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April 10, 1939
(Magill-Shoup)

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I should like first to say that I appreciate this opportunity to present to your Committee my views on necessary revenue legislation. You have heard the saying that "no year is a good year to suggest a tax bill". Certainly this remark would seem to be an accurate forecast of 1940, a year in which a national election will command the attention of the country. Therefore, my appearance here today may well be my last before this Committee on the broad subject of tax legislation.

For that reason, may I digress a moment to thank this Committee and especially its Chairman, Representative Doughton, for the cooperation and consideration which have been extended to me throughout my term in office. Representative Doughton, your Committee, Senator Harrison and the Senate Finance Committee have loyally served the welfare of this country in a manner of which we may all be proud. Working with this Committee and with the Senate Finance Committee has been an experience which I shall always remember with pleasure.

The Opportunity for Basic Reforms

When I appeared before this Committee on March 24th, I said that the Treasury was ready to supply the appropriate Congressional committees with its recommendations for changes in

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the tax system. The chairmen of the two Congressional committees have expressed their interest, and their desire to receive the recommendations as promptly as possible, for action at this session. Some revenue legislation during this session is a recognized necessity, since the income taxes on corporations expire at the end of the year, and excise and sales taxes yielding about \$500 millions expire during the summer. I hope that Congress will take this opportunity, not simply to extend the expiring levies nor simply to adopt the usual series of technical changes to meet particular hardships, but to adopt those few basic reforms that we badly need to put the revenue system on a just foundation. The fundamental reforms that I want to suggest can be adopted, as a practical matter, much better this year than next year; and the encouragement to the taxpayers of the country by their adoption at this time is a factor of real importance under present business conditions.

Developments of the Past Decade

In order to achieve lasting reforms in taxation it is essential to get a proper perspective, a perspective that we are in danger of losing through the close attention necessarily given to tax developments day by day. Before considering specific

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measures I therefore suggest that we look at the development of the tax system during the last ten years.

During the period 1926-1930 the Federal tax system was producing about three and a half billion dollars a year. The Great Depression drove the yield down to two billions in 1932 and government expenditures increased. The result was the Revenue Act of 1932, the first of a series of revenue acts all designed to strengthen the tax system in one way or another.

The 1932 Act put the income tax rates back to the levels prevailing shortly after the War. It also doubled, roughly, the estate tax rates, and imposed a gift tax and a series of manufacturers' excise taxes. Nevertheless, so powerful were the forces of depression that the tax revenue did not rise above two billions in 1933. But for the next five years it increased to an extent practically unprecedented in the recent history of national governments, reaching an all-time record for this country of six billions in 1938.

Among the measures passed since 1932, about equal shares in achieving this result can be assigned, first, to the taxation of liquor following repeal of prohibition; second, to the social security payroll taxes; third, to the further increases in the income taxes, the estate tax, and the gift tax in 1934 and 1935;

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and to the processing taxes while they were in existence. Some revenue was also obtained, in the pressure of emergency, by disallowing certain well-grounded deductions, that are recommended below for reinstatement. Finally, the great recovery in revenue has of course been achieved in large part through the recovery in business from the depths of 1932 and 1933.

Despite the great increases in income tax and estate tax rates and the introduction of a gift tax, these taxes produced only 50 percent of the Federal tax revenue in 1938. This compares with 68 percent in 1929 to 1931. The fact seems to be that, important as have been the developments in direct taxation in the past decade, they have been in large part but the necessary structural work, with much of the content yet to be added if direct taxation is to play the part it should. This point is especially important because, after all, the Federal government collects less than half the country's tax revenue. The State and local tax systems depend on the property tax for two-thirds of their tax revenue and on the gasoline and motor vehicle taxes for 13 percent. Thus they make very restricted use of direct taxes graded to take account of net differences in taxpayers' power to support government.

Aims of Tax Revision

Among the aims of tax reform, encouragement of business must of course rank high. This is partly a matter of specific

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measures designed to lighten the tax load at strategic points. It is also, however, a matter of formulating a definite fiscal policy. This policy, as I explain later, calls for a strengthening of the tax system. The system cannot be strengthened with much assurance unless it is first improved with respect to simplicity, justice, and Federal-State-local coordination -- points that therefore have direct bearing on business recovery.

