MEMORANDUM OF SUGGESTIONS:

INVESTIGATION OF BUSINESS ORGANIZATION AND PRACTICES.

CONFIDENTIAL - NOT FOR PUBLICATION.

Two members of the Temporary National Economic Committee requested a memorandum embodying suggestions for possible lines of investigation. The attached memorandum embodies certain phases. It does not purport to be complete.

A. A. Berle, Jr.,

July 12, 1938.

MEMORANDUM.

Introduction.

Investigation of Business Organization and Practices.

1. General Objectives.

The investigation of business organization and practices (frequently called investigation of monopolies) should be essentially a search to find an organization of business that actually works.

1. Economic organization may be roughly tested by the following:

(a) Does it provide an adequate supply of goods as tested by the normal market? As tested by the apparent need?

(b) Does it provide a maximum number of people with an opportunity to make a living under this process - a life under this process - conceived as conditions under which people can live, maintain families, expect to continue in the economic system and end this side of the relief line or the poor house.

(c) Does it accomplish this process with due regard for the liberty and self-development of the individual?

One result ought to be something in the nature of a triple income statement for the industrial system; the income statement being:

(1) A statement of production - set against

(a) distribution

(b) need.

(2) A statement of employment and wages, set against the number of people who may reasonably be entitled to expect to support themselves in the industry.

(3) A commercial statement of profit and loss.

Such an approach will at least indicate the major successes or, more often, the failures resulting from the existing industrial system. At least, it will end certain illusions which now confuse national thinking. We know in advance that the present productivity of industry, which is so highly regarded and so often praised, is not, in fact, sufficient to meet the aggregate of "legitimate claims" made against it by labor, by consumers, possibly also by investors, in many instances. But this fact is rarely appreciated.

2. Some

2. Some Unwarranted Assumptions.

All previous investigations of this kind have commonly commenced with a set of preconceptions. There is reason to believe that the present investigation may be in danger of doing the same thing. It is appropriate to note a few of them.

(a) Small Business Is Not Necessarily Competitive.

There is a tendency to idealize the early nineteenth century and to assume that small business and the prices it charged were the result of competition. As far as I am able to see, there is little, if any, foundation for this. The village grocery store, the village blacksmith, the village grist mill, were all monopolies. Until the advent of the automobile, they charged conventional prices or administered prices which were not elastic. The people of the village could not go many miles to the next town. In a large measure this is still true in small towns. Such competition as there has been, curiously enough, came from large scale enterprise; mail order houses, and later the chain stores. The theory that prices were adjusted by competition under the old small scale production in small towns, as far as I can see, simply never was generally true, despite some nostalgic reminiscences which are indulged in today.

(b) Small Business Is By No Means Necessarily Humane.

There was actually competition on a wide scale in large centers between small business. But there is no point in idealizing this though, to some extent, it produced desirable results from the point of view of price and distribution. The type of competition in small business is more nearly the New York "sweat shop" in the garment trade, and the elimination of the "sweat shop", as such, while it considerably improved the lot of the workers, has not produced units which stand out as monuments to a desirable social system. Actually, high speed competition by small units is as likely as not to produce, through sheer economic pressure, conditions that are undesirable, if not cruel; undesirable because there is constant attempt to meet the competition by depreciating the quality, as well as the price; cruel because labor, or the shop masters (who are, to all intents and purposes a section of the laboring class) are either exploited or forced to exploit themselves. I am by no means clear that the existence of a large number of half-starved contracting garment shop owners (usually laborers who try to go it independently) may not be only slightly less anti-social than the old sweat shops. If the first was an open scandal, the second is certainly not pretty to look at.

Where there is no competition, the small scale unit may or may not be a creditable piece of social machinery, depending entirely on the character of the men who run it.

Actually,

Actually, the village monopolist, the exploiting grocery store owner, who was also the money-lender, is a perfectly familiar type. He must be set as a liability alongside of similar proprietors, who are assets to the community, in that they handle his store, their cash and their credit relations so as to try to develop the town and make a living easier for everyone.

The principal advantage of small business lay in the fact that public opinion, social pressure and the like, could be brought to bear on the small owner to the general advantage of the community. It cannot be brought to bear on the absentee owner, the chain store proprietor, the mill owner, who is as dominant a factor in the community, et cetera.

(c) Efficienty of Size.

There are two distinct preconceptions which cancel each other. One of them is that large scale enterprise is more efficient; the second is that it is, by hypothesis, less efficient as it grows.

I see no reason for indulging either preconception. The only solid factor about it is that pointed out by Mr. Brandeis on many occasions, namely, that a large scale enterprise will frequently and easily outrun the moral and mental stature of the man or men who direct it.

Aside from that point, the fallacy lies in the undefined use of the word "efficiency". An enterprise large enough to mesh with the financial machinery, including the Stock Exchange and commercial banks, is certainly more efficient, so far as obtaining capital goes, than a small scale enterprise. This is true even if it is less effective technically. It may be in a better position to meet legitimate claims of labor, (most labor union people seem to think so) though I am, by no means clear that this is generally true.

As to straight technical or mechanical effectiveness, there is presumably an optimum size. No one knows in respect to any industry what this optimum size is. Further, the optimum size will change overnight with the development of a new method or process or set of machinery.

The claimed effectiveness of a unit in finance or production may be completely neutralized, despite its ability to produce, if it is unable to bring its production towards a known demand.

