THE SECRETARY OF THE TREASURY
WASHINGTON

July 14, 1941

Dear Chairman Eccles:

I am sending you herewith, in strictest confidence, a copy of a revised draft of memorandum for the President.

I would appreciate it very much if you would study this draft and meet with me at my office at 8:30 tomorrow morning prepared to give me the benefit of your suggestions and criticisms.

Yours sincerely,

H. Morgenthau Jr.

Hon. Marriner S. Eccles,
Chairman, Board of Governors,
Federal Reserve System,
Washington, D. C.

MEMORANDUM FOR THE PRESIDENT

I. The Present Price Situation

Since the beginning of the war, September, 1939, wholesale prices have risen about 16 percent, of which rise the greater part has occurred during the past five months.

The cost of living index has increased 5-1/2 percent since the beginning of the war.

The index of 28 basic commodities has increased 48 percent since the beginning of the war. This latter constitutes a danger signal of inflation which must not be ignored. The wholesale price index always lags greatly behind the index of basic commodities, while the cost of living index does not show anything like the full effects of inflation until long after the seeds of inflation have taken deep root.

The pattern of price rises summarized above roughly resembles the price movements during the first two years of World War I -- little rise in the cost of living, a moderate rise in the wholesale price index, and a sharp rise in basic commodities. Apparently we are at the same point in price history as in 1916 -- on the edge of inflation. 2

The forces making for further price rise are both potent and persistent:

(1) Estimated Defense spending during the fiscal year 1942 will be two and a half times as much as in the fiscal year 1941, exclusive of any extension of the Defense Program since June 1.

(2) More important in its bearing on the danger of inflation than the figures for expenditures of the coming year are the estimates of deficit spending. The net deficit for the fiscal year 1942, as estimated by the Director of the Budget, will be $12.8 billions, compared with $5.1 billions for the previous fiscal year. This assumes the present tax structure. If the present tax bill is passed by Congress, the deficit will be reduced by $2-1/2 billions, (the revenue yield in fiscal year 1942 of the $3½ billion tax bill) but it will still be over $10 billion. This deficit does not take account, moreover, of the new defense appropriation estimates just submitted by the President, and whatever is expended on account of these estimates during fiscal 1942 will be added to the deficit.

(3) During the past year the inflationary force of the Federal deficit has been supplemented by an expansion of bank credit. Total loans of all member banks expanded by an estimated $2.8 billions,

or by 20 percent during the fiscal year 1941. This rise, moreover, has been proceeding at an accelerated pace -- 33 percent of the total estimated increase taking place during the final quarter.

(4) To the fiscal and monetary factors likely to cause price increases during the next fiscal year, the physical factors of reduced shipping space and other difficulties in the way of imports should be added.

Though there are factors to check inflationary trends, such as some surplus stocks of agricultural commodities, unemployed labor resources, and partially employed production facilities, most of these factors were present in the fiscal year 1941 in greater degree and yet did not serve to restrain prevent price rises even though the forces making for price rises were then much weaker. It would, therefore, be unwise to count on these to any important extent.

Important governmental steps have already been taken or are being taken to check inflation.

Every effort has been and is being made to limit price rises through voluntary cooperation with OPACS. These measures to restrain price rises though they have unquestionably been helpful are inadequqte to meet the situation confronting us. We have gone only a small part of the way it will be necessary to go. We must attack the problem on all fronts if we are successfully to check inflation.

We present below some specific tax comments. The problem cannot, however, be met by tax measures alone, but must be attacked on a broad front by a variety of methods. In addition to these tax proposals, we recommend supplementary action along the following lines:

(1) <u>OPACS must be given the power to fix prices where necessary.</u> Price fixing must be regarded as a supplement to priorities and rationing. Without the power to impose a ceiling on prices of commodities where necessary, the task of restricting price rises is made much more difficult. The mere possession of such power tends to make the exercise of that power unnecessary.

On the other hand, in the absence of an adequate fiscal program to mop up excess buying power, the attempt to ~~prevent~~ prohibit unwanted price increase s ~~by fiat~~ ~~a prohibition~~ is bound to break down here, as it has elsewhere, when unaccompanied by these essential supplementary methods.

(2) <u>Increase the supplies of goods required for military and civilian needs.</u> Increased output is in itself a major objective of our defense program and the most effective and desirable means of preventing inflation. There should be further exploration of the possibilities of inducing expansion of production facilities and labor supply where such response could not be expected to occur automatically.

(3) Extension of the present system of priorities to include systematic rationing of scarce supplies to consumers.

(4) Extension of the general controls over bank credit. 9

(5) Establishment of controls over the entire field of consumer credit.

(6) Creation of controls over capital issues. 7

(7) An extension of the Social Security program along lines by which greater coverage and contributions would increase the inflow of funds from current income 5 during the emergency and would not involve any substantial increase in the present outflow.