Simplicity

Among the desirable goals of the tax policy, simplicity is one of the most important. The cost of administration should be kept within reason, and the collection of taxes should be as little burdensome to the taxpayer as possible.

Regional Agencies. The Treasury has considerably simplified tax administration by establishing regional agencies to settle controversies locally, and to speed up the work. It is no longer necessary to come to Washington in order to settle an income tax or an estate tax or a gift tax case. I have no illusions about the possibilities of eliminating completely such complexities as the elaborate provisions on corporate reorganizations, or the even more detailed sections added in 1938 to permit utility companies to reorganize in conformity to the holding company act without unduly heavy tax liabilities. Tax laws cannot be wholly simple in a complex society. Moreover, the sections I have mentioned apply to the few cases, not to the many.

The Four Kinds of Corporation Tax. There is at least one complexity, however, of general application that can be removed. We now have four different taxes applicable to ordinary business corporations: an income tax, an undistributed profits tax, a capital stock tax, and an excess-profits tax. The income tax is of course an excellent fiscal instrument. The undistributed profits tax, on the other hand, has been reduced to a point where it possesses little significance in either obtaining revenue or increasing the fairness of the tax system; it seems mainly to serve as a business irritant. The capital stock tax is not a tax on the actual value of corporate property or even corporate stock, and the excess profits tax is not really a tax on excessive profits. Both taxes are in practice based on the guesses of corporate officials as to future corporate income. The corporation tax system would be greatly simplified, and its justice measurably increased, especially in lightening the tax load on deficit corporations, if all four taxes were consolidated into a single flat tax on corporate net incomes, with some concession in rate to corporations having less than perhaps \$25,000 net income.

Fairness

Another essential goal of tax policy is fairness in the distribution of the tax burden. Agreement with the broad objective, however, has not always been followed by the specific

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steps necessary to accomplish it. The imperative budgetary necessities of the present decade have been allowed to override a number of allowances to the taxpayer that experience has shown are essential to a fair system of taxation. On the other hand, in some cases undue concessions have been made to certain groups of taxpayers; these concessions necessitate extra burdens on other taxpayers and should be removed.

Net Loss Carryover. Among the allowances that in my opinion should be reinstated for purposes of the corporation normal tax and the individual tax is that whereby a net business loss of any one year can be carried forward and be used to reduce the taxable net profit of a later year. At present, a business which has lost \$50,000 a year for three years and has then made \$150,000 in the fourth year must pay tax on the full \$150,000 without any allowance at all for the losses of the first three years, although the plain fact is that the business has made no profit at all over the four year period. No income tax should be payable where there have been no profits. If the Government wants investment in new businesses — businesses which cannot guarantee a profit every year — the least the Government can do is to provide that only net profits over a term of years will be taxed. The same remarks apply to the heavy industries producing durable goods — industries that are particularly sensitive to the business cycle and in which unemployment is most pronounced. Under the present system of allowing no carryover of business losses, the tax system is loaded both

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against new investment and the durable goods industries. Unfairness here, as so often, acts as a deterrent to the business enterprise.

Capital Losses of Corporations. Another example of such loading is the present restriction on a corporation that incurs a loss when it sells a capital asset. This capital loss can be deducted only against the capital gains, if any, that the corporation has made in the same year (plus \$2,000). In many cases, therefore, the corporation does not in practice get an allowance for its capital loss. Thus again the risk-taking type of business is discriminated against, compared to the safe and stable business.

Dividends Received by Individuals. Another allowance that should be reinstated concerns dividends received by individuals. At present a corporation's income is taxed, and then when it is paid out in dividends the stockholder pays the full individual income tax on the dividends with no allowance at all for the fact that the corporation has also paid an income tax. Thus, an extra burden is imposed on all income from corporations, large and small. More serious, perhaps, is the fact that this arrangement gives corporations a strong inducement to raise money by selling bonds or borrowing at a bank rather than by selling stock. This is so because the interest that the corporation pays out on this borrowed money can be deducted from its gross income in computing its net income; but it cannot deduct dividends paid out; and both

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dividends and interest are taxed in full to the individual. A remedy is to give the individual taxpayer some relief from full taxation on the dividends he receives, in acknowledgment of the fact that the corporation has already paid tax on the profits whence those dividends come. The relief need not be so large as to equal the corporation tax, but it should, in my opinion, be substantial. Before the relief was eliminated in 1936, it took the form of exempting dividends from the normal tax (leaving them subject to the surtax). Whether this device would be adequate now must be considered in the light of the fact that while the normal tax is only 4 percent, the corporation tax, except for small corporations, has been raised to 16½ percent at a minimum and will be even more if the rate is increased upon elimination of the capital stock and excess-profits tax, as suggested above.

