

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date September 27, 1941

To Chairman Eccles

Subject: Secretary Morgenthau's
suggestion for 6 per cent limit
on corporate profits

From Martin Krost

MK

Information from the Tax Research Division of the Treasury and from other sources indicates that the Secretary's proposal was made without previous consultation or study of the problem, and that details of the proposal are still in a formulative stage. It was suggested that unless there were a direct exchange of views with the Secretary, it might be desirable to say that, since the details of the Secretary's proposal were not available for study, you were not in a position to comment upon it.

In the event that you wish to state your views on the issue, however, the following brief notes might serve as a rough indication of the general nature of the reply. There are also attached references to the excess profits tax in your testimony before the Ways and Means Committee, in your speech before the Chamber of Commerce, and in your FORTUNE article.

"I have not had an opportunity to study the Secretary's proposal in detail. I do not believe that the Secretary meant to propose a rigid 6 per cent limitation on profits for each individual corporation. I think his statement reflected a very general feeling that excess profits ought to be more effectively taxed than they are under the Revenue Act just passed. Perhaps the Secretary meant to suggest that industry as a whole should be satisfied with a 6 per cent rate of return under present conditions, with an appropriate adjustment of this ratio as between corporations to reflect variations in operating efficiency. [That would be a practical effect of placing a ceiling on the amount of base-period earnings that can be claimed by a corporation under the present law. Some allowance for differences in earning power as reflected in base-period earnings would be made.]

"The Government has not requisitioned industry and placed corporation executives in a position of hired Government employees. So long as it has not done this, it must leave some incentive for corporation management to operate efficiently and to avoid waste in the use of man power and materials. If the Government took everything above 6 per cent this incentive would be gone. That is why, although I am in favor of very high tax rates on excess profits, I should be opposed to a rigid and inflexible upper limit on profits."

Attachment

Excerpts from:

Statement before Ways and Means Committee, May 7, 1941:

"In my opinion an effective excess profits tax is the keystone of a well balanced tax program. Any tax program will have to include a substantial increase in the rates of taxation for corporate incomes in general and for individual incomes. You should not impose increased taxes on the great numbers of business concerns of small and moderate size and on millions of individual taxpayers until you have given them every reasonable assurance that the funds they are being asked to provide will not go to swell the excessive profits of some corporations.

"The excess profits tax now on the statute books does not give any such assurance. If you allow the idea to take root in the public mind that through these vast expenditures a few are being made rich and a few who are already rich considerably richer, the result is bound to endanger the success of our defense effort. In order to prevent an inflationary spiral of price and wage increases, labor should be willing to moderate its demands for increased wages, but labor cannot be expected to follow such a course if employers are permitted to retain excessive profits.

* * * The revenue-yielding potentialities of an excess profits tax were well demonstrated by our own experience during the World War. The present statute could be made to realize those revenue potentialities by changes in a few important respects. I shall mention three:

"1. Restrict the use of the income method of computing the excess profits credit, either by reducing the 95 per cent of past average earnings now allowable to 75 per cent, or by any other method that may recommend itself to the Committee. I agree with Mr. Sullivan's view that all excessive profits, as well as profits directly or indirectly attributable to the defense program, should be subject to special taxation.

"2. Increase sharply the rates now applicable to excess profits. In the light of the maximum 80 per cent rate in force in this country during the last World War, a maximum rate of 75 per cent is not too high. It is also important that the tax brackets used in the present law be revised. I recognize the strength of the arguments for graduating the rates according to the percentage of excess profits to invested capital, the method used at the time of the World War, but if the present method is continued, there is no reason why the maximum rate should not apply to excess profits at a very much lower level than \$500,000. A corporation with this amount of excess profits cannot fairly claim favored treatment as a small enterprise.

"3. Reduce the rate of return allowed under the invested-capital method of computing the excess profits credit from the present figure of 8 per cent to 6 per cent. The figure of 8 per cent was used during the days of the World War. The rate of return that investors

could reasonably hope to realize on investment in securities has been materially reduced since that time. We should make a similar adjustment in our ideas about an appropriate rate of return on equity capital."