(8) A reduction of non-essential Federal expenditures 6 and the Federal lending and underwriting program, 4 such as non-emergency housing expenditures and mortgage ? guarantees.

(9) Promotion of economy in State and local governmental 6 expenditure and a curtailment of their borrowing for non-emergency expenditures.

Even with substantial action along all of these lines it seems probable to us that a substantial amount of undesirable price inflation will occur in this fiscal year if our tax program is not carried farther than has as yet been proposed. We, therefore, urge that the tax program now under consideration by Congress be reexamined in the light of the following considerations.

II. Comments on the Tax Bill

It is important that the yield of the tax bill shall not fall below the $3.5 billion level. In fact, it is apparent from the size of the appropriations and the pressures of consumer purchasing power on prices that taxes even beyond this amount [will have to be raised not later than next year.] 7

In formulating the excise tax program an important consideration should be to divert the demand of producers and consumers for scarce commodities which compete with the defense program. Thus the tax on passenger automobiles might well be made much higher than the 7 percent adopted by the Committee. The production of passenger automobiles will undoubtedly have to be greatly restricted. It would be extremely difficult to prevent price rises on cars sold by some retailers or the setting up of a under the counter "black market" in new and slightly used cars. It is probable that the excise tax will in large part come out of windfall profits which otherwise would 8 be secured by profiteers in automobiles, rather than being passed on in full in higher prices.

Automobiles are mentioned because they are perhaps the most important example. Other commodities which may be in the same category should be examined to determine whether an excise should be imposed and if so, whether it should be on the final product or on a scarce material entering into the product. Through such taxes the demands for the most scarce commodities and the large windfall profits which may be made by those evading price control would be reduced.

A basic revision of the excess profits tax plan is also very desirable. In some respects the excess profits tax plan tentatively adopted by the Committee is an improvement over the present excess profits tax. The revenue will be much larger although to a considerable extent this is due merely to higher rates. Some of the larger defense industries with low rates of return in the base years will pay excess profits tax, whereas they are now exempt.

However, the excess profits tax plan fails to correct one fundamental weakness of the present law. It exempts from the tax profits in excess of a reasonable return on invested capital unless those profits are also in excess of the profits of the base period years.

Substantial numbers of companies make large earnings. A study by the Treasury Department shows that one out of five profit-making corporations with assets of $1 million and over averaged more than 10 percent net income on their reported equity capital during the years 1935 to 1938 and that one out of 25 companies averaged more than 30 percent.

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The manner in which the present law and the Committee's tentative plan exempt important amounts of excess profits is shown in the following examples.

After paying all taxes an automobile company made during the base period years of 1936 through 1939 approximately 28 percent (on the basis of published financial statements, as the company has not filed its excess profits tax return.) Practically all (95 percent) of this amount can be earned tax free under the present law and under the Committee plan. After deducting a computed excess profits tax on the 1940 earnings above the base period average the company, despite the higher income taxes, will still have left approximately 24 percent of its invested capital under the present law and 21 percent under the Committee proposal.

The tax returns of a manufacturer of tractors with approximately $43 million of equity capital indicate that after all taxes it averaged approximately 18 percent during 1936-1939, which amount continues to be tax-free.

A company which has practically a monopoly on one of the important defense materials had earnings after taxes during the base period years averaging approximately 19 percent of the 1940 invested capital, which it can continue to earn tax-free.

A large manufacturer of beverages can continue to earn free of tax over 25 percent of its 1940 reported equity capital.

Thus, large amounts of the kind of profits which are commonly defined as excess profits and were taxed as such under the 1918 Act are free from tax under the present law and the Committee plan.

Failure to tax such profits is unfortunate for a number of reasons:

(1) The highly prosperous, well established corporation which has been making 30, 40, 50 percent or more on its invested capital has a much larger ability to pay taxes than a corporation which has been earning

only 3, 4, or 5 percent on its invested capital, even though the dollar incomes of the two companies are the same. Taxation of corporations in accordance with ability to pay calls for higher taxes on the profits of corporations in excess of reasonable average return.

(2) The corporation which has been making high returns in the base period years is given a competitive advantage over newly organized concerns or concerns which have been struggling to establish themselves. The latter types are limited to a much smaller tax-free return than are the former. The effect is to confirm monopolies in their control and to protect well established prosperous businesses against competition.

(3) If we are to expect all classes of society, including laborers and farmers, to accept the sacrifices of the emergency period and not to press for every possible dollar of advantage, they must be convinced that sacrifices are being distributed according to ability and that no one is making ~~unreasonably~~ large profits. The stability of our prices and wages is thus to a considerable extent dependent on the imposition and enforcement of a true excess profits tax.