as other income is available against which the loss can be written. Although the concept of total risk has not been changed, with the introduction of loss offsets the private risk factor has been reduced due to the appearance of a public risk factor. Consequently for each separate investor, or for the economy as a whole, the size of the angle Θ has been increased, as we consider private risk, as well as private profit only.[2] This procedure induces further investment, as the marginal investment function of the investor or of the economy has remained unchanged. The consequent increase in private risk taken, also implies an increase in total risk. Whether this risk-taking is expressed by conversion of cash into investments, or by shifting less risky into more risky investments, is not of great consequence, and such increased risktaking will be beneficial to the economy, excepting extreme boom conditions. There appears to be little doubt that the higher the rate of loss offset, the higher will be the degree of risk taken, and the extent to which loss offsets will be

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1) When continuing this discussion a "loss offset" in the remainder of this paper for simplicity's sake, as well as expediency, will mean "full loss offset".
2) Schedule I shows the possible effect of the public risk factor in the form of loss offsets. The reduction in private risk is expressed in an increase in the expected rate of return on the investment.

possible in actual practice will depend on the offset provisions in the tax law.[1]

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1) Cf.: Evsey D. Domar: "The Burden of the Debt, A Rejoinder", in the American Economic Review, June 1945. Domar has treated this particular point, and the following quotations from him may underline our statements: "The return on an investment is essentially a compensation for the risk which the investor undertakes. Suppose the law provides for very liberal loss offsets. Will not the tax then reduce both the return and the risk"..... "The point I am making is that a reduction of income tax rates is only one of the several methods of encouraging investment - a method which in practice may often be difficult and undesirable to follow. It may well be more practical to approach the problem from the other side - by reducing the risk involved. Liberal loss offsets and perhaps loss sharing, loss insurance, greater freedom in depreciation policies - these are some of the methods of encouraging private investment which may be more feasible and promising than a substantial reduction in income tax rates".

SCHEDULE I

Exhibit A — Profit Expectation of Hypothetical Investment where no Tax is in effect

Expected Rate of Profit	Chance that this Rate will be earned	Weighted Profit Expectation
100%	1/10	10%
50%	5/10	25%
- 50%	4/10	- 20%
		15%

Exhibit B — Profit Expectation of Hypothetical Investment where a 40% Income Tax is in effect, and loss offsets are not possible

Expected Rate of Profit before Tax	Reduction in Expected Profit due to 40% Tax	Expected Rate of Profit after 40% Tax	Chance that this rate is earned	Weighted Profit Expectation
100%	40%	60%	1/10	6%
50%	20%	30%	5/10	15%
- 50%	--	- 50%	4/10	- 20%
				1%

Exhibit C — Profit Expectation of Hypothetical Investment where a 40% Income Tax is in effect, and loss offsets are possible

Expected Rate of Profit before Tax	Reduction in Expected Profit due to 40% Tax	Expected Rate of Profit after 40% Tax	Chance that this rate is earned	Weighted Profit Expectation
100%	40%	60%	1/10	6%
50%	20%	30%	5/10	15%
- 50%	- 20%	- 30%	4/10	- 12%
				9%

CHAPTER IV

Methods of Risk Reduction

Loss offsetting is one of the few methods which may be employed for risk reduction, compatible with the system of free enterprise. We outlined the various methods of loss offsetting, but it might serve well to keep in mind that we must safeguard against these methods deteriorating into an elimination of the private risk factor by having the government take over all or a great part of the risk. We do not want to lose the risk factor because if private investment would take on the characteristics of public enterprise, it would lose its justification for existence. Business does not mind taking risks inherent in investments as long as investment is not artificially restricted by government measures which increase the risk factor in relation to the profits retained. These risks should include the ordinary risks that cover our economy, but one should not expect private enterprise to carry the risk inherent in wars and severe depressions. Then it is the responsibility of the government to protect the individual, and to guide the economy safely through such times. It is also worthwhile to note that the participation of government in the economy of the country may help to stabilize, and in fact should stabilize the economy. This stabilization, which amounts to a reduction in the risk factor, business, in time, should recognize as an advantage, and influence its investment decisions accordingly.

Nevertheless, methods of risk reduction taking the

form of loss-sharing and loss-insurance should not form part of a tax system, as their influence ultimately may be detrimental to private enterprise.

It is apparent that under these conditions and assumptions losses can only be offset against other available income, and we must create conditions which will enable the investor to make the fullest use of such income. Some sort of loss offsetting is recognized by almost any government which uses business taxes as a means of obtaining revenue for the treasury of the state, but in many cases it was left to chance to enable the investor to make use of the loss offset provision as the case had to fit a particular set of circumstances to fall under the provision. The tax law must provide for very broad loss offset clauses in order to discriminate as little as possible among the various investors, and even then it is not always possible that all firms will benefit from the scheme. In this respect we may note particularly the difference in effect which loss offsets may have on a large or small business. Usually it may be said that due to the size of the business the investments of large corporations are more diversified than the investments of small businesses which are limited in their capital. If the investment of a small firm succeeds, it is likely that a good return will be received on which the scheduled tax is paid; on the other hand, if the investment fails, a large part of the invested funds may be lost. For the large corporation with sufficient funds to cover a wide range of investments, it is likely that some of the

investments succeed, and others fail. Consequently the large corporation will have some income available to offset the losses, and at the same time it is true that their profits will be lower in relation to a successful investment undertaken by the small business. Of course, if all the investments of the large corporation succeed or fail, the company operates under circumstances similar to those of the small firm. The principle of diversification is illustrated in Schedule 2, and it shows that when other income is not available to offset losses, the firm with undiversified investments will be hit harder than the firm which did not put "all its eggs in one basket". Against such risks even offset provisions cannot safeguard the investor, if other income is not available; we must accept it as an inherent characteristic of the private enterprise system. In this connection it must be recognized that by levying taxes on income which eventually might be needed for loss offsets, the risk factor is increased. Tax laws therefore, should provide that taxes on corporate income shall not be imposed as long as a chance of loss exists for any investment.

The above can be accomplished by very liberal loss offset provisions, combined with depreciation and inventory reserves. It would mean that before taxes are levied the risk of loss has been reduced to nil, or in other words the investment cost will have been returned to the investor before taxes are paid. After the source of possible loss has been removed, taxes can be imposed, and although by

SCHEDULE 2

Assumptions: The firms will distribute all net earnings of their operations as under the tax proposal in Chapter V, and all shareholders will fall in the same income tax bracket, and consequently be taxed at the same rate. Depreciation allowances are ignored.

Successful Investments

Small Firm (Capital $1,000)				Large Firm (Capital $10,000)			
Investments No.	Gross	Income Tax 30%	Net Return	Investments No.	Gross	Income Tax 30%	Net Return
A	$500 Profit	$150	$350	A	$400 Profit		
				B	50 "		
				C	150 Loss		
				D	200 Profit		
				E	400 "		
				F	300 Loss		
				G	550 Profit		
				H	700 "		
				J	450 Loss		
				K	600 Profit		
	$500 Profit	$150	$350		$2000 Profit	$600	$1400
	Profit 35% of Investment				Profit 14% of Investment		

Unsuccessful Investments

Small Firm (Capital $1,000)				Large Firm (Capital $10,000)			
Investments No.	Gross	Income tax	Net Return	Investments No.	Gross	Income Tax	Net Return
A	$500 Loss	Loss	$500	A	$400 Loss		
				B	50 "		
				C	150 Profit		
				D	200 Loss		
				E	400 "		
				F	300 Profit		
				G	550 Loss		
				H	700 "		
				J	450 Profit		
				K	600 Loss		
	$500 Loss	-- Loss	$500		$2000 Loss	--	$2000 Loss
	Loss 50% of Investment				Loss 20% of Investment		

levying taxes on the returns of an investment after it has been amortized or depreciated, we do not reduce the investment decision to the basis we strived for, the fact remains that if we allow the investor to retain a sufficient amount of profits to induce him to invest, the lost incentive will not be very great, and we may argue that this payment out of "real" income in the form of taxes is the payment for the service rendered by the government in stabilizing the economy. Before these taxes are paid we must provide for the deduction of losses suffered in the past. Past losses must be deductible from future income, just as losses suffered in the current period must be offset against current income. As will be seen a special provision for future losses will not be necessary as they will be covered by the depreciation and inventory allowance scheme.