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Speech before Chamber of Commerce, May 1, 1941:

"The first source of defense revenue should be the corporation tax and the excess profits tax because, in general, corporations are the greatest beneficiaries, directly and indirectly, from defense expenditures. In other words, the surplus accruing from the expanding national income tends to become concentrated in the first instance in the possession of business corporations. The most certain way to insure against inflation is for the Government to levy on these earnings and divert the proceeds directly into the defense program before they are distributed into the general income stream through higher wages and higher dividend payments.

"Thus, the most direct way to attack the inflation problem is through heavy corporate income and excess profits taxation. If these surplus funds are not thus collected in the first instance at the source, but are later distributed through large wage increases and large dividend payments to the community, it becomes necessary subsequently for the Government to abstract excess incomes through the personal income tax, excise taxes, and other forms of mass taxation. The problem is not avoided but only delayed and made more difficult by failure to tap the profits at the source.

"High taxation of personal incomes and excise taxation will be necessary in any event, but the amount needed from these sources will be reduced by a prior collection at the points where the profits originate, namely, in the business units. If excess profits are not tapped, they will lead to demands for higher wages. Apart from the question of equity and the problem of allaying industrial unrest, is the question of going directly to the source of the increased flow of income and diverting it into the defense program before it spreads out into the community and adds private mass purchasing power on top of the Government's demands springing from the defense program.

"With greatly increased surtax rates, especially in the middle income brackets, and in the absence of an undistributed profits tax, there will be a tendency on the part of some corporations to hold back disbursements of dividends. This is a further reason for heavy normal and excess profits taxes on corporations."

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FORTUNE Magazine, "Price Fixing Not Enough"

"During the emergency we shall have to rely heavily upon the excess-profits tax and the tax on corporate incomes. This is true because, generally speaking, business units are the greatest beneficiaries, directly and indirectly, from defense expenditures. The profits accruing from the expanding national income tend to become concentrated here in the first instance. Consequently, one of the surest ways to safeguard against price inflation is for the government to levy on such profits and divert them directly into the defense program before they are distributed into the general income stream through higher wages and increased dividends.

"Perhaps the most compelling reason of all for the imposition of the excess-profits tax is that, if not taken by the government, such profits will lead to further demands for higher wages. If wage increases continue to be freely granted to those who have already received substantial increases, they will swell unduly the volume of private purchasing power. Labor should certainly be willing to moderate its demands for increased wages, but it cannot be expected to follow such a course if employers are permitted to retain excessive profits. Moreover, with increasing personal income taxes, many corporations may be expected to leave a large proportion of their profits undistributed. In the absence of an undistributed-profits tax, therefore, these will be beyond the reach of the government, unless recovered through heavy taxes on corporations.

"The corporate form of ownership is the principal institution through which capitalism functions. Owners and managers of corporations, vitally interested as they are in preserving capitalism, have every reason to favor, not oppose, heavy taxation of their profits, for thereby they will help to protect the country against the inflationary dangers that would undermine the foundations of capitalism. They have the greatest stake in democracy--the most to preserve. They should not expect those who have the smallest stake to pay an unjust share of taxation.

"During the emergency the excess-profits tax should in my opinion, be the keystone of a well balanced program. Increased taxes, however, should not be imposed on the great numbers of small business concerns and on millions of individual taxpayers until they have been given every reasonable assurance that the funds they are being asked to provide will not go to swell the profits of wealthy individuals and corporations."

Statement of Secretary Morgenthau
before the Committee on Banking and Currency
of the House of Representatives

Wednesday, September 24, 1941

I am glad to testify in behalf of this Bill not only because I am in accord with its objectives, but also because I am convinced of the terrible urgency of the problem which this Bill would help to solve.

As the President said two months ago in recommending to Congress a bill to control prices:

"Today we stand, as we did in the closing months of 1915, at the beginning of an upward sweep of the whole price structure."

In the facts and figures already presented to this Committee there has been ample demonstration of the accuracy and timeliness of the President's warning. Almost any part of the price data presented to this Committee points to the same conclusion, namely, that the pattern of price rises in the past two years is showing an alarming similarity to the price movements during the first two years of World War No. 1.