The difficulty with this line of preconception is that a standard of approach has yet to be set. It is familiarly insisted that the old-fashioned farm was an inefficient unit. Yet if, besides the assumed cost of production, there were taken into account the continuity of employment, the ability to use energies of adolescents and of old people, the ability to take care of sickness and give some scope for individual creation and the like, it might prove that, if the same factors were applied to a large scale plant, the old-fashioned farm was one of the most effective units known. Put differently, a highly efficient plant, according to modern ideas may merely mean a plant which has succeeded in unloading the maximum possible amount of obligations on the community, to be handled socially. Perhaps it has passed on some of the advantages of this escape from obligation to the consumer in the form of price; leaving the state to collect the rest in the form of taxes.

(d) Efficiency in Meeting Need.

The major argument in favor of large scale industry has been that it did raise the standard of living, which, reduced to understandable terms, meant that it stimulated want for many goods and services, produced a great many goods and supplies and got those goods and supplies, on the whole, very widely distributed. I see no reason for indulging this preconception.

A clear distinction ought to be made between what people want and what they need. It is legitimate criticism of such studies as have been made by Stuart Chase that they take as a starting point, not what people want, but what an impartial commentator thinks they ought to want. In New York, it is probably true that milk can be laid down at distributing stations, like chain stores, for 7 cents a quart, but that, if it is delivered in bottles, the cost will be not less than 11 or 12 cents. People ought to want 7 cent milk and be prepared to go around the corner every morning to get it. They actually do want it put on the doorstep.

It probably is true that, without advertising, people would not want the number of things they want today. It does not follow that the standard of living would diminish if they stopped wanting cigarettes or canned soups or cosmetics or a new car every two years. The debate on this point really involves a philosophical assumption, namely, what is the "good life". That discussion started, or rather reached a high point, in the time of Socrates, and no one has resolved it yet.

Nevertheless, because discussions have to start somewhere, the only practicable method of handling an investigation of the industrial system today is to assume that people are entitled to want what they actually do want; and to define economic efficiency as giving people what they want. Anything else involves deciding (and ultimately trying to tell people) what they ought to want, which becomes tyranny pure and simple.

Summarizing these observations, it seems to me that:

First, the general scope of the investigation ought to be a search for an organization of business that actually works;

Second, the standard must be whether it supplies the existing and developing wants of the people as they appear;

Third,

Third, that this involves the provision of an adequate supply of goods;

Fourth, and a distribution system that takes these goods towards known wants to the maximum degree possible;

Fifth, that the system must provide a maximum number of people with means of satisfying those wants through a contribution to the system;

Sixth, that the system must provide the people engaged in the process with a manner of life, which at least tends to satisfy a fair proportion of their wants;

Seventh, the system must evolve a method of organization that does not interfere unduly, actually or potentially, with the liberty of the individual; - i.e., that its controls must release more individuality than they suppress;

Eighth, that there is no need to assume that these tests will be met by any single system or any single standard of size or set of practices at any given point.

As a final point, I note that, whenever a situation appears, it is always wise to attack it with the realization that there is a real reason for it. Habits, in a large country, do not emerge by chance. The reason may not be a good reason or may have ceased to be valid. The habit may be a bad habit. But there is always a reason, with which we may intellectually disagree, but which cannot be disregarded as a social force. Mere interruption of habits and social machinery means nothing unless an equivalent or better machinery is simultaneously provided or suggested.

I. The Subsidy of Industry by the Government.

The immediate problem to be dealt with is that of the relationship of government to business.

As a first step, there should be ascertained the precise contribution or subsidy which the government now makes to existing business. It seems to me, accordingly, that a major and possibly first subject of investigation ought to be the amount of subsidy which the Federal, and possibly the state governments, directly or indirectly, make to industrial enterprise. In one aspect this is really a study of how much of the cost of production, including in that figure the cost of maintaining the necessary labor and obtaining the necessary market, has been loaded off on the community by the enterprise. Without figures before me, it is, nevertheless, safe to say that the result will be little short of amazing.

Among the forms of subsidy there may be listed the following:

(1) Direct Subsidies.

These include direct grants, such as those made to the merchant marine and to the airway lines. Included in direct subsidies must be taken payments made nominally for service, but actually for the purpose of establishing the industry. Mail subsidies are frequent in this connection.

(2) Indirect Subsidies.

These represent the relief of enterprise from charges which otherwise would be paid. I believe that the peculiarly low rail rates granted to newspapers and to second-class material fairly comes in this class. Exemption from taxes, franking privileges, et cetera should be included.

(3) Government Orders.

Technically government buying should not be classified as "aid" to business. Practically, however, it frequently works out this way. It would be interesting to know how much of industrial development depended on buying by the government for government purposes. For instance, how much of productivity of a company like Bethlehem Steel is used by the government for war or navy orders.

(4) Special Privileges Granted.

In this connection shining examples are, of course, patent and trade-mark privileges.

With this must be bracketed government exclusive licenses, for instance, the kind of license the Federal Communications Commission grants to radio companies.

Great

Great care has to be taken especially with federal or state license investigation. For instance, the Federal Communications Commission has taken the view that a part of its business is to protect an existing communication facility from impairment by a competitive facility as in the famous case when a radio beam license between New York and Oslo was denied because there already was a cable communication. Yet the Federal Commission nominally is merely created to keep order in the air. What legal right is there for the maintenance of cable monopolies by the Federal Communications Commission? The same applies to the denial of licenses to use short wave transmission in the United States, thereby assuring a continued monopoly to the A. T. and T.