At present the profit before taxes of a corporation is established by deducting the total cost of operations for the taxation period from the total gross income. In costs are included, besides material expenses and current charges, remuneration of employees and executives, as well as allowances for depreciation. Excepting depreciation allowances and the valuation of inventories, the costs of business are rather fixed items which cannot be manipulated or changed at will for tax purposes. Depreciation charges as well as inventory valuations for tax purposes either are fixed by the government or are arbitrarily established. These two factors in an operating statement of a firm must

be singled out for attention with regard to the influence and effects of an income tax.

Nowadays depreciation allowances are fixed by a schedule which provides for an annual depreciation percentage. In Canada for example, Reinforced Concrete Buildings may be depreciated at the rate of 2% per annum, i.e. over fifty years; Brick, Stone, or Brick Veneer Buildings at the rate of 2½% p.a., Frame Buildings at 5% p.a., Plant and Machinery at 10% per annum, etc. The effect of such a schedule is that the risk of loss remains in the investment during the greater part of a long amortization period. The same, to a much lesser degree, applies to inventories[1] which we also may call investments. Inventories must be reasonably valued for tax purposes, and it is customary to use a cost or market price valuation whichever is the lower. Of course various costs may be acceptable for tax purposes, as inventories usually are bought or manufactured at different times. Larger concerns mainly use the "first in, first out" method.[2] These methods of valuation leave loopholes in the present tax systems for lower valuation, particularly when the market price is concerned, as inventories in many branches of business are difficult to price, and valuations will often be arrived at by estimates. The lower valuation increases the cost of the disposed inventories,

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1) Raw material acquired in the business becomes inventory, but inventory also includes materials which are in process of being manufactured, and partly or wholly finished goods. A business must expect part of its capital to be tied up at all times in the form of inventory.

2) "First in, first out" means that whatever portion of the inventory is used, the cost of the earliest acquisition will be taken for cost valuation, and the price of the remaining items will be used for inventory valuation.

reducing profits for the taxation period, at the same time reducing the chance of loss in future periods.

It is always the desire of the businessman to depreciate or amortize as much of his assets as possible, as long as security market or other considerations do not prevent him from doing so, and the main reasons for this are that he does not want to pay higher taxes than he absolutely has to, as he may retain the remaining net profits, and because he wants to eliminate the chance of loss on his investments at the earliest possible moment. This attitude towards taxes is fairly reasonable, as it happens quite frequently that a concern has to take a loss on an investment after having paid taxes out of earlier returns from the same investment. It is evident that this method of taxation increases risk, and consequently discourages investment. It is quite a different story when taxing surpluses, than when taxing costs, and in the businessman's mind an investment is a cost with regard to his capital, as long as it has not been amortized on his books, or as long as the net returns after taxes have not compensated him for his outlay. It must be admitted that an imposition of taxes on profits, before the investment has been entirely amortized, prolongs the period during which a chance of loss exists, and the consequences of the failure of the tax law to make a cost allowance for uninsurable risks may be serious. The risk factor of an investment can be reduced, as has previously been indicated, by amortizing the investment before taxes are levied. This would amount to an increase in depreciation

allowances. The method of high depreciation allowances has been recognized during wartime with regard to war investments. In Canada the government has granted depreciation allowances up to fifty percent per annum of the cost of several items which could only be employed for war production,[1] and in the United States business was given the privilege of amortizing certain equipment over a five-year period. Although the government still found it necessary to supply a large part of the capital for war expansion, the amortization program was effective in removing impediments to the installation of new equipment.[2] In the United Kingdom special allowances of up to twenty percent were permitted, depending on the character of the investment and on the depreciation period.[3]

The maximum depreciation allowance which could be applied would be a one hundred percent allowance, and this would mean that the entire investment could be amortized before taxes are levied. This method is advocated in the tax proposal of the following chapter. If, on the other hand, the firm does not want to utilize the entire 100% allowance, either because insufficient income is available or because of dividend policies, the depreciation percentage should be established by the investor, and the undepreciated

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1) Order-in-Council of November 1944, P.C. 8640.
2) Harold M. Groves: "Production, Jobs and Taxes," New York 1944, p. 65.
3) For a brief discussion of these measures in the United Kingdom see: T. Balogh: "The Budget Proposals and Technical Progress," in the Bulletin (Oxford Institute of Statistics), 20 May 1944.

part of the investment should be carried forward to the following period.

A similar treatment of inventories is also advocated. By writing-off inventories at the end of a taxation period, not only will the risk of loss on these inventories be removed, but one may be inclined to believe that it would facilitate the disposal of old inventories at market prices, and the acquisition of new stocks.

Such a policy of 100% depreciation allowances for investments and inventories in many cases may make the loss offset clause superfluous, as the risk of loss already has been removed. In fact the depreciation allowance clause may have the same effect as the loss offset clause, and much of the discussion on loss offsets may apply to depreciation allowances with the marked difference that in contrast to loss offsets, they give the assurance that taxes will not be levied before the investment has proven able to carry these taxes. It may further have the effect of discouraging the use of old equipment, outdated plant and machinery, and may become a cause for more rapid technological advances. This in turn might lead to discoveries of new private investment opportunities.

If taxes on corporate income will not be fiscally productive in the first few years when high depreciation allowances may be charged against profits, taxes will certainly be productive, economic conditions remaining favourable, when the investments have been written-off; and in case economic conditions should take an adverse turn, the

concern probably would be able to withstand better the trend of the time after having depreciated its investments. In most cases the government would suffer a postponement, rather than a loss of revenue. In the event that the postponement of taxes on currently earned income should lead to a considerable drop in revenue for the government, we indicated in our initial assumptions that under such circumstances the government would be able to overcome the strain by deficit finance. Covering periods of investment boom, on the other hand, it might be advisable to discourage investment, and then lower depreciation percentages, fixed by the government, may be justified. In this connection it must also be recognized that the above advocated policies may profoundly affect the cyclical fluctuations of corporate incomes, and it will be the duty of the government to compensate for these extreme fluctuations in the economy, if necessary.

Close attention must be paid to the fact that the rate of amortization is closely linked with the price policy of a business, but as the connection between reinvestment and amortization may not be so pronounced, it may be expected that the businessman will form a separate amortization schedule with regard to his price policy, a schedule different from the depreciation allowances calculated for tax purposes. Since in competitive industries business may have to compete with producers or dealers whose investments have largely or completely been depreciated, it is likely that an introduction of the above policy would have less effect on prices

than at first glance might be expected.

With regard to the above policy it must also be recognized that depreciation reserves which accumulate as idle balances constitute a drain on the expenditure stream. In order to avoid these idle balances, corporate profits that are not used for capital outlays should be passed on to the workers or the owners, and thus returned to the expenditure stream.

CHAPTER V

A Tax Proposal

During the past few years several major proposals for a postwar tax policy have been advanced.[1] Strangely enough they do not seem to differ largely from what had been the established practice in the days before September 3rd, 1939. They all have the goal of full employment and a high standard of living in view, at the same time leaving many loopholes which could easily become the cause of failure for their efforts.

Broadly speaking, the tax systems are based on the progressive personal income tax,[2] and they propose a certain rate of taxation for corporations. This procedure was arrived at by assuming that an optimum amount of consumption must take place, and a sufficient amount of savings must be retained to permit an optimum amount of private investment. One must agree fully with these objectives. A worthwhile attempt has been made by arranging an income tax schedule with the goal of optimum consumption and savings in mind. At the same time savings must be utilized.

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1) A.H. Hansen and H.S. Perloff: "State and Local Finance in the National Economy," New York 1944; H.M. Groves, op. cit.; "The Twin Cities Plan," The Twin Cities Research Bureau, June 1944; Beardsley Ruml and H. Chr. Sonne: "Fiscal and Monetary Policy," National Planning Association, Pamphlet No. 35, July 1944; "Postwar Federal Taxplan for High Employment," U.S. Government, Washington, June 1944.

2) The term "progressive" is used to describe a scale of relative burdens in which higher proportions of income are paid in taxes as income advances. The income tax is progressive because the ratio of tax to income increases as income increases.

The proposals support the opinion that if a light corporate income tax, in contrast to a stiff one, is levied, the inducement would be sufficient to obtain an optimum amount of private investment. One cannot dismiss the possibility that business under these circumstances might create an optimum amount of private investment, but at the same time it cannot be denied that such a system of taxation does not assure an optimum amount of private investment. At this point it might be appropriate to state that the following proposal does not guarantee an optimum amount of private investment either, but we believe that its provisions might make it more likely that corporate funds will be directed into private investment channels.