Consolidated Returns. Two provisions in the income tax law are aimed directly at corporation subsidiaries. One is the provision forbidding two or more corporations to file a joint, or consolidated, return even though they comprise a group consisting of a parent corporation and 100 percent-owned subsidiaries. Thus a loss incurred by one of the group cannot be used to reduce the profit of another in the group, though so far as the shareholders are concerned they are simply one large corporation.

Intercorporate Dividends. The other provision makes a corporation include in its taxable income 15 percent of the

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dividends it receives, although these dividends come from profits that have already paid the full corporation income tax. This measure has nothing to do with tax evasion through personal holding companies, a problem solved for the present at least by the series of prohibitive taxes worked out in 1937 on the "incorporated pocketbook", whether foreign or domestic. Instead, this partial taxation of intercorporate dividends penalizes parent corporations, ordinary holding companies, and the ordinary type of investment trust.

There are undoubtedly reasons for controlling the growth of such types of corporate structure, but it is also true that there are many cases where those types are legitimate and even desirable from the public point of view. The tax penalties strike the deserving and undeserving alike, making no distinction of either motive or results. It is therefore pertinent to ask whether we are not wielding too blunt an instrument in these cases, harming some unintentionally and unwittingly allowing others to escape too lightly. Of course, any system of tax laws is bound to affect business practices, and it is not sensible to say that taxation should in no circumstances be used as an instrument of social control; but tax laws are complex enough and hard enough to make fair as revenue producers without being asked to take on the task of social control. It remains a good general working rule that whatever governmental regulation is necessary should be attempted, in the first instance at least, by other means.

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Surtax Rate Structure. The present rate scale of the individual income tax reaches a peak of 79 percent in the top bracket, with several percents added by State income taxes in many cases. From the viewpoint of an equitable distribution of the tax burden I do not believe this rate scale is too severe; but to run it up to such high levels in the top brackets is to make scarcely worthwhile for the wealthiest taxpayers any risking of their capital in hazardous ventures. I therefore suggest that the following combination of measures be considered as a means of preserving the fairness of the tax system while leaving more encouragement for risk-taking enterprise: let the rates in the top brackets of the income tax be substantially reduced and, as noted below, let the capital gains provisions be tightened, the estate and gift tax rates increased, and future issues of tax exempt securities prohibited.

Tax-exempt Securities. It is obvious that the progressive-rate feature of the individual income tax - the keystone of our fiscal policy - is distorted and in many cases completely nullified by the existence of a large amount of tax-free securities. Now that recent Supreme Court decisions indicate a change in attitude toward the problem of intergovernmental immunity, it seems to me that the inclusion of all future governmental bond interest in taxable income is one of the most obvious next steps toward tax justice. More than that, it should tend to push into new enterprises the kind of private capital that can afford to take risks.

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I have discussed five types of allowance that, if granted to taxpayers, would, in my opinion, increase the fairness of the tax system, and encourage investment, especially investment that is willing to take risks. I now come to the other aspect of business: undue concessions that have been made to certain types of taxpayer. Removal of these concessions will serve the double purpose of improving the equity of the system and counterbalancing to some extent the decrease in revenue that would result from the allowances discussed above.

Capital Gains and Losses. A gain from a sale of a stock or a bond or a piece of real estate or any other capital asset is, if the asset has been held more than two years, taxed at a maximum rate of 15 percent. In the vast majority of cases the tax rate is even much less than this. Alongside of the ordinary income tax rates that apply to salaries, interest, dividends, and rents, the rates on these long-term capital gains are absurdly low. One reason given for setting them so low is that the deduction of capital losses is somewhat restricted. A fair tax system cannot be achieved, however, simply through matching an unjustified concession by a harsh restriction. A more sensible procedure is to remove both the concession and the restriction. Hence I suggest for consideration an increase in the tax rates on long-term capital gains, and possibly also on intermediate gains (now taxed at a maximum of 30 percent), coupled with more liberal allowance of capital losses, possibly by letting them be carried forward several years to be offset against future capital gains. The net result should be no deterrent to genuine long-term investment

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(especially in view of the suggestion above concerning surtax rates) and a great increase in fairness among individuals.