(5) The State Field Ought Not to Be Overlooked.

The use of certificates of public necessity have, in fact, resulted in the granting of monopoly licenses in certain kinds of businesses, notably utilities, bus lines, et cetera.

(6) Tariffs.

This point needs no comment. Most industry enjoys tariff protection designed to give it immunity from a considerable degree of foreign competition. In some cases this goes farther and is designed not only to cut out direct competition, but competition from other commodities or goods. In many cases this is designed to prevent the consumer from buying products they do want so that they will be forced to buy products which they do not want.

(7) Government Protection of Price.

It is not altogether clear whether trends in this field have yet gone far enough to make certain the utility of experimental investment. A great experience has been in effect in sugar prices through the operation of the quota prices; but it is not clear that the system has been in effect long enough to justify the time involved. I set it down here for the sake of completeness. In the other fields, however, data is complete and worth doing. For instance, practically all insurance rates are closely regulated by law and minimum rates are quite frequently fixed. Since the public health work of the Government diminishes the mortality and risk, the rate is fixed by a minimum. The effect on the insurance companies is material.

(8) Collateral Subsidies Not Readily Apparent.

Here is a tremendous field which should be thoroughly opened up. This is peculiarly true in view of the attitude of some people that the Government is so much overhead which it has to carry. For instance, the automobile market would cease to exist if the local state and federal governments stopped providing roads. Certainly the expansion of roads and road improvement has had to go hand in hand with the expansion of the automobile industry; when road expansion stops, the automobile industry will run into a saturation point within a very short time.

There are a considerable number of such cases of incidental subsidies running into extremely large amounts. The construction supply trade, for example, is a direct subsidy by the government housing program.

(9) Relief is a Subsidy to Industry.

If it be realized that labor is at least as necessary to production as plants, and that the maintenance of a large body of labor normally ought to be a charge on production in one form or another, only one conclusion can be drawn.

Relief to workers in time of lay-off is a subsidy to industry. General Motors, for instance, pays an average annual wage of approximately $1100 a year. When plants are running full this about takes care of the worker. When the plants shut down or lay off, men who are unable to save on this wage go onto the relief rolls. If this were classified as a cost of General Motors, there might be a different picture of the extent to which General Motors depended on the government for its profits. It will come as a shock to the public to learn that unemployment relief is essentially a subsidy; but I see no escape from the underlying economics of it.

(10) Direct Loans, as Through the Reconstruction Finance Corporation, Farm Credit Corporation and the Like.

The foregoing is not intended as an exhaustive list, but merely as a set of suggestions. The desirable method, I think, would be to take certain industries and companies and go right through the whole list. Reverting to the motor industry, it would be discovered that the industry required huge assistance from the government in the form of patents, licenses, monopoly grants, government orders, indirect subsidies through roads, relief and the like: all of which are costs in considerable degree to the motor industry as at present organized; but pushed off onto the government. A slightly different view of "private initiative" would probably emerge from such a picture.

II. Non-government Privileges to Big and Small Business.

The aim of this should be to determine the effect of certain private mechanisms on the development of the industrial structure.

(1) Short Term Credit.

There should be an investigation of the way the commercial banking system works in extending short term credit in each of the industries investigated. It would be found that certain companies have access to short term credit, others do not. What determines this? In part it is the relationship of management to the banks. In part it is the assets and size of the company. In part it is the success of the company. I am prepared to think that there is probably less discrimination in terms of size down to a certain point in the short term credit field than in the long term credit field noted hereafter, but certain discriminations will readily appear.

More importantly, it will appear that the larger the corporation, the less it relies on short term credit machinery, at least directly; though it frequently does so indirectly by pushing the burden of carrying inventory onto its agents or selling outlets. One by-product of this will be a substantial revision of the classic theory that short term credit is created against the creation of goods, i.e., that production of goods involved expansion of deposits. This would be true under small scale industry, when practically every producing unit went to the banks to expand production or stock. Today, I am inclined to think that short term credit has, in large measure, ceased to be an agency of production and has become an agency of distribution. An instance is one important sub-division, financing of installment buying, by which industry, instead of borrowing money itself, induces the purchaser to borrow money for it.

Another sub-division must be the improvement in the credit status by the mere process of becoming large scale industry with access to the stock market. The small concern having tangible assets, if it wishes to borrow, must be limited more or less to those tangible assets, especially inventory and stock and trade. A large concern, able to create large subsidiaries and to float the stock of those subsidiaries on the exchange, can borrow against fixed or capital assets represented by the stock of its subsidiaries. Further, the amount of credit it can command will be measured, not by asset value, but by the value of securities. For instance, the Southern Pacific Railroad can command credit by pledging the stock of the Pacific Fruit Express. My distinct impression is that it can borrow a great deal more on the stock of the Pacific Fruit Express than it could if it endeavored to give its interest in the refrigerator cars as security.

(2) Long Term Credit-Capital.

It is obvious, though not commonly noted, that in any given industry the large scale unit has a huge preferential position in the matter of raising capital. My belief is that this preferential is the greatest single factor in encouraging large scale as against small scale industry. Specifically it would be found that there is almost no machinery by which any concern can enter the capital markets on decent terms to obtain capital of less than, say, $3,000,000: and that ability to obtain that capital increases steadily and the cost diminishes as the size of the concern increases.