As is indicated in Chapter II private investment is largely undertaken by corporations. It is not sufficient to obtain savings; the crucial point is that these savings are invested. We cannot take the attitude that the government should tax business lightly in the hope that business will fulfil the government's desire. We must be reasonably certain that business will act accordingly. The reduction in business taxes, and the subsequent rise in net profits may cause a rise in private investment expenditures, but it is essential to consider the discussion of Chapter III in this connection.

We had come to the conclusion that profits alone do not determine private investment decisions. We must attach the risk factor to such a problem, and this may be done by the policies advocated in Chapter IV. The effects to be

attained are expected to result from a change in accounting practice for tax purposes, and will not be caused by any revolutionary ideas.

Before discussing the proposal one should point out some of the characteristics of pre-war corporate income taxes which to a large extent, have been retained in the major proposals advanced, although Harold M. Groves and Alvin H. Hansen together with H.S. Perloff recognize their shortcomings, and advocate certain remedies. Broadly speaking, corporation income was taxed at a flat rate in Canada and the United States. Interest and similar charges had been included in the cost of business, and were deducted before taxes had been imposed. Dividends on the other hand, were distributed after taxes had been levied, and in effect it meant that dividends were taxed twice, once while part of the corporation income, and once while part of the stockholders' income. This caused a relative reduction in the progressive effect of the personal income tax, and consequently had a regressive[1] effect on consumption, as the difference of the personal income tax rate would have benefited the stockholders with a low income relative to the stockholders with a large income; it may be assumed that the propensity to consume of the former would have been higher than of the latter.

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1) The term "regressive", in contrast to progressive, is used to describe a set of relationships in which lower proportions of income are paid in taxes as income advances. The cigarette tax is regressive because the ratio of tax to income decreases as income increases.

The character of depreciation allowances was discussed in Chapter IV, and does not need repetition here. Nevertheless it must again be emphasized that in pre-war tax policies the period during which risk remained in investments was unnecessarily prolonged.

The residue of income after taxes and after distribution of dividends was retained by the corporation in the form of undistributed profits. This undistributed surplus could either be used for investment purposes, or could be left in idle balances with the corporation. It offered individuals in high income brackets an opportunity to avoid payment of income taxes. As indicated the only inducement for private investment was the size of corporate profits; the income tax did not contain a compelling influence to dispose of these idle balances in such a fashion that they would not constitute a drain on the business expenditure stream. The recent proposals do not greatly change these shortcomings of the pre-war tax policy.

As this paper is mainly concerned with business income taxes, these will be discussed as the primary subject of the proposal, and other taxes influencing the sphere of business will be considered in relation to the corporation income tax. The proposal has as its primary objective the inducement of an optimum amount of private investment. Our considerations for this goal will have to start from an accounting point of view, and we will deal with the profit of a corporation before depreciation allowances have been deducted, dividends have been paid, and taxes have been

imposed. The profit is arrived at by the usual procedure. From the total income for the taxation period we deduct the total cost of operations including remuneration of executives and interest charges, but excluding the aforementioned items. After this profit has been established the influence of the income tax must be felt in such a fashion that the tax will induce the disposal of the profit into channels which will be beneficial to the economy. We must keep in mind that depreciation allowances as yet, have not been considered, and that dividend payments must also be decided upon.

In the previous chapter we discussed the effects that can be achieved by manipulating the depreciation allowances, and the proposed course of action should be taken. In this way depreciation allowances in fact become investment allowances, and must be considered in conjunction with dividend policies. Further it is the intention to advocate a 100% tax on undistributed profits after depreciation allowances have been deducted and dividends have been paid. The resulting effect of such a 100% tax should be that the corporation has the choice of charging its depreciation allowances against the profit and/or distributing its income in the form of dividends which then would be subject to the progressive personal income tax. The consequences of this policy will be that profits either would be charged against investment allowances, or would be paid out as dividends. The corporation, therefore, will be able to choose between writing off its investments and inventories or declaring its profits in dividends. Investments and inventories naturally can be

written off only when investments have been made, and this scheme should favour the disposal of corporate profits into investments, as the paid-out dividends will be subject to the personal income tax.[1] The result should provide some of the highest income generating payments possible in a private enterprise economy.

The above proposal is a substitute for the loss-offset clause, offering the possibility to safeguard oneself against losses before taxes are imposed. Investment decisions with regard to the risk factor have further been reduced to a point at which taxes are not levied. Consequently taxes which would increase the risk factor do not influence the investment decision, as the corporate investor will not be taxed, if he so desires, until the capital expenditure has been returned.

Many corporations on the other hand, are not able to utilize fully the opportunities offered by this investment allowance, either because all investments have been depreciated or because of dividend policies which must be maintained to offer spendable income to the stockholders or to maintain dividends for security market considerations. These dividends will then be subject to the progressive personal income tax.

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1) Similarly in Great Britain dividends are not subjected to double taxation, as stockholders may apply the standard tax deducted at the source when computing their income tax payments on dividends, whereas undistributed profits are taxed at the standard rate only. Cf.: G. Findlay Shirras and L. Rostas: "The Burden of British Taxation," Cambridge 1942, pp. 97-102.

This procedure, when in full effect, will under all circumstances avoid new idle business balances, and will not drain the business expenditure stream, as new idle balances will either be reinvested or be distributed as dividends, which in turn, after having been taxed as personal income, will be available for consumption or savings. This method may have the disadvantage of creating fluctuating dividend policies but one may believe that the influence of the security market will be sufficient to force the management of corporations to consider market reactions, and maintain a certain rate of dividend payments under all possible circumstances. In corporations whose stock is not traded on stock exchanges, it will almost be universally true that the stockholders will have some influence on management, and consequently will be in a position to safeguard their dividend interests to a certain extent.

The question may arise of how this policy would affect the cash position of corporations since profits must be expended. One might argue that the liquidity position of companies could become impaired, and cause a highly dangerous rigidity in times of adverse economic trends, as well as during periods of prosperity. In defense of such statements it must be pointed out that under the above scheme the original equity capital of the corporation can always be retained in cash balances, and most corporations which can show liquid assets equivalent to the paid-up equity capital stock will usually sail on safe waters. Besides, the capital market may always be called upon to supply funds which would not be

affected by this taxation policy. In general it may be said, that if corporations can retain liquid funds up to the limit of their equity paid-up capital, their position will be sound enough to withstand circumstances which might necessitate an immediate availability of cash. It might well be true that by inaugurating this policy new companies would be differently affected, as these new companies will have complete freedom of disposal of their surpluses as long as the paid-up equity capital has not been returned in the form of investment reserves. The complete effect therefore, will be felt only by firms which have had some time of operation under the scheme. It must be further admitted that in the beginning of its operation this policy may, under adverse conditions, diminish effective demand because the retained profits, in the form of liquid reserves, will replace the funds expended on the actual investment of the paid-up equity capital. It is assumed here that collected taxes would have some income generating effect in the form of government expenditures.

A further argument against the scheme may be advanced after it has been in operation for some time, and the investments financed by the paid-up equity capital have been returned as investment reserves. Under the scheme investments are not submitted to competitive bids in the capital market, and consequently some of them may be unwise, others may become speculative, and others may be made merely to strengthen the prestige of the management or the company. To a certain extent this criticism is justified, but since management usually

has a personal interest in the affairs of the company, it will try to make the best possible decisions. In any case these funds will be returned to the income stream which would be only partly true if they were paid out as dividends, assuming that some of the dividend payments were saved and not invested. Although it must be admitted that competitive bids from the capital market are missing, it is not certain whether this is regrettable. Most investment decisions involve highly technical problems of which the capital market has little knowledge. Corporation executives may embark on projects involving technical improvements and innovations which would not be financed by outside funds. Moreover it is probable that business has a better knowledge of market potentialities than the capital market, and management may be able to find and exploit investment opportunities that would remain unnoticed or would not appear attractive to "outside" investors.