In the last war we waited too long. It was not until August, 1917, that the first step was taken to check price rises. The Lever Act empowering the President to control

food and fuel prices was not introduced until June 11, 1917, and did not become law until August of that year.

By that time the damage had already been done. The general price level had risen more than 75 per cent and the forces making for further price rises had become so powerful that they could not be stopped.

Are we again to wait until prices have risen 75 per cent before we take bold and effective action?

The wholesale prices of farm products have risen 37 per cent in the past year, and of that rise, 6 per cent has occurred in the last month. All commodities have risen 18 per cent in the last year and 2 per cent in the last month alone. Similarly down the line: foods are up 25 per cent; hides and leather up 13 per cent; textiles up 23 per cent; building materials up 12 per cent; and chemicals up 14 per cent.

The public is amply aware of what is happening. The housewife knows that pork chops that were 29 cents a pound in January were 30 in February, 31 in April, 32 in May, 35 in June, 37 in July, 38 in August and 41 at the moment, a total rise of 40 per cent in those nine months. The housewife knows that eggs have risen more than a third since

January, that coffee is up about one-fourth in the same period, and that sugar and flour are up almost a fifth in the same period, respectively. The housewife, the business man, the wage-earner, and the Government employee all know from their daily experiences that prices are rising.

The forces at work today are the same as those that brought our inflations in previous periods of war or rearmament. Yet there is fortunately one difference in the situation which, I believe, can save us from the disaster of inflation now. This time the public and the Government are aware of what happened before and what is happening now. All of us are able, if we choose, to take positive, effective, preventive measures in time.

That is what the Congress is being asked to do today. Passage of this Bill would be one additional step forward in the war against inflation, the war on our home front, the war that must be fought and won if we are to preserve our American heritage.

It is true, of course, that price control alone will not conquer inflation. This Bill alone cannot stop price rises. Every government that has attempted to check inflation has

found that direct price controls alone cannot hold down the lid when the income of the consuming public is increasing and the amount of goods available to the consumer is decreasing. Additional steps are necessary.

Our Government has already taken some of them:

(1) The Congress has passed, and the President has just approved, a tax bill designed to raise more than 3-1/2 billion dollars of additional revenue. This is a major accomplishment in the anti-inflation effort, for it will absorb a substantial portion of the increased incomes that are initially responsible for price rises.

(2) Secondly, the Treasury is engaged in a borrowing program designed to absorb still more of this excess income. Through the sale of Defense Savings Bonds and Stamps the Treasury is trying to borrow a large proportion of its funds from current consumer incomes, rather than from banks. In the past four months 1-1/4 billion dollars of Defense Savings Bonds and Stamps have been sold.

(3) Thirdly, a new form of borrowing - the tax anticipation note - has been introduced, with the object of absorbing consumer incomes before the date at which income taxes fall

due. During the month of August more than \$1 billion of these notes were sold, absorbing income that might otherwise be pushing up prices in the market place.

(4) Fourthly, the Board of Governors of the Federal Reserve System has recently been given the authority to control consumer installment credit and has just increased reserve requirements of member banks as a further check against inflation.

(5) Finally, the Office of Price Administration has been exerting every effort to control prices through the cooperation of producers and consumers.

Those are the more important steps that the Government is now taking to check price rises. But they are not enough.

If we are to be sure of victory in the fight against inflation, we must prepare further to increase taxes. We may have to extend the general controls over bank credits. We shall certainly have to reduce capital expenditures for non-defense needs, and widen the sale of Defense Savings Bonds and Stamps.

It would be wise to extend the social security program to absorb purchasing power now and pave the way for increased purchasing power after the emergency.

It will also be essential for Federal, State and local governments to reduce non-defense spending as much as possible.

I am looking forward now to an early meeting of the joint committee of the taxing and appropriating agencies of Congress, a committee that has just been created to study the whole problem of non-essential Federal expenditures. I hope that this committee will receive constant support from Congress and the country at large, for it can make a vital contribution in the anti-inflationary struggle.

We must do much more than cut down purchasing power; we must attack the problem from the other side. Rising prices can also be retarded by increasing the supplies of goods which do not compete with defense needs.

