THE SECRETARY OF THE TREASURY
WASHINGTON

July 15, 1941.

Dear Chairman Eccles:

In confidence I am enclosing a copy of the memorandum which we discussed this morning and which was submitted to the President today.

Sincerely yours,

H Morgenthau Jr

Secretary of the Treasury.

Honorable Marriner S. Eccles,
Chairman,
Board of Governors of the
Federal Reserve System,
Federal Reserve Building,
Washington, D. C.

MEMORANDUM FOR THE PRESIDENT

I. The Present Price Situation

Apparently we are at the same point in price history as in 1916 -- on the edge of inflation.

The pattern of price rises summarized below 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.

Since the beginning of the war, September, 1939, the wholesale price index has risen from 75 to 87, or about 16 percent. The greater part of this rise has occurred during the past five months.

The cost of living index has increased 5-1/2 percent since September, 1940. Half of this increase has occurred in the past two months.

The index of 28 basic commodities has increased 48 percent during the same period, despite the fact that the prices of many basic raw materials have been controlled by the Office of Price Administration and Civilian Supply. This increase constitutes a major 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 forces making for further price rise are both potent and persistent:

(1) The Budget estimates Defense spending during the fiscal year 1942 will be $15 billion, or two and a half times as much as in the fiscal year 1941. This increased estimate does not take account of extension of the Defense Program made after June 1, and of additional sums needed for Lend-Lease.

(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 $3-1/2 billion tax bill) but it will still be over $10 billion.

Again this estimated deficit does not take account of the expansion of the Defense Program after June 1, 1941.

(3) The inflationary force of the Federal deficit has been supplemented during the past year by an expansion of bank credit. Total bank loans expanded by an estimated $3 billions, or about 20 percent during the fiscal year just past. This rise, moreover, has been proceeding at an accelerated pace.

(4) Prices will be increasingly stimulated by (a) the shortage of raw materials for civilian goods, (b) increased absorption of idle capacity in many industries, (c) further increases in agricultural prices and wages.

Also making for further price increases are the heightened obstacles to imports, such as reduced ship space, higher shipping costs, and cutting off of normal foreign sources of supplies.

Though there are some factors in the situation operating to check inflationary trends, such as surplus stocks of some 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 price rises even though the forces making for price rises were then much weaker.

Important steps have already been taken or are being taken to check inflation. Congress has made provision for the Treasury to sell defense savings bonds and stamps and so to absorb, for the Defense Program, funds which might otherwise be used for civilian purchase of goods. This program is well under way.

The Treasury Department has also launched a plan for selling tax anticipation notes which will facilitate the prepayment of income taxes and will more promptly withdraw purchasing power represented by such taxes.

The Ways and Means Committee is holding firmly to the goal of $3.5 billion from the tax bill.

The Office of Price Administration and Civilian Supply is making every effort to obtain the cooperation of producers and distributors in limiting price rises.

These measures to restrain price rises though they have unquestionably been helpful are inadequate 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.

Certain tax matters relevant to the problem of inflation are discussed later. The problem, however, cannot be met by tax measures alone. There should be additional action along the following lines:

(1) OPACS should be given the statutory power to fix prices where necessary. Price rises cannot be controlled when inflationary forces are at work without effective power to impose price ceilings with direct penalties. The mere possession of such power tends to make its exercise unnecessary.

The attempt to prevent unwanted price increases by fiat, however, is bound to break down here, as it has elsewhere, unless it is accompanied not only by an adequate fiscal program to absorb buying power, but also by the additional methods listed below.

(2) Increase the supplies of goods required for military and civilian needs. 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) Delegation to OPACS of priority authority to provide systematic rationing of scarce supplies to industries making civilian goods. In order to obtain a fair distribution of scarce supplies among consumers it may later prove necessary to extend the rationing to ultimate consumers.

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

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

(6) Creation of controls over capital expenditures.

(7) An extension of the Social Security program along lines which would increase the flow of funds to the Treasury from current income during the emergency and would increase the outflow of funds when needed in the post-defense period.

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

(9) Reduction of non-essential Federal expenditures, also an appeal for economy in State and local governmental expenditure and for curtailment of their borrowing for non-emergency expenditures, thus building a back-log for the post-defense period.

Even with substantial action along all of these lines it seems probable to us that some undesirable price inflation will occur in this fiscal year. Other methods must be sought to control it. The principal mechanism for diverting this rising stream of buying power from inflationary outlets is taxation. It is the most effective of all the broad powers at the command of the government. The tax system should be designed as far as possible to reduce consumer demand for goods of which the supply is inadequate. 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 annual addition to the Treasury revenues provided by the new 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 further increases in rates or extensions of taxes are necessary.

In formulating the excise tax program an important consideration should be to reduce the demand of producers and consumers for scarce commodities which compete with the Defense Program and to absorb windfall profits resulting from scarcity of supply relative to demand. 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 "black market" in new and slightly used cars. It is probable that a sufficiently high excise tax will prevent increased prices from resulting in windfall profits for dealers and middlemen and will not increase prices of automobiles to consumers beyond what they otherwise would be.

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 escaping price control would be reduced.

A basic revision of the excess profits tax plan is urgently needed. The excess profits tax plan tentatively adopted by the Committee is in some important respects an improvement over the present excess profits tax. However, it fails to correct one fundamental weakness of the present law. It leaves exempt from the tax profits in excess of a reasonable return on invested capital to the extent that those profits are also in excess of the profits of the base period years.

Substantial numbers of companies are in this category. 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 one out of 25 companies averaged more than 30 percent. These companies can continue to earn profits at virtually these rates without paying excess profits tax under either the present law or the Committee's tentative plan.

The way in which the present law and the Committee's tentative plan leave exempt large amounts of excess profits is illustrated by the following actual examples.

A. After paying all taxes an automobile company made during the base period years of 1936 through 1939 approximately 25 percent. Practically all (95 percent) of this amount can be earned and yet be free from excess profits tax under the present law and under the Committee plan. In 1940 the earnings of this concern, after the pay--ment of taxes, will be approximately 26 percent of its invested capital, under the present law.

B. The earnings of a manufacturer of tractors with nearly $50 million of invested capital averaged, after all taxes, approximately 18 percent of invested capital during 1936-1939, which amount will be free of excess profits tax under the present law and the Committee's tentative plan.

C. Similarly 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 its 1940 invested capital, which it can continue to earn free of excess profits tax.

D. A large manufacturer of beverages can continue to earn free of excess profits 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 excess profits tax under the present law and the Committee plan.

Failure to apply excess profits taxation to 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 those corporations which have the higher rates of 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 rate of return free of excess profits tax 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 convincedthat sacrifices are being distributed according to ability and that no one

is making unreasonably large profits. The prevention of inflation is thus to a considerable extent dependent on the imposition and enforcement of a true excess profits tax.