Depletion. The present law allows excessive depletion deductions to oil and gas wells and certain types of mine. As the Treasury has often pointed out, a large amount of revenue can be recovered by closing this loophole.

Estate Tax and Gift Tax Coordination. The estate and gift taxes together contributed only 6.9 percent of the Federal revenues in 1938, and only 3.9 percent of total Federal, State, and local revenues. One of the reasons why these taxes do not play a larger role is that wealthy persons can split their giving between life and death in such a way that the transfers fall only in the lower brackets of each of the two taxes. Moreover, there are two exemptions, one for each tax. The remedy for this situation is not merely to increase the rates, nor even merely to eliminate one of the exemptions. The aim, it seems to me, should be to coordinate the gift tax and the estate tax so that, from the transfer tax point of view, it makes practically no difference to the donor whether he gives during life or at death. Of course if some tax incentive to give during life is deemed desirable, it can be given, even under the coordination suggested below. At present such incentive as exists may fairly be called erratic and far too costly in revenue.

This coordination would in effect consider gifts and the final distribution at death as a unified series of transfers. At the present time successive gifts are cumulated for tax purposes. It remains merely to cumulate the estate as if it were a final gift.

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There then would be one exemption and one rate scale. If it were desired to give new inducement to gifts it could be accomplished through special credits. Furthermore, any undue hardships at death could be eliminated through special provisions.

With this loophole of avoidance closed, it would probably be desirable to increase the yield of the estate tax still further through somewhat lower exemptions and higher rates in the lower and middle brackets. The Federal estate tax at the present time applies to a very small proportion of estates and the tax on all but the top portions of very large estates is relatively small. In my opinion the rates on the highest brackets of the largest estates are already sufficiently high and should not be increased, although the total tax on those large estates would, of course, increase as the middle and lower bracket rates were increased.

Estate Tax Insurance Exemption. The exemption granted to life insurance (up to \$40,000) under the estate tax gives a preference to those fortunate enough to be able to save in this manner over all other savers and other forms of saving. Removal of this discrimination is in my opinion highly advisable.

Coordination with State and Local Taxes

In a federal system such as ours, coordination of federal, state, and local taxes becomes one of the major goals of fiscal policy.

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Growth of Conflict. While the national government has been obliged to strengthen its revenue system, the States have been faced with a similar problem. They too have experienced drastic declines in revenue and increasing demands for expenditure. To meet their revenue needs they have reached out for new tax sources. Taxes on incomes, retail sales, alcoholic beverages, tobacco, and chain stores, and a variety of business taxes have been newly imposed in many States. As a result, there has been an enlargement of the group of taxes that are imposed by both Federal and State governments. Transfers of property at death are taxed both by the Federal Government and 47 of the States. Individual income is subject to the Federal income tax and 34 State income taxes. Motor fuel is taxed by the Federal Government and all the States; the Federal Government and 44 States derive revenue from alcoholic beverages; and in 31 States the Federal and State Governments tax tobacco. Similar duplications exist in many other taxes.

Results of Conflict. The simultaneous expansion in the revenue systems of both the States and the Federal Government has greatly increased the conflicts between national and State taxes and between the taxes of the various States. The results are increasingly unsatisfactory to everyone. The various units of government find their revenues adversely affected by competing taxes of other governments. The costs of collection are higher in proportion to the revenue than if this competition did not exist. The types of taxes that States have felt obliged to impose often give rise to smuggling

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across the State lines, necessitating practically the setting up of customs offices by the States. The taxpayer is also adversely affected. He is often subject to two or more taxes on the same income or the same transaction. These taxes are frequently imposed without regard to each other so that the levies are unequal and onerous. For example, in some States combined Federal, State and local gasoline tax levies reach 10 cents per gallon. The taxpayer must prepare numerous reports which must often be compiled in different ways to satisfy the many requirements of the different taxing authorities. Even the salaried individual must fill out several forms for income tax (including duplicates) in many States.

