

December 10, 1942

To: Hon. James F. Byrnes

From: Leon Henderson

Subject: Public Policy on Government Subsidy Payments

1. We Have Obtained Control of the Price Structure.

In order to prevent a run away price and cost situation, it was necessary for the Government last spring to bring the entire price and cost structure under control. Selective control of prices gave way to the General Maximum Price Regulation, to greatly extended rent control, and to the development of wage and salary stabilization. By these and subsequent actions we have brought under price control 90 percent of the cost of living, and virtually all wholesale prices except those of finished combat items and subassemblies. These measures broke into the spiralling inflationary movement which was under way at that time and permitted us to bring the price situation under control.

2. Limited Price Increases May Now be Permitted to an Extent Consistent with the Maintenance of Control.

The attainment of control does not, however, end our job. Now that control has been attained it is necessary to manage prices, that is, do the more refined job of administering prices in such a way as to facilitate the war production program and the general requirements of the war economy. The original assertion of control over the inflationary price spiral required a rigid and inflexible attitude towards prices. So long as there was any question about the control of the explosive inflationary forces, the price instrument could not be used to promote the objectives of the war economy.

Price administration, on the other hand, requires a certain flexibility which could not be risked until control was assured. Successful administration permits of some upward movement. But the permissible upward movement must be sufficiently small so that it does not have repercussions on farm prices and wage rates which would in turn react on the price level, set off the spiral again, and endanger our control.

3. Although the Price Structure is Now Under Control, the Forces Making for Cumulative Increases Remain Present.

Our price ceilings are being subjected to the pressure of increasing costs of production and distribution. These pressures will persist and increase because of war dislocations, regardless of our ability to stabilize raw material prices, or wage rates, or transportation rates.

(a) The drive to secure an adequate volume of raw materials means pressing on marginal sources of supplies, the use of which would not be economical under normal circumstances. It means in many cases the substitution of new and more costly raw materials for those normally used.

(b) The drive to attain full use of facilities means the utilization of facilities that are less efficient than those now in use.

(c) The withdrawal of 10 million men from the labor force by the end of 1943 will require not only a drastic shift of workers from industry to industry with attendant problems of retraining, but the introduction into the labor market of an almost equal number of nonworkers. Output per man hour must be expected to diminish and labor costs per unit of output to increase.

(d) Transportation costs must be expected to increase as a result of the rerouting of traffic, the delays due to congestion, and increased maintenance costs.

(e) Beyond these cost increases there are others which must result from the commitments the Government has made with respect to parity in the field of agricultural prices, and the elimination of substandards and inequalities in the area of wages.

4. In General There is Elbow Room for the Absorption of Substantial Cost Increases.

In the field of industry corporate profits before taxes averaged \$4 $\frac{1}{2}$  billion in the period 1936 to 1939. In 1941 they amounted to \$14 billion. This year they will total at least \$19 billion. In agriculture also net income of farm operators, that is, income after all expenses, has increased from \$4 $\frac{1}{2}$  billion in 1939 to \$9-3/4 billion this year. This is \$1 billion in excess of the peak rate raised in 1919.

5. There Will Nevertheless be Many Situations in Which Profits Will not Permit the Absorption of Cost Increases.

This is true of the marginal output of many industries, output which is essential to the war effort. Even though the bulk of an industry's output is being produced under favorable conditions, some part may be produced at costs higher than the price ceilings. It is also true for distribution of essential civilian commodities in particular areas, and for the production of specific commodities whose ceiling prices will be insufficient to cover direct costs, even though the profits of industries from the production of other commodities may be generally favorable. In those cases the returns to producers must be increased if the production and distribution of goods essential to the war effort is not to be impaired.

6. Returns to Producers Can Be Increased Either by an Increase in Prices or by Subsidies. Price Increases Should Be Avoided for Commodities Which Bulk Large in the Government's or Consumer's Budget.

(a) Price Increases. Where major cost-of-living items are directly or indirectly affected, industry-wide price increases should be avoided. (1) Such price increases expand the profits of firms whose profits are already more than adequate at the same time that they provide relief to those firms which need it. (2) It is difficult to prevent the pyramiding of such price increases throughout the price structure. (3) The administrative difficulties of adjusting the whole series of interrelated prices are formidable. (4) Finally, an increase in the cost of living makes it extremely difficult to avoid an increase in farm prices and wage rates, with consequent reactions on prices. If further increases in farm prices and wage rates are permitted, we will again be involved in an upward price-cost spiral. The prices of significant cost-of-living items must, therefore, be firmly held, lest our control of the price structure be jeopardized.



(b) Subsidies. In the case of such items producers' returns must be increased by subsidies wherever such an increased return is necessary to maintain the essential production or distribution. Such subsidies will cost consumers and the Government a fraction of the original cost increase in contrast to price increases which cost the consumer and the Government more than the cost increases.

7. Conditions for the Granting of Subsidies.

(a) Subsidies should not be used to meet increases in the cost of producing or distributing commodities which have only a minor direct or indirect effect on the cost of living. Such cost increases may be met by price increases without raising the cost of living sufficiently to threaten our control.

(b) Subsidies should be provided only for the production and distribution of goods essential to war production or to the maintenance of the health and efficiency of the civilian population. Wherever it is deemed advisable to encourage continued production of non-essential commodities, price increases rather than subsidies are indicated.

(c) All possible cost economies should be required before subsidies are granted. This condition means not only that waste and extravagances must be eliminated; it means also that positive programs must be adopted to standardize or simplify output, concentrate production to secure optimum operations, and cut costs in other ways. Such economies are necessary not only to protect price ceilings, but also to secure maximum use of our resources for war. Sufficient economies will not be attained by any automatic processes. Positive and vigorous Government programs are needed.

(d) Subsidies should be granted only to those firms which still need them after having made all possible cost economies. They should be granted on an industry-wide basis only when the profits of producers of the bulk of an industry's output are at unreasonably low levels. Unless subsidies are confined to the firms which need them, a substantial part of the saving associated with the subsidy device will be lost, and the cost of subsidies will approach that of price increases.

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