

ment medium for all individuals, it would probably be in the public interest if they were more widely held than they are at present, and they have considerable merit as a hedge against inflation. At present, however, share prices are too high to warrant investment by small savers. The supply of shares could be increased, and prices reduced, by making corporations more willing to finance new investments from shares rather than from bonds or bank loans. As I mentioned earlier, a major deterrent to the expanded issue of new shares is the fact that the corporate income tax treats interest as deductible. Hence, the true cost of dividends to the corporation is relatively higher than that of interest on bonds and loans. To take the figures of footnote 5, the cost before tax of dividends to the corporation, at a 52-percent tax rate, is 6.5 percent when the yield to the share owner is 3.1 percent, as compared to a pretax (and posttax) cost of 4.7 percent of interest on bonds. Even now substantial numbers of new shares are being issued, but probably not as many as would correspond to the high level of stock prices.²⁰

The issue of new shares could be stimulated, if this argument is correct, by changing the deduction rules for the corporate income tax. Interest paid by corporations, according to this proposal, would no longer be fully deductible; instead it would be deductible only to the amount of taxable interest received; in other words, net interest paid would not be deductible.²¹ At the same time the percentage rate of the tax would be adjusted downward, since the purpose of this change would not be to increase the total tax burden on corporations. To safeguard payment of interest on senior obligations, it would be made possible to obtain a tax deferment to the extent necessary to pay such interest in case of insufficient income. An incidental consequence of this change, and one which most economists would probably applaud, is a modest reduction in the marginal tax rate on corporations, which would probably lead to a greater effort to cut down unnecessary expenses and a greater willingness to bear risk.²² The principle that taxation should not interfere with sound rules of corporate finance will also find general support.

The introduction of this change in the deductibility of interest would have to be gradual, for the proportion of junior to senior obligations varies between firms so that the tax payable by some firms might change suddenly even though the total yield of the tax remains unchanged; a sudden change in the tax base might therefore be disruptive. One way of arranging a smooth transition would be to leave the present deduction rules in force for interest on debts contracted before a cutoff date and apply the proposed rule only to debts contracted or renewed after that date. The tax rate could then be reduced

²⁰ Footnote 6 also shows that the advantage of bonds over stocks has narrowed considerably in recent years, although it is still appreciable.

²¹ The deduction of interest paid from interest received would be allowed since otherwise financial corporations, whose business it is to lend money obtained by borrowing, would be placed in an impossible position. Only taxable interest received would be considered, since tax-exempt interest already enjoys special consideration.

²² If in 1956, the last year for which corporate income tax data are available, the proposed change had been fully in effect, taxable income of \$46.9 billion, would have been increased by about \$3.5 billion or 7.4 percent; the last-mentioned figure was estimated by adding the interest paid and subtracting the taxable interest received in all industrial groups for which there was a net outflow of taxable interest. The average tax rate of 45.6 percent could consequently have been reduced to 42.5 percent, and the marginal tax rate of 52 percent correspondingly to 48 percent.