Again it is important to notice what happens when a concern graduates from the class of being a "private" or "family" enterprise and becomes a publicly financed stock exchange affair. Directly its securities and particularly its stock gain admission to an exchange, there is a change in valuation. Physical assets are immobile as a basis for credit, save for a limited extent on first mortgage. The valuation placed on these assets is not very far from a conservative physical valuation. But the stock representing those same assets, when listed on the exchange, will sell on an entirely different basis; the aggregate value of such stock is not infrequently 6, 8, 10, or 15 or 20 times even the balance sheet asset value. Since additional capital can be raised by the flotation of additional stock at or somewhere near market value, the result is to give to the large concern an ability to raise several times the amount of capital on the same assets which are available to the individually owned or family owned or closed concern.

To a less extent this is true of obligations or bonds issued by the corporation. These again are commonly measured, not by the underlying assets, but by the apparent earnings, which, indeed, must be the real source from which the interest and ultimate re-payment of the bonds must be expected. Naturally, therefore, publicly financed concerns have a ready avenue to much more capital and much cheaper capital than any smaller enterprise.

A factor must be noted. By the device of authorized or unissued stock and the existence of a market quotation a publicly financed corporation can virtually print its own currency for the direct purchase of other plants. The United States Steel Corporation purchased the Columbia plant on the Pacific Coast in this way. It is a familiar practice to find the expansion of a corporation accomplished through the direct exchange of stock through new assets. Through the medium of holding companies, the same machinery can be still more effectively used.

(3) Buying Privileges.

To a greater or less extent the large unit is fostered by the use it can make of its mass buying power. To some extent this has been curtailed by the provisions of the Patman Act, but it is probably true that a considerable amount of privilege survives. It does not, of course, follow that a lower price for a large or continuous order is necessarily wicked or even uneconomic. It may be literally true that the cost of dealing with a single customer is less than the cost of dealing with many customers: by consequence, that size and power to buy en masse is, therefore, more effective. If so, however, it is worth discovering what happens to the supplier under these circumstances. It may well be that so-called "efficiency" is not a real saving, but consists of shoving the cost item of production from the back of the buyer to the back of the seller or by him onto the back of labor. It would be interesting, for instance, to know whether the real profits of a chain store corporation came from actual saving of waste or whether they come from the fact that, in place of many small shopkeepers, there are now a highly exploited group of so-called "store managers," on the distribution side and a highly exploited group of small suppliers on the production side.

(4) The Privileges Granted to Labor Unions.

It is axiomatic among business men that a small business cannot cope with a powerful labor union. A labor union can dictate, not only rates of pay--which presumably should be uniform--but the number of employees, which frequently will put a small concern out of business. A large concern can meet labor demands, either because it can pass the cost on to the buyer, or because it can improve its methods and expand its machinery sufficiently to satisfy progressively demands for higher pay and more jobs through increase of output and increase of productivity per man. It is a familiarly known fact in large scale business that, whatever pay scale is set, the business can, over a period of years, improve its methods so that the ratio of labor cost to the cost per unit of ultimate output remains the same. Small businesses frequently cannot do this.

In this connection, some consideration ought to be given towards the possibility of uniform labor schedules in competing industries. Naturally, if there are differential wage scales in competing industries, the industry having the lower wage scale has an advantage. The late Frank Taplin prepared charts at one time showing that differential wage scale between southern bituminous mines and northern bituminous mines inevitably put the northern mines at a hopeless disadvantage, with the result that bituminous coal traveled a thousand miles farther to supply Consolidated Gas Company in New York, although the logical suppliers were the bituminous mines in the Ohio Valley region. Incidentally, it is probably due to this that the Norfolk and West Virginia roads were prosperous when most other railroads were unable to make ends meet.

It is possible that it would be found that labor contracts, which were non-uniform, were as dangerous as railroad rebates used to be in the olden days--that is, that it is as dangerous to allow discrimination to labor unions as to public service agencies.

(5) Rates For Power, et cetera.

This subject ought to be dealt with in very much the same way as rates for labor or for large suppliers. It is very possible that there is a real saving when power is supplied in large quantity to one customer. On the other hand, this may not be true.

The point here simply is to discover whether or not large scale or quasi monopolist development is due to real effectiveness, or to the fact that strategic position is increasingly weak as size diminishes. This examination ought to be started without preconception. Save in the long term credit field, the case either way appears to be wholly unproved. Sharp distinction has to be made between private discrimination forced by mere mass, and actual discrimination arising out of lower cost of large scale transaction. In the latter cases, the genesis of lower cost ought to be looked at so that it can be discovered whether or not such lower cost is not merely the forcing of cost back on to the laborer or community or a forcing of it on to the consumer.

III. The Effects of Large or Small Business on Initiative and Product.

It is frequently said that government interference stifles initiative, that laissez faire (which presumably would include the allowing of business to set up any norm of size it chose) tends to decrease initiative. We have no accurate information on it.

1. Technical Improvements.

For instance, the development of new inventions. At present a very large number of inventions are made in research laboratories of large corporations. We have no knowledge as to how many of them are used; and, of course, no guide at all as to what would happen were these inventions open to exploitation by any group other than the corporation developing them. It would be interesting, accordingly, to have some factual knowledge as to whether the net result of research laboratories is not to stifle inventions, once they are made, quite as much as to cause actual invention.

