

February 8, 1945.

Governor Ransom

Chairman Eccles

Attached is a highly confidential memorandum which I presented today to the Vinson Committee at Judge Vinson's request. There appeared to be unanimity that something along this line should be done and that in no circumstances should any copies or word of this get to the public because of the obvious repercussions that might follow. Therefore, the members of the Vinson Committee all turned back their copies to me after the meeting, and I would, accordingly, appreciate it if, after you have had an opportunity to read this, you would return it to me so that I will be in a position to say that no copies are outstanding.

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Attachment

ET:b

(IDENTICAL MEMORANDUM SENT TO EACH BOARD MEMBER)

*2/10/45  
all returned*

February 8, 1945.

Dear Dan:

In accordance with our understanding at the meeting this morning, I am enclosing two copies of the memorandum for your confidential use.

Sincerely yours,

Honorable D. W. Bell,  
Under Secretary of the Treasury,  
Washington 25, D. C.

Enclosures 2

ET:b  


STATEMENT OF M. S. ECCLES BEFORE THE VINSON  
COMMITTEE AT THE REQUEST OF JUDGE VINSON

2/8/45

STABILIZATION OF CAPITAL VALUES

Prompt action is urgently needed to halt a further inflation of capital values. Farm values have increased by more than 44 per cent over 1935-1939 averages, and in eight States values have risen more than 60 per cent above prewar levels. Similarly, urban real estate selling prices are up 33-1/3 to 50 per cent or more over the 1940 level. Likewise, in the stock market prices are higher than at any time since the autumn of 1937 and are fully 80 per cent above the low point of the spring of 1942.

If left uncontrolled, the vast and rising tide of war-created liquid funds could overwhelm the markets for real estate, urban and rural, and for stocks and commodities generally, including surplus materials. Smart money is already going into capital assets for speculative purposes and to take advantage of a loophole in the tax structure. Blocked off by allocations, by rationing, and by price controls applying to scarce materials and goods, these liquid funds, including billions now invested in war bonds, could be used to produce a disastrous inflation of capital values that are not now subject to effective controls.

Manifestly, if that were permitted to happen, the result would be calamitous for Government financing. It would wreck the stabilization program. It would make a mirage of the G. I. Bill of Rights. No one could foretell the extent of the consequences if there were an unchecked flight of funds from bank deposits and Government securities into capital assets of various kinds.

The Inflation Potential

The enormous wartime expansion of liquid assets dwarfs anything in our history. The total of currency, demand deposits, and U. S. Government securities held principally by individuals and corporations<sup>1/</sup> is rapidly approaching 200 billion dollars, and has nearly tripled since we entered the war. It will continue to increase as long as the war lasts. Since we entered the war, upwards of 70 billions has been borrowed from the banking system, which means an equivalent has been added to our money supply. To the extent that war financing continues to rely on purchases of Government securities by the banking system, this enormous money supply will continue to grow.

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<sup>1/</sup> Deposit and U. S. Government security holdings of insurance companies, of commercial, savings and Federal Reserve banks, and of Government trust funds are excluded; Treasury deposits and holdings of State and local governments are included.



Some idea of the magnitude of liquid assets already existing can be gained from a comparison with the total at the end of the last war. Then, in 1920, currency and demand deposits amounted to less than 25 billions. Today the total exceeds 110 billions, or between four and five times as much. Then, Government securities held principally by individuals and corporations amounted to less than 20 billions, as compared with more than 80 billions now. In other words, liquid assets in the hands of individuals and businesses today aggregate nearly 200 billions, as compared with about 45 billions then. Similarly, Government debt, which was approximately 25 billions at its peak after the last war, is nearly ten times as large and is still growing. Yet, the relatively small volume of funds then, when left uncontrolled, produced one of the worst inflations and consequent deflations in the history of this country.

It was apparent when we entered the present war that the excess of incomes over goods available for civilian use would be so great, notwithstanding high taxes, that priorities, rationing and price controls would have to be applied. Except for rent ceilings on living accommodations, however, nothing has been done to prevent an inflation of capital assets.

Instead, the tax structure contains such a loophole as to invite speculators to acquire capital assets, and the bigger the speculator, the greater the advantage to him of rising prices in real estate, in the stock market, and in other capital assets not now covered by controls. This leaves a glaring gap in the line of defense against inflationary forces.

### The Danger to Government Financing

There can be no positive assurance that funds which are already invested in Government securities or which should be invested in future issues will not shift to capital assets unless some effective action is promptly taken. The nature of the inflation control problem has changed drastically since the war began. So long as there were no vast accumulations of liquid funds attention was on the so-called inflationary gap; that is, the excess of income over available supplies of civilian goods. Now, however, there is not only the problem of excess income, but the additional problem inherent in the vast reservoir of expendable and volatile funds which already exist and will continue to expand as long as the war continues. This clearly presents a grave danger.