The above in short, is the proposed scheme, of which a numerical example is given in the appendix of this paper. On the above merits alone this proposal would not stand. It needs certain auxiliary measures to strengthen its foundation, but it must be noted that its measures would help push private investment in the economy beyond the limit which the interest rate, and the marginal efficiency of capital would tend to set for it, if business had to obtain all new investment funds from the capital market. In fact when the time comes that the full effect of the scheme will be felt in the economy, investments will be undertaken even if

negative returns were shown as long as the negative returns would exceed the income retained after surpluses have been distributed and been subjected to the individual income tax. In other words the scheme would tend to lower the marginal efficiency of capital not only to zero, but it would permit a negative marginal efficiency of capital, a situation which some theorists have prophesized may be necessary, but which in a private enterprise economy has been considered hardly possible. It must be observed that in order to achieve this effect surpluses must be available for investment. Without the surpluses the present day economic rules would apply. Nevertheless the fact that a negative marginal efficiency of capital may induce investment under this scheme, should have a stabilizing influence on the economy. In case a period of prosperity should tend to decline, and tend to approach a period of depression, the fact that under the above policy a negative marginal efficiency of capital is possible, would cause the available surpluses to be invested counter-acting the economic trend, and in all probability raising the marginal efficiency of capital, replacing some of the lost surpluses, so that in case of subsequent adverse times the economy would again be prepared, and be able to withstand the new challenge.

Considering the depreciation and inventory clause, the term investment must be applied only to investments and inventories of the particular trade, and must not be employed to build up reserves by means of investments which are not connected with the line of business. It must be emphasized

in order to safeguard the security, as well as the money markets, that it would be unwise to allow paper securities, i.e. equity stock or debt obligations, to be considered as investments, even if the corporation should deal in these securities. Nevertheless certain reserves might be set up for these securities which must be approved by the taxing authority. Special attention will have to be paid to businesses such as banks, holding companies, trust companies, insurance companies, and similar concerns. As suggested this field needs special provisions which would allow these enterprises to function normally without giving them undue privileges, which could prove detrimental to the economy. The same provisions should be applied to land under all circumstances in order to prevent an unwelcome boom in this field.

A further risk reduction provision may be instituted in the form of market reserves which may be formed when market opportunities are unfavourable, and investment opportunities cannot be profitably utilized. This estimated market reserve must be approved by the taxing authority to whom an application will have to be made. The market reserve must be returned to the income of the next taxation period, and is solely intended to enable the corporation to bridge unfortunate market circumstances. A similar feature that must be mentioned is the clause allowing deduction of losses suffered in the past from newly earned income. At present losses suffered in the past sometimes may be deducted as a business cost, but in this respect, as is the case with market

reserves, the taxing authority might allow the setting up of special reserves against which eventual future losses might be charged. This could be achieved by setting aside a fixed amount, accumulated over several years, and subject to approval by the taxing authority. This reserve might be carried forward indefinitely until the time when it should be needed. If it should ever be used, renewal of this reserve should be permitted, and the fixed amount might be expressed as a percentage of capitalization. It would constitute an extension of the loss offset clause.

Also related to the depreciation allowance will be the consideration of capital appreciation which naturally will rise in importance. If this loophole is not eliminated our scheme would undoubtedly meet defeat. For this reason profits on all assets sold by the corporations must be considered as income, and consequently will fall under the corporate income tax. If the individual investor should like to realize on the capital appreciation of his investments by disposing of them as a corporate entity in the form of equity stock, the personal income tax must provide for measures to combat such misuse. This point, therefore, will be discussed under the personal income tax.

Before turning to a consideration of personal income taxes, some taxes not covered under the above scheme, which have been included among business taxes in times past, should be referred to. One of these is the excess profits tax. This tax, although a useful tool to curb profiteering and inflation during war and boom times, is generally agreed

to defeat our purposes in ordinary times of peace. It would curb incentive, and should be abolished. Furthermore, it could not be incorporated in the proposal advocated.

Payroll taxes could be included as a cost of business in our system. To finance unemployment compensation they would provide a desirable incentive for stabilization of employment. If treated in this manner these taxes may have a slight influence on prices. Since in a modern democratic state unemployment compensation should come under the jurisdiction of the central governmental authority, the elimination of these taxes might relieve some regressive effects. Nevertheless, if the government should feel that it is the duty of business to supply part of the funds for an unemployment program, this tax undoubtedly could be called upon, and if this tax is kept within reasonable limits few ill effects would be felt by business.

Capital stock, license, and property taxes are mainly levied by subordinate governments, and are not considered here. Co-operation in this tax sphere with the central government is advocated.

As mentioned in Chapter IV, the above proposal may create budgetary, as well as economic fluctuations to a greater extent than other proposals advanced, and as advocated before, it will be the duty of the government to compensate for these fluctuations, preferably by a compensatory fiscal policy. In this respect the tool of lowering the 100% depreciation and inventory allowance may be used to restrict private investment under acute boom conditions.

From an administrative point of view the above proposal should constitute an easy task, and probably could be handled by the present tax organization. It will be essential, however, to keep a tight control on the manipulations of investment allowances, and dividend information must be relayed to the authorities handling the personal income tax.

The above proposal is based on the undistributed profits tax principle, and since undistributed profits taxes have been advocated in the past, and have been tried in the United States, it might serve well to look at one of its most noted examples and compare it to our proposal. The United States Revenue Act of 1936 provided for an undistributed profits tax, but due to its ineffectiveness and failure it was repealed during the following year. Why did this act prove to be a failure? The undistributed profits tax was recommended for the declared purpose of:[1]

a) Correcting "the existing differences between corporate taxes and those imposed on owners of unincorporated businesses";

b) Seeking "equality of tax burden on all corporate income, whether distributed or withheld", and thus preventing evasion of surtaxes through the "accumulation of surplus in corporations"; and

c) Effecting "great simplification in tax procedure".

The tax was further intended to substitute for the existing corporate income, excess profits, and capital stock taxes, all of which were retained. As finally enacted, the un-

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1) The Tax Policy League: "How shall Business be Taxed?" New York 1937, (Ellsworth C. Alvord: The Taxation of Undistributed Profits from the Business Point of View), p. 30.

distributed profits tax[1], in broad outline, included:

a) The imposition of a so-called normal tax upon the "net income" of corporations, graduated up to 15 per cent;

b) The imposition of a so-called surtax on undistributed profits, graduated from 7 per cent to 27 per cent, upon the "undistributed net income" of a corporation;

c) The taxation to the corporation, at normal rates, of 15 per cent of the dividends received from domestic corporations;

d) The inclusion, for purposes of the undistributed profits surtax, of 100 per cent of the amounts received as dividends from domestic corporations; and

e) The subjection of all dividends distributed to individuals to the normal tax of 4 per cent.

In practice the tax proved to be unfair mainly to those who could least afford to pay. It caused a certain instability by forcing dividend payments without considering the ability to declare them, particularly penalizing the small and new concern which had not developed sufficiently to accumulate adequate surpluses and reserves. Many detailed shortcomings could be cited, but that is not our purpose.[2] Nevertheless it must be pointed out that its main defect consisted in that the tax did not touch those people on whom the act of saving and investment depended to a large extent - the individuals with high incomes - and consequently individuals subject to high personal income taxes. The tax did not penalize for not investing, it punished the individuals whose

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1) The Tax Policy League: Op. Cit., p. 91.
2) Cf.: Slade Kendrick: "The Undistributed Profits Tax", Washington 1937, Alfred G. Buehler: "The Undistributed Profits Tax", New York 1937.

savings and investments contributed so highly to the stability of the economy. In other words it penalized companies controlled by lower income groups by forcing them to minimize corporate savings in contrast to the high income groups who benefited and remained untouched. Although the tax may have had some beneficial effect on the propensity to consume of the dividend-receiving lower income groups, the tax did not provide an inducement to invest the accumulated savings of individuals and corporations. In contrast the above advocated proposal:

a) corrects the existing differences between corporate taxes, and those imposed on owners of unincorporated businesses by treating all businesses on an equal footing;

b) Equates the tax burden on all corporate income by taxing undistributed profits at a rate of 100%, and consequently forcing investment or distribution;

c) Simplifies the tax structure;

d) Eliminates other corporate income, excess profits and capital stock taxes;

e) Does not favour any income groups, and treats them according to their ability to pay by means of a progressive personal income tax;

f) Favours new enterprises up to the time when they have soundly been established;

g) Stabilizes businesses before they are subjected to taxes, and in turn stabilizes the economy as a whole;

h) Induces business to invest.

To support this proposal a general methodological discussion of the Personal Income Tax scheme will be necessary to show its interrelation with corporate taxes. Two objectives must be kept in mind. Consumption must attain

a sufficiently high level to be able to support an optimum level of production of goods and services, and savings must be so adjusted as to supplement business savings in the form of accelerated depreciation allowances to the extent that through these combined sources of savings an optimum amount of private investment can be financed. Further it must be observed that the personal income tax will be considered in conjunction with corporation income taxes to form one single policy. The lack of co-operation and interaction often defeated our efforts in the past, and because of, and despite this interrelation, simplicity must be achieved. We are not dealing with hundreds of thousands of businesses or corporate enterprises that on the average are managed by fairly competent men, but with millions, and in some countries tens of million of ordinary human beings, many of whom may not understand the most elementary principles of a tax return. The Canadian Government during the last few years had made great progress towards the simplification of income tax returns and this policy should be adopted universally.