2. The Development of New Uses and Fields.

It already appears from the experience of the Tennessee Valley Authority that a very large untapped use for power could be developed by different forms of organization. Specifically, they organized cooperative associations to take care of the local marketing of electric current; and the Tennessee Valley Authority sells only to municipalities or to such cooperative associations. Commercial enterprises are commonly obliged, not only not to do this, but to discourage this because they have to protect their other marketing outlets, such as marketing by middlemen and the like. A single unit producer, who did not feel responsible for the whole system, conceivably might get farther than the large scale enterprise.

3. The necessity of Protecting Capital Investment.

One reason why individual initiative is almost always resisted in any business system lies in the fact that it can destroy the existing investment of capital--a new method, a new machine upsets all of the interests.

Labor will commonly resist the process almost as much as capital or the employers, though not always. The C.I.O. did not resist the introduction of the rolling machine in the steel district, though inevitably the effect must be to throw out of work a great many steel employees, who will not be replaced through employment in the manufacture of rolling mill machinery. Certainly the sugar refiners have consistently resisted the logical development in the sugar trade, which is the refining at the sugar mill in small units instead of transporting raw sugar to the United States for refining here.

4. Geographic and Natural Advantage Effects.

A large business can develop "blankets" (the famous one is the Pittsburgh-plus system) whereby a manufacturer market with a nearer by manufacturer. It has never been ascertained whether it makes for competition or monopoly. Conceivably every price "blanket" which an industry dominated by large units can lay down is to increase, rather than to decrease competition, since the alternative would be the erection of local plants.

Here the choice seems to be what kind of a system is really wanted. A monopoly is no less monopolistic because it is local. In fact, a local monopoly is likely to be more cut-throat from an economic point of view than a national monopoly though it does not have the same political threat. The problem is whether a few large scale competing units are socially more desirable than a relatively large number of small scale monopolies dominating the lives of that particular district. Much of the thinking today tends towards the feeling that local monopolies would be preferable; but a close study of the life of, say, West Virginia, compared to the life of, say, Detroit, Toledo and Flint, might lead to a revision of the theory.

IV. <u>National Concentration of Power</u>.

I presume some attention will be given to the problem of the concentration of power. This ought not to be confused with concentration of property or ownership. These are two different problems. I have not been able to get up any intellectual respect for books like Lundberg's "Sixty Families" (leaving aside the fact that it was extremely inaccurate) because property is one thing and power is another. Concentration of power in New York or Boston has nothing whatever to do with the private fortunes of individuals. The Van Sweringens were no less powerful at the end of their lives, when they were bankrupt, than they were in midstream, when they had between them a fortune worth on paper two or three hundred million.

A study of concentration of property interests and of income would be interesting, but probably would prove nothing except the existence of a property owning class. By the time it was discovered that one hundred thousand individuals owned a considerable percentage of the national income, it would also be discovered that most of these individuals had very little to say about what actually was being done. There may be strictly social reasons for having no individuals with large incomes, though I rather doubt this; but such reasons have little to do with industrial organization. Powerful individuals in industry may have large incomes; or they may not. There is no particular connection between the two facts.

The methods of control are well known. The most obvious of them are listed here purely for convenience.

Ownership
Joint ownership with others
Ownership of voting stock
Ownership of controlling voting minority
Ownership of a special class of stock over
weighed as to vote
Pyramided holding corporations

Interlocking

Interlocking directorates
Interlocking marketing agreements
Unity of financial group control
Control through short term credit
Control through patent licenses and price restrictions
Control through being a principal customer
Control through monopoly of a necessary raw material, e.g. rayon,
Et cetera.

No accurate definition of control has ever been made. It is impossible to describe the process. In a good many cases the results would be fantastic in the extreme. I have a good working knowledge of how the firm of J. P. Morgan and Company "controls" the Guaranty Trust Company. They have no legal control of any kind. There is nothing to prevent the Board of Directors from doing anything it pleases. Yet at various intervals in the life of the Guaranty Trust Company it has been in difficulties and on each occasion it has applied to Morgan and Company for assistance and got it. By consequence, they not unnaturally seek and generally, though not always, follow the advice of Morgan. There is nothing necessarily vicious in this. It was frequently good advice from the strict banking point of view. Certainly it was good ethics in the 1921 incident. But it does create the problem of power. There is no way of changing that relationship unless and until some system of capital banking is evolved, whereby the Guaranty Trust Company can look for help in time of trouble to someone other than the private interests.

I have observed that the concentration of power is more likely to come from unity of interest, than from any legal device. This seems almost beyond legal control. You cannot prevent men whose interests are about the same, and whose minds run along similar lines, from doing about the same thing at about the same time.

It seems to me that one important line of study is that of industrial geography. The Aluminum Company has preempted certain great areas in the United States through its alliances with the power companies. In this connection, let me say that it would be an assistance to the State Department if more were known about the alliance between that company and the Niagara-Hudson and that company and the Canadian power interests than is known today. We know the result well enough. No industry can buy power in the St. Lawrence area without making terms with that particular group of interests.

Very much the same thing is true in the rayon industry. Here there is practical control, through the control of the supply, over knitting and weaving of rayon. That, I understand, is one of the few country-wide "blankets", sharing distinction with the block booking in the movie industry, and, until recently, the "follow the leader" steel price.