We are in a position to do just that. The Government has in its warehouses vast quantities of cotton, wheat, and corn. Our granary doors should now be opened, enough at least to prevent unreasonable price rises. Such a step would be in agreement with our established agricultural policy - the ever-normal granary. Having accumulated stocks in times of low prices, they should be distributed in times of high

prices. Now is the time to draw on these supplies, both as an anti-inflationary measure and as a preparation for replenishing them if that should again become necessary.

The concept of an ever-normal granary, which calls for a control of falling farm prices, seems to me to call equally for control over rising farm prices. This Bill, however, specifically restricts the authority of the price control administration over farm prices. That is, I believe, the major defect of the Bill. I strongly recommend that this inflexibility be removed - in the interest of the attack upon inflation, in the interest of the standard of living of our people and in the long-run interests of farmers as well.

I am not disturbed by the general level of agricultural prices now prevailing, but I am deeply concerned about the danger that agricultural prices will continue to rise as they did in the World War. Such a rise would hasten general inflation, would restrict the standard of living, and would even interfere with the health and morale of our people. And it cannot be repeated too often that in the long-run the worst sufferers from inflation are farmers themselves.

After the First World War inflation, agriculture was the hardest hit and the slowest to recover.

It has been suggested during these hearings that this price-control bill should include a ceiling over wages. I should like to go on record as not sharing this view. In free countries labor is not a commodity, human beings are not property; and they should not be treated as such.

I fully appreciate that wages affect the cost of production and the general level of prices. However, I feel very definitely that if we can on the one hand keep the cost of living from rising, and on the other hand impose adequate taxes on excessive profits, then we will have removed the major causes for demands for general wage increases. Furthermore, it is worth noting that the major portion of our defense industries today is covered by collective bargaining contracts, and only a sharp rise in the cost of living is likely to upset those contracts.

Two weeks ago I said at Boston that it was folly for labor leaders to seek continual increases in wages every few months, and that it was equally shortsighted for farmers, businessmen, landlords or bankers to seek to exploit the present abnormal situation for selfish gain.

If we provide effective price control and adequate excess profits taxation, and if it should later develop that wage rates are not being kept within bounds, we shall have to consider other measures. As yet, however, I see no necessity for them.

Before closing, I feel it my particular responsibility as Secretary of the Treasury to point out to you the special interests of the Government and the Treasury in stopping prices from rising further.

As the nation's largest purchaser, the Government is concerned with the problem in a very direct way. Congress has already appropriated more than 50 billion dollars for defense, and the end is not yet in sight. The rise in prices which has already taken place will cost us billions of dollars. If prices are allowed to behave as they did during the World War, we may find that our defense program will cost us double without giving us a single additional gun or plane for that extra expenditure.

We not only are the nation's largest purchaser of goods, but we are the nation's largest employer. The Government now employs nearly one and a half million civilians in the Executive Departments, with a payroll now running at

the rate of 2-1/2 billion dollars a year. A substantial rise in the cost of living will raise for us as an employer a choice of evils: to permit the real incomes of our employees to be unjustly reduced, or to increase still further the payroll that we must meet.

I fully appreciate that it requires courage on the part of Congress to pass this Bill. It always requires courage to put brakes on rising prices. But if any lesson is to be learned from the record of the past, it should be that inflation is inevitable in times like these unless all of us - Congress, the Executive Departments, and the people - fight it on all fronts and with all the strength and courage at our command.

We should gain courage from the knowledge that inflation is not only accompanied by serious evils but is followed by even greater evils. We should never lose sight of the fact that inflation is always followed by deflation and that the ride down is a lot longer and a lot harder and a lot more painful than the short intoxicating ride up.

After all, this question of inflation is one that goes to the very heart of the social aspirations of the American people. An uncontrolled price rise now would endanger the

fruits of our hard-won progress of many years. If we lack the necessary realism and courage now, we shall place multitudes of American farmers, workers and Government employees at the mercy of those whom I have called "the three horsemen -- the speculator, the profiteer and the hoarder."

Every hardworking and thrifty man and woman in the United States has a direct personal stake in the success of the battle against inflation. I regard it as vitally important for Congress to pass this bill and pass it promptly.

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