With the prospect of a high level of consumption in mind, we must enable that section of the population whose propensity to consume is the highest, to make their influence felt. Consequently the low income groups should be as little as possible affected by the income tax, not only from an economic, but also from an ethical point of view. For this reason comparatively high basic exemptions should be incorporated in a tax system, and relative regress-

ive surtaxes should be eliminated. The entire tax scheme should be on a progressive basis. It would seem that the following initial basic exemptions would be appropriate:

$1,250.00 for single persons

$2,000.00 for married persons

$ 500.00 for each dependent,

and these exemptions may be changed if the price level should undergo considerable fluctuations. This initial exemption should be followed by a progressive income tax[1] which will be effective on any income above the basic exemption. We may designate the income before deduction of exemptions as Taxable Income, and after deduction of exemptions as Net Taxable Income. Tax rates on net taxable income should rise slowly up to a level at which inducement will still exist to invest savings. Although statistical data is not available on this subject, one may be inclined to suggest a top-limit of 60%, and with the different risk reduction features attached to the corporate income tax scheme, investment in the highest income brackets is likely to be undertaken even at this rate. If for a moment we return to a consideration of the risk factor, it may be expected that wealthy individuals will be less affected by the influence of liquidity preference and their state of wealth, than individuals of smaller means. Consequently wealthy people may be inclined to undertake investments for a return which might not be sufficient to induce investors of lesser financial strength.

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1) See schedule 3.

Schedule 3

PERSONAL INCOME TAX SCHEDULE

Basic Exemptions: To be deducted from Taxable Income

Single Persons	$1,250.00
Married Persons	$2,000.00
Dependents, each	$ 500.00

Progressive Tax: To be calculated on Net Taxable Income

$ 0 - 1,000	Tax $	0	plus 10%	of amount over $	0
1,000 - 2,000		100	15%		1,000
2,000 - 4,000		250	20%		2,000
4,000 - 6,000		650	25%		4,000
6,000 - 8,000		1,150	30%		6,000
8,000 - 10,000		1,750	35%		8,000
10,000 - 15,000		2,450	40%		10,000
15,000 - 20,000		4,450	43%		15,000
20,000 - 30,000		6,600	46%		20,000
30,000 - 50,000		11,200	48%		30,000
50,000 - 100,000		20,800	50%		50,000
100,000 - 150,000		45,800	55%		100,000
150,000 -		73,300	60%		150,000

When discussing the personal income tax, it must be clearly understood what constitutes taxable income. Undoubtedly salaries and wages will be included, as well as interest, dividends and net rent. Among these different sources of income it may be debatable whether they should be treated on even terms. There may be some ethical justification to levy surtaxes on unearned income, but due to the progressive nature of the personal income tax, differentiation has no economic foundation.

None of these categories of income included capital gains. Many treatments of this source of income could be considered[1], but of necessity due to the nature of the corporation tax, few courses will be open to us to follow. For our purposes investments undertaken by individuals could be considered as a corporate enterprise, and fall under the hammer of the corporate income tax, but since individual investments mainly take the form of corporate securities, such a treatment might cause a stock exchange boom of unprecedented proportions, and further it would not be fair towards the lower income groups that are not financially able to take advantage of such investment opportunities. It is therefore, proposed that capital gains be taxed as ordinary income, and they must be included among the taxable income. Capital gains will be considered as income at the time of sale or transfer of the investment, and this income will also have to be calculated on investments after they have been held for a perio

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1) Cf. Harold M. Groves: Op. cit., pp. 75-83.

of ten years during which taxes had not been paid on the accumulated capital gains. This latter provision must be included to enable the taxing authority to absorb from time to time benefits granted to corporations by means of the depreciation and inventory allowance, which expressed themselves in a higher valuation of the stock equity, and in order to absorb capital gains on other ventures. It will help further to achieve a wider distribution of wealth, as these taxes must be paid after ten years even if the securities or investments are not disposed of. Consequently it may force wealthier individuals to part with some of their investments to pay their tax obligations. Security valuations for this tax may be based on stock exchange quotations, but it would be preferable if the taxing authority would set a stock quotation for all corporations at the end of each taxation period. Such valuations should keep the trend of stock exchange quotations in sight.

It would be further desirable to introduce an averaging scheme, particularly with reference to the capital gains taxation, in order to distribute fairly the incidence of the progressive tax schedule. A considerable number of people have unstable incomes, and if their incomes could not be averaged over a certain number of years, they would, affected by the progressive nature of the income tax, pay more taxes than those people with a steady income, although their total receipts over a number of years may be the same. It is therefore, suggested that averaging of incomes be allowed so that those persons who would otherwise be treated

unjustly could make use of such a procedure. In order to simplify the administration of such a provision, incomes of less than $5,000.00 per annum should be excluded from the scheme, particularly since the various rates would not benefit these lower income groups to a considerable extent. The decision of choosing a method of averaging may be left to the discretion of the taxpayer, whether he prefers a five or ten-year period - but it should be emphasized that each year only once can be declared for averaging purposes.

Capital gains being declared as taxable income, the treatment of capital losses must be in proportion to this method, and capital losses should be deductible from all taxable income, i.e. earned, unearned and capital gains, a provision which should bring some of the savings of the lower income groups into the investment channel. Of course capital losses may also be applied for averaging purposes.

The taxing of capital gains may bring considerable argument, but since capital losses can be deducted from taxable income, and the business tax structure contains several provisions which safeguard against capital losses, the inducement for investment lost by the taxation of capital gains may largely be alleviated.

Before turning from this methodological discussion, one should not fail to mention one other category of taxes, e.g. consumption taxes in the form of excise and sales taxes. These taxes increase prices, hamper consumption, and to a lesser degree, savings. They particularly affect the low income groups who spend most or all of their incomes on con-

sumption. Due to these taxes less may be consumed as prices have increased by the addition of the tax. This tax is highly regressive, and should be abolished, although it is suggested that excises on cigarettes and liquor be retained, partly because these items can carry the tax very well, but mainly for ethical reasons to reduce individual consumption. It is true that for certain persons, who under no circumstances would reduce their consumption of cigarettes or liquor, the tax may be highly regressive. but in general this tax, particularly with reference to liquor, may prevent some excess consumption.

Whether the above proposal would be effective if incorporated into a fiscal policy of a nation, only experience could tell. The section concerned with the taxation of corporate enterprises would probably be gladly accepted by business, and it may find considerable opposition in other parts of the community. Its reception by the public or by politicians from another than economic viewpoint is not considered here. Proposals have been advanced which may improve on other schemes that were offered, and at the same time an effort has been made to keep the proposal within limits which can be administered. In this field success can never be guaranteed, but one must try the best possible methods under the circumstances.

CHAPTER VI

Business Taxes in the National Economy

Business must be taxed for the purpose of allowing, and possibly inducing, the private enterprise entity, industry, trade or agriculture, to perform its proper role in the national economy. This role consists in producing an optimum amount of goods and services, and in this way providing jobs, and a high standard of living for those willing to take advantage of this opportunity. This attitude is quite in contrast to the viewpoint expressed on the subject by the National Association of Manufacturers and the Congress of American Industry in the United States, which held in 1936 that "Government very properly should take through taxation from the income of production, as from other sources, such portion as is necessary to perform economically the constitutional functions imposed upon it."[1] Our view on the subject has been stated above. The trend of economic and social change in recent times, has drifted away from the attitude expressed by the National Association of Manufacturers, the Congress of American Industry, and many prominent institutions and personages representing industry, labour and government. Of course, if in the process of accomplishing what they set out to do, business taxes contribute their share toward the expenses of the state, they have also served a secondary purpose.

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1) Noel Sargent: "The Attitude of Business Concerning Business Taxation," The Tax Policy League, op. cit. p. 15.

The fear of an increasing national debt only becomes a threat when the national debt gets out of hand, i.e. when the ratio of the national debt to the national income increases, and interest payments rise in proportion to the national income. When considering the limit of the national debt, we must consider it as a ratio in conjunction with 1) the nature of expenditures themselves, 2) the wage and price structure, 3) the tax schedule, 4) the distribution of the debt, 5) above all the level of the national income and the amount of interest payments.[1]

Only if the above viewpoint is taken can taxes be integrated into an economy, and although the old-fashioned attitude which concerned itself with the revenue angle only, may have provided more revenue than under certain circumstances provided for by the advocated proposal, taxes levied for revenue only, ultimately will do more harm than good to the economy.