There is even more importance in knowing why those things happen, than that they happen. I think it would be found that the real desire to monopolize the market, either directly or through alliances, is less an anxiety to make huge profits than a desire to be sure that the concern will continue to exist. As to results, one might compare the steel industry with the highly competitive textile industry and, when the comparison is finished, ask whether the country would be materially better off if steel production were to follow the pattern of the textile mills.

For it must be considered that competition in large scale industry does not produce results as it does in small scale industry; that it does not drive the least efficient producer out of existence. It drives the least efficient producer into bankruptcy, whereupon someone buys the enterprise for a song; he can charge a lower price because he has no fixed charges to pay for his capital; he can then bankrupt the next most inefficient producer; et cetera. Only when the entire industry has been bankrupt and competition is reduced to the basis of their operating profits does the condition arise in which any unit in the industry goes out of business. The economic law of competition works, no doubt; but the time taken for it to work is so long that we have not completed any cycle of that process yet; though it is just beginning to be completed in the sugar production industry and perhaps in the textile industry.

My point is merely that it, by no means, follows that some concentration of power may not be desirable in certain industries. I am by no means clear that, in some situations, the controlled cartel may not liberate individuals in the industry a good deal more than uncontrolled competition.

V. Evaluation of the Job Done.

My hope is that the investigation of each industry will wind up with an evaluation of the job done by that industry, rather than, as in the case of previous anti-trust investigations, an assumption that any particular form is or is not wicked. As I see it, the real question is whether a good job is being done from all points of view. In the introductory note a suggestion was made as to a triple balance sheet, which would serve as some test. More specific headings as to which one would like to have an estimate are these:

(a) The amount of employment
    - Wage scale-hourly and annual
    - Regularity of employment
    - Conditions of employment

(b) The output
    - Actually marketed
    - Apparently needed

(c) The price
    - Price is merely a method of distribution
    - How nearly does it work?

(d) The waste in the process of production and distribution.

This last factor can be roughly measured by the direct costs (e.g. cost of the raw material and the direct cost of labor) set against the price to the consumer. Unless this difference shows up in terms of net paid out profits or

accumulated

accumulated surplus, it goes to individuals who lie between the producer and the consumer. These individuals find their means of making a living through just this process. In a sense, waste is a form of taxation of the consumer for the benefit of a set of people in between, who have to be taken care of somehow; the elimination of waste means, of necessity, finding some useful form of outlet for the people displaced.

(e) <u>The profit or loss</u>.

From a commercial point of view, the job is evaluated, at least partially, by profits or loss. The results of any audit of the entire industry are likely to be surprising. It has been said that the oil industry, for instance, works at a net loss in any given year, though, of course, some units make very large profits. In this aspect operating profits only are important; the distortion of them by the financial structure is a relatively minor element. The operating profits indicate what the financial structure could be or ought to be.

(f) <u>Improvement of the art</u>.

Any fair evaluation of any industrial process must include a study of the speed and soundness with which it has evolved. If it be assumed that there is virtue in improvement of the process, as such, that degree of improvement is worth noting.

I am not altogether clear that mere swift improvement is desirable in itself. Certainly it is not unless the results are promptly passed on to the consumer and all costs involved in it are taken care of. For instance, the evolution of labor saving machinery may lower the cost of production. It may also throw a great many people out of work. The cost of reestablishing the people thrown out is thrown off on the community; except as savings of men involved may be used up. In this sense, as things now stand, much of the cost of the improvement of any art is paid for, not by the industry, but by other people financially least able to bear it.

The problem is whether it is socially more desirable to have rapidly developing technique in industry, irrespective of who is hurt in the process, or whether it is better to have a regulated technique.

Highly competitive development tends towards the first process, a cartelized form at least affords the possibility of the second.

(g) <u>Life created</u>.

I am unable to think of any audit of an industry without thinking of what happens to the people engaged in it.

The automobile industry is highly successful from the point of view of production. But the life history of an automobile worker might tell a wholly different story. Certainly, without some general notion of what the industry does to its people, we have no method of appraising whether the industry is a good thing or a bad thing for the country as a whole--"good" and "bad" being determined by the general average of the health and happiness of the largest number of people.

VI. Claims against industry.

If the system in any industry is to be judged by its effects, some audit has to be made of the effects which apparently are desired. Another way of putting this is that some examination ought to be made of what the industry is expected to do.

There are four main claims which are being advanced:

(a) The claim of the consumer for the product.

This is a claim for all goods or supplies which may be needed. This is not limited merely to all goods and supplies which can be paid for commercially. A low price naturally increases the ability of goods and supplies to travel towards need; a higher price impedes this. To this extent price is important: price is the method by which goods move from production toward need. It is, so far as I can see, the only reason why price has any importance at all. But there may be non-commercial ways of getting goods towards need, e.g., relief purchases, surplus commodity distribution, community use, et cetera, which in greater or less degree cut under the price system.

(b) The claim of labor.

For continuous work at an adequate rate of pay, labor organizations are establishing their claim almost entirely in terms of hourly wage rates and hours of labor. I think this is probably short-sighted; it would be more consonant with what they perhaps really want if the claim were advanced in terms of annual income and permanency of jobs, plus pensions and sick relief. Nevertheless, it ought to be possible to get some clear statement as to what the labor organizations really are steering for.

(c) The claim of capital for a return.

This is historic; it involves some idea of the reward or hope which has to be held out to induce investment of capital. Since most investment is at least partially risk-bearing, this would be interest plus a premium for risk.

