May 26, 1938.

Dear Mr. Harrison:

This is to acknowledge receipt of your letter of May 20th reviewing the course of events during the past six months and commenting on the recovery efforts which have been made and the problems still before us.

Your analysis indicates that we are much closer in accord than we have been on some occasions. In general, I am in agreement with what you have to say. However, with regard to the longer future, I doubt whether our thinking is running parallel, for I do not regard reduction of surtax rates as of fundamental importance.

On the contrary, I cannot agree that if you just keep the capital markets open you will get new production and consumption on anything like an economically and socially adequate basis under conditions now prevailing in this country and throughout the world. I would be interested to know whether you disagree with conclusions reached by a number of academic and professional studies, such, for example, as those by the Brookings Institution, which bring out very clearly, it seems to me, that we can no longer fall back on the assumption that as savings accumulate they will be put to productive rather than speculative use.

However valid this theory of automatic conversion of savings into productive enterprise may have been during most of our history when we had a relative scarcity of investment capital and borrowed a good deal of it from abroad, I cannot escape the conclusion today that our problem is very different and that we are faced with the necessity for maintaining a much better balanced relationship between the three factors of savings, consumption and capital formation. I recognize that recoveries in the past have characteristically been led by new capital investment and I am fully in accord with the need for keeping the capital markets open, but this is not enough at this juncture in our economic development, as I see it.

You could remove all of the so-called inhibitions and scrap most of the taxes on capital and it would not, in my judgment, automatically flow into desirable new production unless tariff and trade barriers were removed, the foreign debts cleared away, industry and agriculture put on an equal footing, and monopolistic practices of organized industrial and labor groups broken up. In other words, in a free world economy or a free competitive market, it seems to me theoretically possible at least that conditions might be re-created under which capital formation would, as has been the case in the past, lead the way to recovery by going into production and thereby giving employment. Much as that permanent road appeals to me, as a practical matter these days I see no very encouraging hope of traveling that way fast enough.

The alternative, as I see it, is that the government will be compelled in the end to maintain a high rate of taxation, including not only retention of the surtaxes but a broadening of the entire tax base.

The prevailing conditions which I mention include the slow rate of increase in the population, restricted immigration, the disappearance of the frontier in the west and south, and restricted world trade due to tariffs and quotas, exchange controls and fluctuating currencies. Confronted with these factors, I cannot help but feel that it would be to the interest of capital to advocate such taxation on a broad income tax base as would in effect sustain buying power and thus make for a sustained and expanding production. This, in turn, would serve not only to protect existing capital investment, but also to provide a productive and profitable outlet for accumulated private savings.

The idea is by no means new or untried, for we have an example of its application in England and some of the other capitalistic democracies, where taxation has been applied in such a way as to make possible various public expenditures which in turn tend to maintain a reasonably even flow of purchasing power and thus to keep production at continuously high levels. It seems to me that this is very much in the interest of the capitalist because he is better off in the end since the products of the mill and factory continue to find a market and the return in profits to the owner of capital, after paying high income taxes including surtaxes, is far greater than would be the case if the economy were allowed to generate speculative and other unbalanced conditions leading inevitably to the closing down of plants and the depreciation of investment.

I realize, of course, that the execution of such a policy would have to be very skillfully managed and well timed, and that there must be at the same time every encouragement for the employment of capital in new production--that there must always be an ample supply of funds for that purpose. Likewise, I have felt all along that fiscal and monetary policy should go hand-in-hand and that taxation should be keyed at all times to encourage new production and, accordingly, that taxes on consumption certainly should be reduced or removed in depressed times.

I cannot go along with the idea, however, that there is any shortage of investment funds now and that surtaxes should be lifted for that reason. If the purpose of lifting them is to encourage capital to go into new enterprise, then it seems to me you are approaching the problem from the wrong end and that the lack here is not of capital but of ability of the general public to take off existing inventories, let alone new production in any important volume.

This subject is too ramified and complex to be dealt with adequately by letter, but I felt that I could not pass it by entirely in reply to your summation, with which, as I have said, I am generally in accord as far as it goes.

Sincerely yours,

(Signed) M. S. Eccles

M. S. Eccles,
Chairman.

Mr. George L. Harrison, President,
Federal Reserve Bank of New York,
New York City.

ET:b