Business Taxes, as well as Personal Income Taxes, must be considered in conjunction with Consumption, Savings, and Investment. The influence on these economic factors by the taxes must be interrelated with the effects of the fiscal policy of the government, as well as with other governmental policies affecting the national economy.

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1) Cf.: Neil H. Chamberlain: "Prof. Hansen's Fiscal Policy and the Debt," American Economic Review, June 1945.
M. Kalecki: "Full Employment by Stimulating Private Investment," Oxford Economic Papers, March 1945, No. 7.
Evsey D. Domar: "The 'Burden of the Debt' and the National Income," American Economic Review, December 1944, pp. 798-827.

In times past the government has performed its function of political representative of the community. It represented the country with regard to foreign policies, it provided for the defense of the country against its enemies, it provided services which private individuals would not or could not undertake. Generally however, government kept clear of economic grounds. The field of economic policy was left to private individuals who in their strife for personal gain, were supposed to advance the interests of the community automatically. Important structural changes, as time went by were not heeded, and public policy did not react in time to these fundamental changes, a failure which had severe repercussions in the occurrence of severe depressions. This failure may be attributed mainly to the fact that prosperity, as well as depression, were regarded as essential characteristics of a system of free enterprise and private property. We must be cognizant of the fact that in the modern world no system can survive which permits the continued recurrence of serious depressions. If a private enterprise economy must be plagued by serious depressions, this system is doomed. We believe that economic fluctuations can be controlled, and with this control the system of free enterprise, within the limits explained, can survive.

Accepting the possibility of business cycle control, we must recognize that this control can only be exercised by public administration. Therefore, government must be admitted into the economic spheres of the community. Our goal is continuous prosperity and full employment. If we

want to achieve this, we must accept some government participation in the economic life of the country. We have discovered that the maintenance of sufficient total outlay is a basic necessity for full employment in a money economy, but we must also admit that the structural changes of the times also left their mark on the individual minds of the population. Previously the economic system automatically determined the distribution of its product, and the direction of demand. If this distribution benefited us we were thankful, and if it did not, we accepted it as an inevitable result of the private enterprise system operating under the price level. Despite the appearance of inadequate housing, nutrition, health, and the lack of other essentials of life for a large section of the population, it was not recognized that the capacity of the system to supply certain minimum standards, if the economic demand was not created through the automatic functioning of the system, could still be harnessed, and nothing was done about it.

The appearance of political ideas which guaranteed these minimum economic standards at the cost of certain essential liberties, finally put the decision of the problem into the hands of the people. If private enterprise can guarantee certain standards of life it may have a good chance of survival, and if this guarantee cannot be given, its death knell has sounded. "Freedom from want" has become the slogan of our society, and we must set out to achieve certain minimum standards for every member of our community. Every person must be able to enjoy certain minimum food requirements which

are necessary to maintain an adequate nutrition standard. At the same time public-health services, with hospital and medical care must be supplied to the entire population in order to overcome preventable disease. This plan should be reinforced by housing conditions commensurate with modern standards. Housing should be provided for the entire population adequate to ensure modern sanitation and health conditions. Finally minimum educational standards must be provided for the entire population. Financial ability to meet individual educational costs should not become the criterion to determine educational standards. Children in poor parts of the country should benefit from similar educational facilities, as those in richer parts. In addition advanced educational opportunities should be provided for the highly gifted members of the community without considering their financial ability to pay for them.

Government must guarantee these minimum standards through a social security scheme, and it must be left to private enterprise in conjunction with public enterprise and government planning to achieve the maximum standards expressed in an optimum output of a full employment economy. We have maintained that this problem hinges partly on the maintenance of outlay, and this outlay in turn hinges on the maintenance of a sustained demand as far as private investment is concerned. Investment expenditures are made in anticipation of consumer demands and are not likely to be made unless business is assured in advance of an adequate market. We hear much of the reluctance of businessmen to

take risks and engage in new ventures because of a lack of confidence. However, business confidence is an effect and not a cause. It will exist if there are markets to look forward to; it will not exist if markets are lacking. Purchasing power must be maintained at a high level, and if this is done private industry, trade and agriculture will supply the market with the goods and services demanded by the public, - a rich variety of goods at reasonable prices. Experience has shown us that the consumer is the real employer. If he receives adequate income, business has a buyer for its products, and having a buyer for its products, it has jobs for the workers. The effective demand must take up gigantic proportions because the powers of modern industry to produce, far exceeding those of any earlier period in history, mean that an enormous output has to be reached before full employment is approached. Private enterprise and government together must act to maintain and increase output and income to provide an optimumutilization of our resources in a full employment economy.

Up to now our main efforts were directed to stimulate private investment, but as we have seen, we must also effect a full utilization of consumption opportunities to create the effective demand necessary for continued investment. We have followed the principle that taxation according to ability to pay is desirable. Consequently we arranged that under the proposed tax scheme all tax payments will be shifted unto the progressive personal income tax. In this way the incidence of the corporation income tax is clarified.

The plain fact is that taxes taken by themselves alone are more or less restrictive. We must consider them as expansionary only if they are not paid at all but induce expenditures, or if the tax funds collected are expended. Taxes must be as little restrictive as possible to maintain private investment as the greatest income generating factor, and in order to obtain an optimum amount of consumption. Under the proposed scheme business is not taxed but the disposable surplus is paid out to individual owners who in turn pay taxes under the progressive personal income tax, which must be set up in such a manner that optimum consumption and optimum private investment will be undertaken.

The essentials of a full employment economy, we may conclude again, are the maintenance of sufficient outlay which will result in investment and consumption expenditures, that are ultimately expressed in the National Income. When dealing with the National Income we must take note of the following four factors: 1) the change in productivity per man hour, 2) the change in the working population, 3) the change in the length of the working week, 4) the change in the price level. We are assuming that we consider a Full Employment National Income. Nicholas Kaldor[1] with reference to these four factors has come to certain conclusions for Great Britain. For the United States and Canada the problem must again be investigated.

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1) Nicholas Kaldor: "The Quantitative Aspects of the Full Employment Problem in Britain," in Sir William Beveridge: Full Employment in a Free Society, New York 1945, Appendix C, pp. 395-398.

For Great Britain the minimum rate of increase in the productivity under full employment conditions in peace time could be put at 2 percent per annum. United States estimates, which with certain reservations may be applied to Canada, agree with this minimum rate of increase.[1] For thirty years the output per man-hour of American manufacturing industries - based on the machine - has risen at a rate of over 3 percent per year. The years covering the late war resulted in phenomenal increases of productivity for several industries. New projects were created, better methods developed, and particularly the appearance of substitutes contributed greatly to the stupendous expansion of output in American and Canadian industry. Many of the new industries are here to stay; the old established industries are benefiting from the new methods developed during the war years; and substitutes in many cases have replaced some of the established products for all time to come. One has only to consider the possibilities offered by the development of radar. Through new electronic devices electric power may exert a greater influence on industrial productivity than was ever thought possible before the war. The discovery which harnessed atomic energy, and which at some future time may make this new source of energy available to industry, may again baffle our imagination.

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1) Cf.: Jacob L. Mosak: "Forecasting Postwar Demand III," Econometrica, January 1945.

To cite a few examples in the field of new methods, new welding processes in the opinion of production men were among the foremost striking savers of time and cost; the productive genius of American industry developed practically overnight rubber substitutes to replace the raw material of the lost plantations of Malaya and the Netherlands East Indies, and Chemistry generally throughout the war years has opened up territories, particularly by the development of plastics, which undoubtedly will contribute to maintain the increasing rate of productivity, not only in American and Canadian industry, but in all countries where industry has become established. Many factors influenced industry during the war years, and although the output was stupendous, the overall rate of productivity was lagging, due to such factors as waste and organizational inefficiency, the lack of skilled labour, and long working days, the disappearance of competition and the character of excess profits taxation. In times of peace, when war and emergency measures have been relaxed, and under conditions of full employment, the industrial advances made during war time, will make themselves felt. The 2 percent yearly increase in productivity is likely to be maintained, and the minimum rate of increase arrived at by Nicholas Kaldor to cover Great Britain may be accepted for the United States and Canada, but in all probability will be surpassed. The problems connected with an increasing industrial productivity are manifold. Under conditions of full employment and a stable or increasing population, an increasing productivity

must mean increased output, and a higher standard of living. In times past however, output has not increased in proportion to productivity.[1] Although we may strive for an increasing amount of leisure for the worker, we must also maintain, and preferably increase, weekly wages, and these objectives can be achieved only when total output increases in proportion with productivity.