(d) The claim of management.

This claim has never been stated and no one knows what it is. Management wants pay, of course, but it also wants prestige, power, et cetera. In a word, it wants very much what most politicians and people in government want.

One of the most important things that the investigation can do is to serve as a forum in which these various claims can be stated. If, industry by industry, there are certain sessions set aside at which each group can lay out what it expects the industry under investigation to do for

it

it, we shall have brought the discussion measurably forward. This would clear the air in the whole field of labor; likewise in the whole investment field; and it is possible we might even get some more or less rational ideas as to what is expected of an industry in dealing with the public. The "public" would be represented generally by the immediate customers of the industry; at all events, I can think of no other way of getting an intelligent statement of position.

VII. The Program.

It is obvious that no memorandum could undertake to lay out a program in advance of the data. Certain observations may be worth consideration.

(1) Methods of control are meaningless unless an objective is stated.

Senator O'Mahoney has worked out an extremely interesting bill to license corporations. It has a variety of substitutes for federal incorporation, desired by many statesmen from President Taft on. This is a brilliant and apposite method of control.

But unless the reason for the control and the result to be achieved is accurately arrived at, it means very little. The individual licensing corporations would be merely an economic dictator; we should merely replace a more or less management control by a more or less responsible political control unless very careful standards are laid down. A fair criticism of the technique of the New Deal has been that it indulged shotgun imposition of regulation without adequate definition of standard. The possibility of recapture or perversion of an agency like the Securities and Exchange Commission, for example, gives pause for thought. By consequence, before the problem of ultimate control is taken up, the purpose and design ought to be definitely worked out, so that the normal methods of enforcement can cover the great bulk of the area, leaving administrative processes to deal with the doubtful, the experimental, and the cloudy areas.

If the argument in this memorandum is accepted, the design of any control undertaken should be to

(a) provide more goods, better goods and cheaper goods;

(b) to provide more jobs, better paying and steadier jobs;

(c) to provide continuous ready access to capital financing needed to create and maintain additional plant; to provide for the continued development of the arts.

This diverges from the newspaper approach.

Where a high degree of competition will accomplish the result, that should be the method used. Where a high degree of cartelization under suitable control will accomplish the result, that should be the method. Where quasi-public ownership produces the result, use that. The answers will be different in different fields.

2. Control by Competition.

Legislating competition (unless all previous experience is worthless) simply does not work out. The unit which has the greatest number of governmental privileges (see section one of the memorandum, page 6) accompanied by the best access to the capital market, and the best access to markets and natural resources, will, of necessity, eventually either monopolize or dominate the field.

If really small scale units are desired, the really effective procedure would be to take away corporate privilege of limited liability. Men who are asked to sign their own names to their own notes will usually be limited by the resulting risk.

I doubt if this possibility will be seriously considered. During the century in England (1720-1810), when corporations were virtually forbidden, the system worked until the end, but from 1800 on the pressure towards large scale enterprise became unbearable; and the "Bubble Act" had to be repealed.

Failing this, it is probably more effective to assist competition, rather than legislate the large unit out of existence. This involves working out a variety of expedients.

Capital Credit Banks and a Capital Reserve System.

(a) Revised methods of capital financing.

It has already been noted that small industry does not have the same access to the capital market as does large industry. A small step in the right direction was made by the change of the rules of the Comptroller of Currency with reference to bank loans and investments; but this is too limited a step to have general effect.

A real system of capital credit banks is plainly indicated; a system which would have to be backed by a capital reserve bank (presumably, a division of the Federal Reserve Bank) able to create credit, and to join in contracting it when necessary. This calls for a separate study.

Until this is done it is mere waste of time to grouse about "Wall Street." The Wall Street banking system is doing exactly what one would expect it to do--no less and no more. If anything real is to be accomplished along this line, the foundation has to be laid for a capital credit system that really works.

(b) Methods of taxation.

The country has been through two or three fights in connection with corporate taxation, one of them having to do with the undistributed surplus tax and another with its modification and attempt to repeal. A courageous investigation of the working of that tax would be worth doing, but (politics and predispositions aside) it is fairly clear how it will come out.

The undistributed surplus tax was put on under the theory that corporations today could be trusts for the perpetual accumulation--that is, could go on accumulating income and adding it to capital without limitation. This is true. Through compound interest a few corporations could eventually control the whole United States.

What was not realized was the fact that a high undistributed surplus tax, though it retarded growth of existing large corporations, gave them a perpetual franchise, not only to stay large, but to be the only large corporations in existence. No small business could grow up to a point where it could give its larger competitors any real battle. In consequence, every small business was in danger far more than the large; and knew it; which was the real reason for the revolt and ultimate modification of the tax. Arithmetically, there could be no other result. Failure to distinguish between investment and holding corporations on the one hand, and operating or producing companies on the other, in which the owner, though he might technically "own" the income, was devoting it to building up a producing unit, frequently in the hope of competing against larger units, made the tax necessarily unequitable. Further, and still worse, the tax left it open to the large unit to increase the area of its influence through marketing agreements, trade alliances and the like. Thus it did not even prevent the expansion it was designed to remedy. There was a blissful ignorance of the fact that a "small company" is not a matter of mathematics. A concern with a $75,000 average income might be a large grocery store; but it would be a pitifully weak steel or automobile plant.

