OFFICE OF PRICE ADMINISTRATION
WASHINGTON, D. C.

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CONFIDENTIAL

MEMORANDUM

To: Honorable James F. Byrnes
Director of Economic Stabilization

From: Prentiss M. Brown
Price Administrator

Subject: Reduction of Prices and Profits

Section 2 (a) of the Emergency Price Control Act of 1942 provides that maximum prices must be generally fair and equitable and that they shall effectuate the purposes of the Act. Among the purposes of the Act is the elimination and prevention of profiteering. The Amendment of October 2, 1942 empowers the President to provide for making adjustments with respect to prices to correct gross inequities. In Executive Order 9250, dated October 3, 1942, the President delegated this power to the Price Administrator. The Executive Order further directed the Administrator in fixing, reducing or increasing prices to determing ceilings in such manner that profits are prevented which in his judgment are unreasonable or exorbitant.

There are certain difficulties inherent in any attempt to achieve control ofprofits by fixing prices. Maximum prices under price ceilings are set on a product basis. Profits, however, are realized on a company basis. A single company may produce several products. It is frequently impossible, therefore, so to adjust product prices as to control company profits. In fixing the ceiling for any product, moreover, a single maximum or a series of maxima may be established. In either case the ceiling will be set at a level which is calculated to be generally fair and equitable, but the profits realized by the several producers who sell under such a ceiling may vary. It is impracticable, therefore, to attempt completely to eliminate unreasonable or exorbitant profits through the employment of existing techniques of pricing. In large part, however, such profits can be prevented through price action and through the renegotiation of contracts or they may be recovered through taxation.

The Executive Order clearly imposes upon the Office of Price Administration an affirmative obligation. Whenever the Office fixes, reduces or increases the maximum price of any product, it must set it at a level that is calculated to prevent firms producing the major part of the output from realizing profits that are unreasonable or exorbitant.

The Office has always taken profits into account in determining the fairness and equity of the levels at which maximum prices have initially been established, in determining whether maximum prices will be increased as costs rise, and in determining how large an increase will be granted. The changes in prices and profits that have occurred since the initiation of price control have been so great, however, and the variation in the movement of prices and profits between industries has been so large that it does not now appear to be practicable to employ the profit standard that has been used for those purposes in determining whether profits are to be deemed unreasonable or exorbitant.

It is possible for the Office to maintain a lower standard in refusing or granting increases in maximum prices than it can apply in defining unreasonableness or exorbitance. It is undesirable, on the other hand, to raise the level employed in the former case to the point which it is practicable to establish in the latter case. The Office has therefore decided to establish a double standard of profits, with a lower level to be retained in determining whether prices will be raised, and if so how far, and a higher level for determining whether profits are unreasonable or exorbitant. It is proposed to say, in effect, that if profits are above the lower level the Office will not raise prices; that if they are below that level, it will raise prices only to the point which will re-establish profits at that level; but, finally, that when profits rise above the higher level, the Office will cut prices because such profits are unreasonable or exorbitant.

It is necessary, therefore, for the Office to define the level above which profits will be held to be unreasonable or exorbitant. The possible alternatives have been analyzed in considerable detail. A definition which would have been stated in terms of percentage return on investment or net worth was rejected because of the administrative difficulties which would be involved in computing the value of an investment in examining corporate financial structures, and in making allowance for differences in risk. A definition which would have employed aggregate dollar profits in a base period as the test was rejected because it would have made no allowance for the varying changes in volume of output which have occurred in different industries since the base period. A definition stated in terms of profits as a percentage of dollar sales was rejected because it would have amounted to a standard of costs plus a percentage of costs and would thus have guaranteed rising prices to cover increased overhead per unit as volume declined and would also have provided for enormous increases in aggregate profits in many cases where Government purchases caused an expansion of output.

The Office proposes to adopt for internal use in defining unreasonable and exorbitant profits a standard which will be computed as follows: First, an industry's output in the current year will be compared with its output in the year 1941 (the accounting period closest to the year October 1, 1940 - October 1, 1941 which is specified in the Emergency Price Control Act) and the percentage of increase in output will be determined. Second, the industry's aggregate profits in 1941 will be ascertained and this figure will be increased by a percentage which is one-half as large as the percentage of increase in output. Third, to the sum thus obtained there will be added a return of 7% on additions to investment since 1941. Fourth, profits in excess of the resulting total will be held to be unreasonable and exorbitant.