In Great Britain, Kaldor assumes, that the population will reach a peak in 1970, and be stabilized at a level only slightly below that of 1970, with an effective working population of some 12.5 percent below that of 1945. For the United States and Canada the picture may not be as pessimistic, and changes in population will further depend on immigration policies which cannot be foretold.[2] In the light of economic and political developments however, it is likely that immigration will be of considerably lesser influence on the population trends of the United States, and probably of Canada also, during the second half of the twentieth century, than it has been during the past. In the United States it is expected that the population will increase until some time between 1955 and 1980 when a peak somewhere between 140 and 160 million people will be reached.[3]

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1) Cf.: Spurgeon Bell: "Productivity, Wages, and National Income", Washington 1940, pp. 169-172.
2) For American and Canadian Population Growth see: E.L. Bogart and D. Kemmerer: "Economic History of the American People", New York 1942, pp. 737-765; C.A. Ashley, Editor: "Reconstruction in Canada," R.H. Coats: General Economic Setting, Toronto 1943, pp. 17-18.
3) Frank Lorimer, Ellen Winston, Louise K. Kiser: "Foundation of American Population Policy," New York 1940, pp. 9-10.

For Canada forecasts are somewhat more difficult to make, but it may be assumed that the trend of American population growth will closely affect that of Canada. While the continuation of population growth would in itself bring about great problems, its cessation will also bring serious problems, and involves fundamental economic adjustments. Nevertheless the approaching cessation of population growth in Great Britain, as well as in the United States and possibly Canada, may have advantages that in the long run may equal or outweigh its disadvantages. Greater emphasis must be laid on production and distribution, and the interrelation of these factors must be geared to the interest of the people, the consumers of goods and services. At the same time attention must be paid to the fact that the population must be maintained, and positive measures must be developed consistent with other social interests, for offsetting the present trend toward population decrease, so as to assure population maintenance at relatively high levels.

In 1948 working hours in Great Britain, according to Kaldor, will be reduced to the 1938 level, and may be assumed to fall by 10 percent every twenty-five years. In the United States and Canada the trend of the working week has also been steadily declining, and prior to the outbreak of war, a 40-hour week was the most common arrangement in American industry. This is a considerable reduction from the average 55-hour week[1] at the turn of the century, and

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1) Dale Yoder: "Labor Economics and Labor Problems," New York 1939, p. 283.

it would indicate an approximate 20 percent decline over a twenty-five-year period. It may be expected that industry will again return to a 40-hour week, and the assumption that the working week will decrease at the rate of 10 percent over twenty-five years seems fairly reasonable, but we must recognize that there is an ultimate limitation to the reduction of working hours. Our assumption therefore must be considered in this light, and expectations seem to indicate a probable stabilization of the working week between the 30-and 40-hour levels.

Kaldor further assumed that governments will pursue a monetary and wage policy which maintains the price of final commodities at a constant level. In this respect it might be well to state briefly the contentions generally advanced in favour of a stable price level: 1) Creditors will be enabled to be paid back the same command over goods and services as that which they originally loaned; 2) Businessmen will not have to fear wildly fluctuating prices; 3) Windfall profits due to the lag of costs behind rising prices will be eliminated; 4) Consumers are assured of their monetary purchasing power; 5) Businessmen are protected against shrinkage of inventory values which accompanies falling prices, and frequently forces business to contract operations. Opponents of a stable price level base their arguments mainly on the following grounds: 1) Improving techniques will cause a profit inflation if money costs fall; and 2) a stable general price level does not ensure flexible individual prices within the system. These contentions however, do not consider the fact

that part of the benefits realized from technological improvements will go to labour, and consequently money costs will not fall greatly. Further the term "stable price level" does not represent the point of view that price adjustments cannot take place. It should present the contention that the general price level should be kept as stable as possible, but should allow for individual adjustments, when these become necessary, within the frame of a stable general price level. A system which maintains a stable price level seems to be advisable. It is superior to a slowly falling price level, and prevents complications which would arise under a slowly rising price level. Debtor and creditor groups are treated fairly, and the seller and purchaser know approximately what price they will have to pay for certain goods. Nevertheless attention should be drawn to the fact that wages should increase during periods of technical advance, so that costs may be kept approximately constant, and abnormal profits prevented.[1]

The maintenance of a stable price level is of particular importance at the present time when inflation threatens to disrupt our economy. Although prices have increased above 1939 levels, they have not got out of control. It might be well to remember that after World War I throughout 1919 and 1920 a shortrun boom swept the United States and Canada. The same forces which caused the inflationary

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1) Cf.: John H. Williams: "Free Enterprise and Full Employment," in Financing American Prosperity, edited by Paul T. Homan and Fritz Machlup, New York 1945, pp. 359-373.

boom at that time are present again to-day. Shortages of consumer goods were accentuated by extensive speculation in inventories, and the consequent rise in prices was much more rapid than that of the war itself. Financial profits, in the nature of speculative mark-ups, were large. The effects of this price boosting were rapidly rising costs of living, and this stimulated demands for increases in wage rates. Acute industrial unrest developed. Extensive cancellations of orders and the curtailment of production schedules followed the so-called "buyers' strike" of 1920. A general collapse of prices resulted. Within one year the all-commodity price index was sliced in half, and the paper gains of the boom period were wiped out. Business started to progress through the period of recovery, and prosperity was not accompanied by advancing prices, but a stable or even declining price level. The formidable technological advances resulted in low-unit costs of production, accompanied by high corporate profits which contributed to the stock market boom and speculative tendencies which resulted in the crash of 1929.[1]

From the above we should realize that prices must be kept in line with productive activity. This means low and stable prices in an economy with a sustained level of high activity, and reasonable profit-making opportunities. Prices must be kept at a level where the total product can continuously be taken off the market by the current purchasing

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1) Edwin G. Nouse: "Price Making in a Democracy," Washington 1944, pp. 307-310.

power. Prices must represent productive values in order to shorten the period of readjustment. Paper profits not only will prolong reconstruction, but will make final recovery more difficult.

With these points in mind the government must set out to plan a fiscal policy which will be sufficiently flexible to absorb economic fluctuations as they may occur. In considering the national income as a basis for fiscal planning, a change in productivity must be expressed in a proportionate rise in the national income, all other factors remaining unchanged. The same applies to a change in working population, and a change in working hours. A change in the price level, although undesirable, must also be included in the calculations which will show us how the economy is faring and what actions must be taken. It is imperative that the National Income, a Full Employment National Income, is maintained at all costs. Private outlay, together with essential government outlay, must form the basis of the National Income, and if they are not sufficient to achieve full employment, further public outlay will be required to complement the other factors in their strife to maintain a full employment national income. The effectiveness of these additional public outlays will depend on their income-generating effects, and it is suggested that the budget should have as progressive a character as possible, i.e. that it will lead to a redistribution of monetary income from high-saving into low-saving groups if the budget is balanced, and if a deficit must be shown, expenditures should be

directed into those channels where the propensity to consume is highest.[1]

It may be seen at first glace that the entire problem is a tremendous one. Without planning it could never succeed. The government, the authority responsible for the well-being of the population, must have sufficiently centralized information to be able to determine at any time whether the expenditures poured into the economy by private as well as public bodies, are sufficient to maintain the national income at its proper level. If the government, perhaps by means of a Planning Board, should ascertain that insufficient outlay is expended, it must have at its disposal measures which will supply the funds that will restore the national income to its proper level. If on the other hand too much is expended so that the price level is endangered, reductions must be undertaken. This can be done by 1) reducing government outlay up to a level where necessary services and projects would not be affected, 2) increase business taxes by way of a reduction in depreciation and inventory allowances, 3) re-arrange the personal income tax schedule in order to curb investment, and if necessary consumption, 4) levy consumption taxes, 5) introduce rationing, etc. Increases of the national income by means of fiscal policy could be affected by 1) extending public expenditures, 2) reducing personal income taxes,[2] etc.

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1) Cf.: Henry C. Wallich: "Income-Generating Effects of a Balanced Budget," Quarterly Journal of Economics, November 1944, p. 78.

