TABELL'S MARKET LETTER

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Tax reform is a subject much in the news of late. It has been suggested that a major program for overhauling the present tax structure will be proposed in the near future by the Nixon Administration, and there are a few observers who will not agree -- whatever their biases as to the shape reform should take -- that change is long overdue. This is particularly true, in our own opinion, of the way in which we have chosen to tax corporate profits.

The eloquent Dr. Henry Wallich, Yale Professor and Senior Consultant to the Secretary of the Treasury, has made a valuable contribution to tax reform discussion in an article in the April Fortune. In it he discussed VAT, which is not a brand of Scotch, but the value-added tax, a device particularly popular in Western Europe. VAT, quite simply, consists of a tax levied at a fixed percentage rate on all sales, but with the tax paid by suppliers deductible. Since the tax is effectively imposed only once on a given stream of income, it becomes, in reality, an actual percentage tax on G.N.P.

VAT has long been one of our favorite proposals, and Professor Wallich states its case eloquently in his article -- which we wholeheartedly recommend. He despairs, however, of being able, in practice, to substitute VAT for the corporate income tax entirely. In this connection, we have our own favorite radical proposal which, we think, could make for both a more efficient tax structure and better allocation of economic resources. That proposal is quite simply to raise the corporate income tax to 100%, with dividends as a deductible item. The effect of this, naturally, would be to eliminate the current corporate practice of retaining earnings and to force all profits to be paid in the form of dividends to stockholders.

To understand the need for this sort of radical surgery, it is necessary to understand what is wrong with the present system. Its central shortcoming, in our opinion, is that, last year, some $45 billion (total after-tax corporate profits) was deployed without being in the least subject to the discipline of the market place. The net effect of the present system is to create two classes of corporate earnings -- one privileged, and one subject to virtually confiscatory taxation. The undistributed portion of corporate profits (almost $60 billion last year) is taxed once at roughly a 50% rate. The remainder gets the same 50% lopped off the top, after which the recipient of the dividend pays a tax of between 20% and 70% on the dividend income he receives. For investors in the top tax bracket, this involves a total tax of 85% -- or a case where, of $6.66 of corporate profits, $1.00 is returned to the owner of the business, and $5.66 goes to the taxing authorities.

This is not even the worst objection, for the most pernicious effect of the present system is on resource deployment. A manufacturer of, say, buggy whips will normally retain some portion of his post-tax profit and reinvest it -- in most cases in expanded buggy-whip capacity. He will not use the earnings, for example, to enter the computer peripheral business because he has spent his entire life in buggy whips, and knows little about computers. And he will be disinclined to pay a higher dividend because the entire system conspires to make a dollar of retained earnings worth more than a dollar of distributed earnings. This process tends to go on, until the buggy whip manufacturer goes out of business taking large sums of his stockholder's money down the drain with him. Had our manufacturer been forced to pay his earnings in dividends to stockholders, they, at least, would have had the option as to whether investment in buggy whips or computer peripherals was in their own best interests.

In practical terms, our proposed system would have less effect than might be expected on total tax revenues. Pre-tax corporate profits last year (third quarter-annual rate) were $84.4 billion, of which $38.9 billion was paid under the present corporate-profit tax, $25.4 billion was distributed as dividends, and $20.1 billion was retained. Suppose, the entire $84.4 billion, $59 million more than was the case last year, had been distributed and was subject to tax. Assuming an average 40% tax rate, this would produce $23.6 billion in personal income tax revenue to make up for the $38.9 billion lost from the present corporate tax. The $15 billion difference is where Professor Wallich's value-added tax might well step into the picture.

The major objection to this system, of course, would be that the corporate community would have to find some way of replacing the $20 billion of stockholder's money, which it is now deploying without consulting with those stockholders. The answer, of course, is that they could obtain it quite simply by the flotation of new security issues. We trust we are not overly proud of our own industry, if we state that Wall Street is admirably equipped to handle the distribution of such issues at minimal cost -- the financial community's historic function and something it has always done rather well. And it would then be the free-market, rather than the whim of corporate executives which would determine where newly-generated capital was employed and at what cost.

We think, in summary, that forced distribution of corporate profits, elimination of the corporate income tax, plus a possible value-added tax, would constitute not only a meaningful tax reform, but would be a stimulus to more efficient allocation of scarce capital resources.

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