This definition is a compromise between the extremely rigorous standard which would have been involved in defining unreasonable and exorbitant profits in terms of a fixed percentage on investment or a simple base period aggregate, on the one hand, and the extremely generous standard that would have been involved in defining such profits in terms of a percentage on sales, on the other hand. Its effect will be to permit industries to realize increasing aggregate profits and an increasing return on investment as volume expands, but it will not permit them to realize a constant margin on sales or an increase in profit which is proportionate to the increase in output. In short, it will eliminate any increase in profits which is attributable to an increase in price since 1941 and a part of the increase which is attributable to the increase in output occasioned by the growth of Government expenditures. It will combine increasing aggregate profits and an increasing return on investment with a declining margin on sales.

In some cases it may appear that profits in the base period of 1941 were themselves unreasonable or exorbitant. The Office is considering the feasibility in such cases of defining unreasonableness and exorbitance in terms of the extent to which the increase between 1939 and 1941 of an industry's profits as a percentage of sales exceeded the increase realized by industry in general. In order to bring the industry in question into line with industry as a whole, its 1941 profits would be deflated in making the computations described above.

The Office is now making a statistical analysis, industry by industry, of the movement of profits between 1941 and 1942 in order to determine the significance of these standards. This work will be completed within the next two weeks.

Whenever profits are found to be unreasonable or exorbitant, the maximum price of the commodity in question will be reduced to a point which is calculated, in the light of realized and probable future changes in output and in costs, to prevent producers in general from realizing net profits before income and profits taxes which are in excess of the limits set forth above. It is recognized, of course, that there will be cases in which the standard of unreasonableness and exorbitance must be modified in detail to fit the peculiar circumstances of a particular industry, and cases in which considerations other than those relating to profits must be taken into account.

The foregoing discussion relates to those cases in which prices will be reduced because profits are unreasonable or exorbitant. There may be other cases, however, in which prices will be reduced even though profits are not held to be unreasonable or exorbitant, if such action is calculated to contribute to the prevention of inflation. This may occur:

1. Where prices were caught by the General Maximum Price Regulation or initially set by a specific regulation at a level higher than that required for fairness and equity to producers and consumers.

2. Where a cut is required directly to relieve an undue squeeze at a later stage of the production or distribution of a particular commodity in order to maintain the price of that commodity at retail.

3. Where it is possible indirectly to relieve pressure on producers or distributors by reducing the prices of collateral cost items which are not themselves the subjects of a squeeze, thus assisting them to preserve the level of prices at retail.

4. Where a price cut at an earlier stage of production will be carried through by competition or can be carried through by OPA to the retail level, thus reducing the cost of living.

5. Where goods are sold to agencies of the Federal Government, so that a price cut will directly reduce public expenditures.

6. Where a price cut at an earlier stage of production will be

carried through by competition or by the cost-plus provisions of contracts at later stages or where it can be carried through by OPA or where it can be carried through by OPA or by the renegotiation of contracts so as indirectly to reduce public expenditures.

7. Where costs per unit of output have declined, as a consequence of expansion of output or a reduction in the costs of materials, while prices have remained stable or have failed to decline in proportion to the reduction in costs.

8. Where independent action at different dates has distorted the normal differential between the prices of related commodities and reduction of the higher prices will serve to restore the normal relationship.

In such cases, maximum prices may be set below the level which is required solely to prevent unreasonable or exorbitant profits. They must, however, be set at levels which are generally fair and equitable within the meaning of the Emergency Price Control Act of 1942.

To summarize: It is proposed to establish three areas with respect to the relationship of profits to maximum prices. Within the lower area, maximum prices may be increased because profits are held to be so low that prices are not generally fair and equitable. Within the upper area, maximum prices must be reduced because profits are unreasonable and exorbitant. In the middle area, prices are generally fair and equitable and profits are not held to be unreasonable or exorbitant. This area, however, is wide enough to permit the Office to reduce maximum prices for reasons other than the fact that profits are held to be unreasonable or exorbitant, as long as profits are high enough so that prices may be held to be generally fair and equitable.