To the extent that these funds flow, as they have already begun to flow, into capital assets and to drive their values steadily higher, the effect is cumulative and increasingly dangerous. Individuals and businesses will be increasingly unwilling to put idle balances or excess income into fixed debt obligations and will be induced instead to buy capital assets. There is no opportunity, except through black markets, for such funds to

go into scarce goods that are controlled. There is nothing to prevent them from going into real estate, stocks, or other capital assets -- including surplus property -- that can be sold for more and more dollars as prices go higher and higher.

Such a situation makes fixed obligations, like Government securities, increasingly unattractive. It is not an overstatement to say that the entire war financing program could be quickly put in jeopardy if any substantial shift of funds from fixed obligations to capital assets were to take place.

Moreover, to the extent that the public came to regard Government securities as a less desirable investment than the purchase of capital assets, or, to put it another way, to the extent that the public lost confidence in Government securities and sought to protect dollars by putting them into real estate, stocks, or other assets, the inflation potential would rapidly increase in magnitude. For under such conditions the Government would have to rely more and more upon the banking system to obtain funds and thus more and more supplies of new money would be added to the already swollen supply.

#### The Obligation to War Veterans

This Government has constantly appealed to the public to support the stabilization program in its own interest and particularly in the interest of the armed forces. The theme has been dwelt upon over and over again that we must not lose on the home front while they are winning on the battle front. They have been led to believe that their visions of a home, a farm, and other necessities and comforts of life can be realized when the war is over. Congress has encouraged this hope in the so-called G. I. Bill of Rights and in providing dismissal pay. The obligation is inescapable to take whatever steps are necessary to protect the values of these necessities and comforts so that they will not be hopelessly out of reach of the veterans of this war.

The Congress and all who share the responsibility for success of the stabilization program will face a wrathful day of reckoning if stay-at-home profiteers and speculators are not effectively prevented from driving the prices of these values to a point beyond reach of the veteran's purse. War profits are not in that purse. No sympathy need be wasted on the speculator. He can protect himself. Invariably, it is the little people who are ruinously drawn into the vortex of upward spiraling prices.

### Equity Requires a Curb on Capital Values

Apart from the injustice that would be done to the veteran and to the great mass of the public who want to be protected from inflated values, there is a gross inequity in a situation that puts a premium upon capital gains which are a by-product of war expenditures. Capital gains alone have remained practically untouched by wartime taxation. In fact, while the tax treatment of capital gains was revised under the Revenue Act of 1942, on the whole, rates were lowered rather than raised.<sup>1/</sup> Since then no substantial change has been made. The maximum rate on long-term capital gains is 25 per cent for both corporations and individuals. Long-term gains are defined to mean gains from the resale of capital assets held six months or more, an absurdly short period if the purpose is to reach the speculator.

Yet, sharply progressive surtax rates, rising to a high of 91 per cent, are imposed on war profits received in the form of dividends, salaries or wage incomes. A 95 per cent excess profits tax is levied upon operating profits of corporations. Thus war profits have been limited to this extent. But no corresponding curb has been placed upon capital gains, and the differential in favor of capital gains has been magnified. The bigger the taxpayer, the greater the inducement today to dispose of or refuse to invest in fixed obligations, such as Government securities, and to take advantage of the loophole provided by the treatment of capital gains. Given this advantage, large taxpayers are learning to "transform" profits into capital gains in order to evade high surtax and excess profits tax rates. The more these values are allowed to rise, the more the speculator stands to gain because of the inequity in the tax structure, and, conversely, the more those who obey the Government's injunction to invest in war bonds lose by comparison. The underlying pressures to shift into capital values will increase as the war continues and as the supply of goods under Government controls remains static or shrinks while money supply grows.

### A Penalty Rate on Capital Gains Is the Most Effective Control

A penalty rate on capital gains corresponding to the highest surtax rate is the most effective and simple over-all instrument to take the speculative fever out of the market for real estate, stocks, commodities, and other capital assets. Once that impulse is removed, the danger will be largely, if not entirely, met. Should further controls of a direct nature subsequently appear necessary they can be applied wherever the need may arise. The problem has not been and is not now, to any important degree, a matter of credit-financed inflation of values. On the contrary, the

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<sup>1/</sup> The maximum rate on gains from the sale of assets held for over 18 months was increased from 20 to 25 per cent and for gains from assets held for over 24 months from 15 to 25 per cent. For assets held from 6 to 18 months the maximum rate was reduced substantially, and for gains under 6 months the situation remained about unchanged.



volume of credit has been diminishing on balance in both urban and rural property values. The volume of credit in the stock market is but slightly more than a billion dollars, or about twice the low point of 1942.

It is a misnomer to call the penalty rate on capital gains a tax. While it utilizes the capital gains tax mechanism and would close the present tax loophole, it is not in any sense a revenue measure. On the contrary, the more effective it is as an anti-inflation device, the less it would yield in revenue. It should not open up the tax question at all, and should be removed like any other inflation control when the need for it no longer exists. It would be a grave mistake to fail to put it into effect before capital values rise still more.