The Next Step. Although in a Federal system of government the tax structure will inevitably be complex, the existing confusion and conflict can be diminished. A variety of suggestions have been made from different sources. Thus, it has been proposed that uniform returns be used by different States and the Federal Government in collecting the same tax and that uniform apportionment formulas be adopted to avoid taxing the same income or transaction twice by different states. In the case of some taxes it has been suggested that the Federal Government administer the tax and distribute its proceeds among the States whence the revenue comes. Another suggestion is that the Federal Government leave some of the revenue sources to the States and that the States leave other sources to the Federal Government. Federal

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collection of taxes accompanied by grants-in-aid to States has also been suggested.

It is high time to consider seriously how the national and State Governments can coordinate their taxes in such a manner as to minimize duplications and conflicts, to reduce the taxpayer's cost in complying with the tax laws and to assure adequate revenues to all governments. The existence and seriousness of the problem have been widely recognized and there has been a good deal of talk about it. To date, however, little has been accomplished.

In my opinion, the most fruitful approach to this difficult and complicated problem is through the appointment of a national commission made up of men having the highest possible level of ability and public confidence. They should represent not the Federal, State or local Governments as such, but the national interest at large. They should have at least one year, more probably two or three, in which to hold hearings and prepare a report, and ample funds should be provided for staff work. The function of the Commission would be to study the inter-governmental fiscal problem in its many ramifications and report to Congress. I suggest that Congress consider the creation of such a Commission.

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Adequacy of Revenue

It is trite to say that a tax system should yield adequate revenue. The real question is, what is "adequate" in any given year and place. Yet this question is at the root of our tax problem. Unless we answer it, all our specific recommendations for changes in the tax system assume at best an air of temporary structures resting on foundations apt to be shifted at a moment's notice. Here it becomes necessary to complement the backward glance over the past decade given at the beginning of my statement with a look into the future of the next five years or so.

As we look, certain probabilities take form. To what policy they should lead may not be entirely self-evident, but it is clear that we must resolutely face the problems that they raise.

The Prospects for a Balanced Budget.- The present tax system is powerful; but it is not so powerful that it will stop all increase in the public debt over the next five years or so, even given some measure of business improvement and some reduction in expenditures. In a year of great prosperity, with a national income of some 80 billions of dollars, the current revenues might rise to 8 billions; and, depending on the course of expenditures, a moderate amount of debt reduction, perhaps not more than a billion dollars and conceivably less, could result in such a year. But over a longer period, good years and bad, the present revenue system will result in a substantial increase in the public debt,

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assuming no radical change in expenditures. The crux of our expenditure problem lies in relief and national defense. Together these items are accounting for _____ of our total national expenditures for the current year.

Even with the lowest expenditures on relief and defense that can reasonably be expected, it is in my opinion unreal to talk of balancing the budget next year or even the year after next; but, unless we are to commit ourselves to a philosophy of continuing increase in debt, it will be necessary to enact this year measures that will, within three or four years, bring in added revenue. These measures are indicated in detail below. It is not so much the exact date of budget equilibrium that matters, or even the precision of the balancing, as it is the adoption of a program that commits us to a trend in this direction during the next five years.

The Necessity for a Commitment Toward a Balanced Budget.-

Such a program seems to me to play a vital part in increasing the national income.

The healthy functioning of the country as a whole depends in the last analysis upon the healthy functioning of the wage-earners and the businesses of the country. We must rely upon business to provide employment for at least the great bulk of our men of working age. I have suggested some measures of

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tax fairness that will remove specific obstacles to business recovery; but the problem is much broader than that. When the uncertainty of conditions abroad are coupled with the uncertainties of an unbalanced national budget, and when measures to produce a balance are hopes, not realities, it is not surprising that the man who has saved money, whether a few dollars or a million, refuses to take a chance on an investment in anything save the soundest, best established, most stable securities. He knows that business must sometime face new taxes heavy enough to bring the budget into balance, perhaps even heavy enough to retire some part of the debt, and he cannot know where they will fall. Since he cannot forecast the future, he marks time. The result is business stagnation, not the steady business advance which has been characteristic of the country.