If it were really desired to create a set of competitive units, one of the simplest ways of doing so would be to allow an exemption from undistributed surplus taxes--or possibly even from competitive income tax--until the corporation reached a size equal to, say, 25 percent of its largest competitor, provided the income were devoted to building plant or paying debts incurred for that purpose.

The reverse process, of making it impossible for any existing or future small concern to fight a winning battle with the larger concern, whose capital structure and access substantially are already controlled, obviously destroys more competition than it can further.

(c) Access to technical improvements.

It is at least conceivable that equality of access to all technical improvements might be granted on standard terms. Every invention could be made available to everyone who desires to use it, provided the same royalty payment is made.

What was desired through the operation of patent laws was to encourage invention. To some extent, probably, the ability of the patentee to grant an exclusive license accomplishes this end; in theory, at least, he might sell the exclusive license, or secure commercial development of his patent more profitably if he could grant such an exclusive license. But against this the fact that the exclusive licensee needs fear no competition for a considerable period of time; also, that much, if not most, invention is made in corporate research laboratories.

(d) Non-competitive fields.

There are fields, of course, in which competition does not work out. This is particularly true of transportation; in part also of power; and, in my view, is true of many natural resources, especially oil. Here the real choice is between regulated monopoly and government ownership. The analysis laid down by Professor de Vitti di Marco in his "Public Finance" (Marghet translation) is, I think, the best in print.

Briefly, that analysis suggests that choice between government or quasi-public ownership and private monopoly turns entirely on the relative efficiency of the two forms of production in taking the product to the need. Where the product is standard and uniform, where the inefficiencies of government ownership are not materially greater than the inefficiencies of monopoly, and where the greater actual use can be developed from public ownership, the public ownership is preferable.

There are other reasons for desiring certain fields within which government expenditures may result in direct production of wealth; but they need not be detailed here.

3. Control by Regulation.

In certain fields it will eventually become plain that either (1) there will be no real competition or (2) competition cannot produce a balance.

It is customary in certain circles to become violently excited at mention of regulation, rather than competition. Much of this proceeds from a lack of ability to distinguish between different kinds of business, and rests on the assumption that competition will produce a balance.

The sound points of objection seem to be: Regulation is always inherently dangerous; it is often unsound to have government boards making regulations, without assuming responsibility for the results. The decay of the Interstate Commerce Commission is an admirable illustration. Regulation is always an attempt to generalize and I have yet to see a regulation, either of my own making or of any one else's that fitted the situation. Finally, there is always the certainty that, at some stage in the history of a regulative body, the regulations will be used for purposes which are either corrupt, political, or doctrinaire. Any of these three may produce violent and extremely unhealthy results. A Harry Daugherty running the Securities and Exchange Commission, as at present constituted, or a Whitney running the Federal Reserve Bank, could create a series of interests which would take years to dislodge. Public utility regulations of many states have turned out to be a means of sanctifying privileges, rather than of protecting the public.

The beneficial side of regulation is this: there are certain fields in which we are not prepared either for monopoly or for public ownership, yet when planning is essential to a secure economy. Here it may well be that some sort of cartel formation or other organization of the industry is essential.

The fields in which this is true are likely to be these:

(a) Fields in which the unit of industry is inherently large. This is particularly true, for instance, of the steel industry; certain natural resource industries; the power industry.

(b) Fields where a planning of output is inherently necessary. This is true of motors, of oil, possibly also of copper. I am not yet clear about textiles. For instance the motor industry in 1937 undertook largely to increase its output and sales. It did this at the cost of suspending much of its activities in 1933 and causing widespread distress in the Detroit and Ohio area. Had anyone of the companies undertaken unilaterally to limit its output, a competing company might--and probably would--have increased its output. Had the four major companies entered an agreement to plan their output, they would have been liable to criminal indictment. Yet common sense would indicate some planning of output in the motors field; just as it does in the mining of crude oil. The market can be estimated; the need is approximately known; a mere senseless over-stocking and shutting down accomplishes nothing.

(c) A third essential where the regulative or quasi cartel system might be appropriate is the dependence of a large number of people on a reasonably continuous, reasonably even flow of the product. Against the obvious interest of the consumer and the theory (delighted in by economists) of an elastic price, there must be set a simple fact. You cannot gamble with the economic safety of a large district simply in the hope that the expansion of inventory will lead to a lower price, which in turn will lead to an expansion. The expansion of industry may lead to a lower price, but this in turn may lead to a spiral engendering the hope of further price cuts, which will stop activity for a period of time, during which an entire district is out of work and all economic processes suffer accordingly. Meanwhile the human suffering occasioned by the stoppage is extreme.

(4) <u>Areas of direct production</u>.

I am pretty clear in my own mind that, within ten years, we shall be forced into a vast expansion of direct production of one sort or another; and that this is likely to be on a more or less regional basis, rather than on a strictly industrial basis. The Tennessee Valley Authority may very well prove to be the great example in this regard.

The advantages are obvious. Production without interruption because of annual fluctuations is possible; so is distribution without intervention of the usual cumbrous, wasteful marketing process. Local government units, such as municipalities and towns, may be used to their full efficiency, cooperative associations giving full scope for local initiative may be developed; accessory activities of all kinds may be created.

My feeling is that the constructive side of the report will need to develop the areas in which all control forms, namely, competition, regulation and direct production, are used. As stated above, there is no reason for assuming that any of the three is the sole answer for all industries, for any one industry, or for all localities.