2) Business Taxes on Income cannot be reduced under the advocated proposal, as all the net business surpluses must be absorbed by the progressive personal income tax.

Besides Fiscal Policy measures, the active participation of the government in the economic life of the country involves the establishment of tremendous organizations. It is almost universally true that the government has become the biggest business corporation in any country. Through this active participation in the economic life alone, the government can exercise a tremendous influence on the economy of the nation. By supplying services, operating monopolies, or by undertaking public works, millions of people become dependent on the government for their daily income. This branch of government enterprise must also be as flexible as possible. It must be able to extend its operations, and to contract its activities, but all these actions must be decided by the centralized executive of the planning board. Co-operation among government agencies and among different levels of government is one of the first stipulations for success.

Referring to different levels of government it may seem strange that their tax policies were not discussed. By advocating a central Planning Board it is precluded that all matters relating to fiscal policy should, as far as possible, be conducted and executed by that body. Interference by subordinate levels of government would unnecessarily complicate the problem. The central government should provide the finances for subordinate governments, and may call on them for assistance in various schemes appertaining to them. It is recognized that constitutional objections must be overcome, but a fiscal policy can be successful only if it is

centrally controlled. Interference in this field by municipal, local, provincial or state governments would hamper our projects.[1]

Up to now the discussion, as it were, dealt with a closed economy but in reality we are not dealing with one single country; we must also consider the influences of policies of other countries upon our country. The National Income is not only influenced by internal factors, it is also affected by visible and invisible imports, and visible and invisible exports which form the balance of payments. They must be included in the considerations of a fiscal policy, as they will be of the greatest importance in the postwar world.

We may realize the magnitude of the problem of economic policy and planning, and this may impress upon us that taxation comprises only part of the problem. To look at the entire field of economic and fiscal planning may be confusing, and it is for this reason that we must arrange the separate parts in as simple a manner as possible. This will also apply to the role taxation will have to play. We have striven to consider this fact. Simplicity must not only

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1) "Business Taxes in the states of the United States are a conglomeration of heterogeneous taxes imposed for different purposes, on different bases, under many forms of rate schedules, and with many types of administrative machinery. They are characterized, in general, by arbitrariness, complexity, and lack of co-ordination. Businesses are subject not only to property taxes, net income taxes, excise taxes, sales taxes, capital-stock taxes, and severance taxes, but also to a great variety of special charges, including privilege, license, and occupation taxes." Alvin H. Hansen and Harvey S. Perloff, op. cit., pp. 44-45.

be achieved for the benefit of the population, it is of the utmost importance that the planners themselves deal with simple problems which they may grasp without having to look through complicated curtains to detect the core of the problem.

Business taxes as we have seen cover a section of fiscal policy, a very important section at that. It has been emphasized that we must pay great attention to them. They may mean the difference between depression and prosperity, unemployment or full employment. Their effects may often be surprising and disappointing, at other times overwhelming. Businessmen in their strife for profit are the most sensitive people imaginable, and they react at a moment's notice. We have tried to integrate these considerations into the tax proposal advanced. As is the case with many things, success or failure will depend on the individual reactions of the businessmen which together may form a tremendous wave, often breaking anything that obstructs its path. The proposal tries to direct this flow of reactions into favourable channels.

APPENDIX

In the following example I shall consider a hypothetical manufacturing business subject to the taxes as proposed in Chapter V. The corporation is owned by three individuals, whose stockholdings are as follows;

A - 500 shares of $100.00 P.V.

B - 250 shares of $100.00 P.V.

C - 250 shares of $100.00 P.V.

The capital of the company consists of 1000 shares of $100.00 Par Value, and A and B take active part in the management of the business, drawing annual salaries of $10,000 and $5,000 respectively. We will assume that due to the investment allowance, machinery costing $50,000 has been purchased during the past year, and that undepreciated plant and equipment amount to $50,000 also. Inventories remaining at December 31st of Period 1 are valued in the books at $20,000 and dividends declared for this period will amount to $20,000.

Period 1:

Total Revenue	$500,000.00
Cost of Operations	400,000.00
Profit before Depreciation and Inventory Allowances, and before Dividends	$100,000.00
Depreciation Allowances	60,000.00
Inventory Allowances	20,000.00
Net Profit before Dividends	$ 20,000.00
Dividends	20,000.00
Profit subject to 100%	$ 0.00

In the following calculations we may see how the different stockholders will be affected by the Personal Income Tax. We shall assume that the stockholders will not receive any income except that paid by the corporation.

The family status of the stockholders is as follows for the calculation of basic exemptions:

A - Married, two children

B - Single,

C - Married, two children.

Personal Income Tax Calculation for Period 1:

	A	B	C
Salary	$10,000.00	$ 5,000.00	
Dividends	10,000.00	5,000.00	$5,000.00
Taxable Income	$20,000.00	$10,000.00	$5,000.00
Less: Basic Exemptions	3,000.00	1,250.00	3,000.00
Net Taxable Income	$17,000.00	$ 8,750.00	$2,000.00
Tax at Schedule Rates	$ 5,310.00	$ 2,012.50	$ 250.00

Period 2:

Due to last year's purchase of machinery no new investments have been made during this period. The new machinery enabled the concern to increase their output, and consequently their profit. Inventory valuation at the end of the period amounted to $30,000, and depreciable assets were at $40,000.

Total Revenue	$550,000.00
Cost of Operations	440,000.00
Profit before Depreciation and Inventory Allowances, and before Dividends	$110,000.00
Depreciation Allowances	40,000.00
Inventory Allowances	30,000.00
Net Profit before Dividends	$ 40,000.00
Dividends	40,000.00
Profit subject to 100% tax	$ 0.00

Personal Income Tax Calculation for Period 2:

	A	B	C
Salary	$10,000.00	$ 5,000.00	
Dividends	20,000.00	10,000.00	$10,000.00
Taxable Income	$30,000.00	$15,000.00	$10,000.00
Less: Basic Exemption	3,000.00	1,250.00	3,000.00
Net Taxable Income	$27,000.00	$13,750.00	$ 7,000.00
Tax at Schedule Rates	$ 9,820.00	$ 3,950.00	$ 1,450.00

Period 3:

Although further expansion could be undertaken, the directors feel that the time is not ripe to undertake new capital investments. Revenue has remained at the same level but costs have risen somewhat. All assets have been depreciated, and inventory valuation at the end of the period was $40,000.

Total Revenue	$550,000.00
Cost of Operations	450,000.00
Profit before Depreciation and Inventory Allowances, and before Dividends	$100,000.00
Depreciation Allowances	0.00
Inventory Allowances	40,000.00
Net Profit before Dividends	$ 60,000.00
Dividends	60,000.00
Profit subject to 100% Tax	$ 0.00

Personal Income Tax Calculation for Period 3:

	A	B	C
Salary	$10,000.00	$ 5,000.00	
Dividends	30,000.00	15,000.00	$15,000.00
Taxable Income	$40,000.00	$20,000.00	$15,000.00
Less: Basic Exemption	3,000.00	1,250.00	3,000.00
Net Taxable Income	$37,000.00	$18,750.00	$12,000.00
Tax at Schedule Rate	$14,560.00	$ 6,062.50	$ 3,250.00

Averaging of Incomes:

Although under actual circumstances averaging should be applied to five or ten-year periods, to complete the hypothetical and imaginary example, I shall apply a three-year period as it will suffice to show the effects of an averaging procedure.

		A	B	C
Taxable Income	Period 1	$20,000.00	$10,000.00	$ 5,000.00
	Period 2	30,000.00	15,000.00	10,000.00
	Period 3	40,000.00	20,000.00	15,000.00
Total Taxable Income Applicable to Averaging Period		$90,000.00	$45,000.00	$30,000.00
Taxable Income Applicable to one Period (Divide Total Taxable Income by Number of Periods)		$30,000.00	$15,000.00	$10,000.00
Less: Basic Exemption		3,000.00	1,250.00	3,000.00
Net Taxable Income		$27,000.00	$13,750.00	$ 7,000.00
Tax at Schedule Rates		$ 9,820.00	$ 3,950.00	$ 1,450.00
Total Tax Payable for Averaging Periods (Multiply Tax by Number of Periods)		$29,460.00	$11,850.00	$ 4,350.00
Tax Payable if Averaging Not Allowed:	Period 1	$ 5,310.00	$ 2,012.50	$ 250.00
	Period 2	9,820.00	3,950.00	1,450.00
	Period 3	14,560.00	6,062.50	3,250.00
		$29,690.00	$12,025.00	$ 4,950.00

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