It is unfortunate that it was not put into effect much earlier before prices had risen to present levels. It would have been far better to close the loophole before speculative funds were able to take the advantage of it that has already been taken. The longer action is delayed and the more speculative funds take advantage of this opportunity, the more inflated prices will be and the more irretrievable the damage is bound to be. This barn door should be closed before any more horses escape, for it is legislatively difficult, if not impossible, to make action sufficiently retroactive to recapture all that have already escaped or will escape so long as the opportunity to do so exists.

To attempt to deal piecemeal with the situation by other methods, such as limitations on credit, would be putting second things first. The penalty rate may well prove sufficient by itself to hold this sector in the line of defense against inflation. If so, the complex machinery of regulating and enforcing price and credit controls by direct means would be avoided. To put curbs on real estate values, for example, without at the same time blocking off other avenues of capital gain would invite the shift of speculative funds from regulated to unregulated fields. The penalty rate is the only weapon for striking at all fields simply and simultaneously. Moreover, this weapon would reach both cash and credit transactions entered into for capital gain, and would do so without interfering with normal nonspeculative transactions, whereas if credit restrictions alone were applied, they would fail entirely to reach cash transactions for speculative purposes and would be an unjustifiable interference with normal, nonspeculative credit transactions.

The argument, valid in normal times, that high rates on capital gains may be a business deterrent will not hold water in a period of inflationary danger. Not only are capital gains today as much a war profit as are the gains now reached by the excess profits tax or high surtaxes, but it cannot reasonably be contended that private investment needs to be encouraged as long as war expenditures remain at a high level and there is neither manpower nor materials for new plant or plant expansion. After the war, when a sufficient supply of manpower and materials becomes available for civilian production, the situation will be entirely different. It will

then be important to encourage new investment. At such time, of course, provision should be made to make sure that this inflation control device will not be a deterrent to investment in new and desirable private enterprise.

#### Inflated Capital Values Would Undermine Postwar Stability

It is apparent that if the dangers outlined here should not be avoided and capital values were to rise to excessive levels, the entire basis for postwar stability and prosperity would be undermined. All postwar planning rests on the assumption that prices will not rise substantially above present levels. Capital values could not be inflated without infecting all the rest of the economy, with all the ultimately destructive sequences flowing from inflation of the price, wage and income structure. Inflated farm land values after the last war, coupled with the price collapse, were at the bottom of the agricultural distress that accompanied the "prosperous Twenties". The hardship then fell particularly to the lot of the war veterans who bought farms. It was reflected in wholesale bank failures in the agricultural areas. It needs to be repeatedly emphasized that great as was the havoc wrought by the inflation and subsequent deflation of the early Twenties, especially in the ruinous effects upon agriculture, the inflation potential then was not a circumstance to what it is now and will be after this war.

#### Proposed Penalty Rate on Wartime Capital Gains

Congress should be asked to impose a substantial wartime penalty rate on speculative capital gains obtained from the resale of assets purchased during the period of the inflationary emergency and dating back to January 1, 1945. The wartime rate should be kept separate from the regular capital gains tax, which would apply to the sale of assets purchased after the emergency is over.

The special rate should apply to all profits defined as capital gains under current provisions. It should apply to individuals and corporations alike and steep rates should be imposed. If the property has been held for less than 2 years the rate might be 90 per cent, and thereafter for each additional year it might be reduced by 10 points until the existing rate on capital gains is reached. Capital losses incurred on transactions subject to the war tax on capital profits should be deductible against such profits.



Summary of the Case for Action Now

Those charged with responsibility for carrying out the stabilization program should bring the situation forcefully to the attention of Congress. The case for prompt action on this line is so strong that it is difficult to see how Congress could refuse to act. Until this gap in the line is closed, there is the ever-present danger that more and more of the billions that are or should be invested in war bonds will be tempted into capital values. To the extent that this happens, it not only undermines the Government's financing operations, but it multiplies inflationary forces that threaten now and in the postwar. More and more funds would then have to be raised through the banking system. That, in turn, means more and more newly created money, adding fresh fuel to inflationary fires. This argument alone should be compelling. But there are other strong considerations. The so-called G. I. Bill of Rights is one of many assurances to returning veterans that they will be helped in buying a home, a farm. What becomes of such assurances if the prices of homes and farms are driven to prohibitively high levels by a failure to close this gap? How can anyone defend a situation in which the bigger the speculator, the greater the advantage to him in escaping from high surtaxes through this loophole? What becomes of pledges to take the profiteering out of war when this invitation to make fortunes out of war conditions is held out to big speculators, businesses, as well as individuals? How can we hold the line on the labor front if we fail to put a stop to this flagrant war profiteering?

If this simple over-all action should subsequently turn out to be insufficient to curb rising prices of capital assets, then supplementary action to restrain the use of credit could be taken with justification now lacking. The defect in credit curbs alone is that they put second things first at a time when credit is not the dangerous factor, and they prevent regular, legitimate transactions, but fail entirely to reach the speculator operating on a cash basis. The penalty rate on capital gains would strike effectively at the speculative buyer without interference with legitimate transactions.

The leak in the dike should be stopped without further delay -- before it overwhelms the entire stabilization program.

February 8, 1945.