Sources of Added Revenue.- A definite policy looking toward the balancing of the budget sometime within the next five years or so seems to me to imply the following steps:

First, a declaration of the policy in unmistakable terms.

Second, the continuation of the sales and excise taxes that otherwise expire this year.

Third, a program of readjustment within the several taxes as suggested in the sections above. The net effect of these readjustments will probably be a loss of revenue, but they are essential because of the very fact that the system as a whole

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must raise more revenue. When the tax burden becomes severe in the aggregate, injustices within the system that might otherwise as a practical matter be ignored may become intolerable.

Fourth, an increase in rates and a decrease in exemptions, in a manner calculated to cause the least immediate disturbance to consumer purchasing power and to capital's willingness to invest. Here the most promising points of attack seem to be:

(a) The rates of the estate tax and gift tax (coordinated as suggested above) in the middle and lower brackets. The full revenue from increases in these brackets will not come in until three or four years have passed, but when it does arrive it will be a powerful factor operating to balance the budget.

(b) The exemption of \$40,000 under the estate tax-gift tax. This could, in my opinion, be substantially lowered.

(c) The middle brackets in the individual income tax, especially those between \$5,000 and \$50,000. An increase here rather than elsewhere seems indicated by the manner in which the weight of the tax system as a whole is at present distributed. It must be remembered that even the wealthiest man has part of his income in the middle brackets, so an increase there would in part directly recoup the loss incurred by reducing the rates where they are most restrictive economically, that is, on the top parts of his income.

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(d) The exemptions under the individual income tax. By lowering the single exemption from \$1,000 to \$800 or thereabouts, and the married exemption from \$2,500 to \$2,000 or thereabouts, not only will a new class of taxpayers be awakened into consciousness of the needs of the government, but all existing taxpayers will be required to contribute something more.

This program recognizes the desirability of increasing the role of direct taxation in the system of the national government.

Whether it would prove adequate to balance the budget at the proper time would of course depend on many factors, some of them adduced above, that cannot be examined in detail here. At the very least, however, it would be a program, not a policy of drifting that is in itself a sort of choice by default; and the achievement of a carefully formulated program must, in my opinion, be the cornerstone of our fiscal policy.

through

The merits of the estate tax entitle it to an important role in the Federal tax system. It permits the application of the principle of ability to pay although on a somewhat less exact basis than the individual income tax. It is the best available means for preventing the perpetuation and increasing concentration of great fortunes. As compared to other taxes it has relatively little effect in discouraging enterprise. The contemplation of the distant future is of less importance in determining one's business decisions than the realities of the immediate present. Such effects as there are tend to offset each other. The prospect of estate taxes may discourage some persons from trying to accumulate fortunes while it may encourage others to accumulate more than they otherwise would in order that they may leave a competence to their dependents.

Changes in the law during the past few years have gone a long way to make the estate tax the factor it should be in the revenue system. The exemption has been decreased to \$40,000 and tax rates have been increased to a maximum of 70 percent on amounts transferred in excess of \$50,000,000. The place of the estate tax in the tax system, however, is still not as large as it should be. In 1928 the tax accounted for --- 1.0 percent of the Federal revenues while in 1938 it accounted for 6.9 percent. As a proportion of total Federal, State

- 2 -

and local revenues, estate and inheritance taxes amounted to 2.0 percent in 1928 and 3.9 percent in 1938. One of the reasons why the estate tax does not yet fill the position it should in the tax system is that it is widely avoided by making gifts before death. In an attempt to end this avoidance, a gift tax was imposed in 1932. While the gift tax has reduced the incentive to avoid the estate tax, a large incentive remains. There are two exemptions, one for the gift tax and one for the estate tax. Likewise, there are two rate scales, each beginning at very low rates. A person with a large fortune can reduce his tax markedly by taking advantage of the two exemptions and the two rate scales.

The avoidance cannot be offset merely by eliminating the gift tax exemption and increasing the rates of estate and gift taxes. Inequities among taxpayers would be increased if only these steps were taken. Many persons are not able to dispose of large amounts of their wealth by gift. Some need to retain their wealth to maintain control over their businesses. Others feel that they cannot give away their property because of the uncertainties of the future and the desire for protection in old age.

In my opinion the solution lies in considering gifts and the final distribution at death as a unified series of transfers. At the present time successive gifts are cumulated.

- 3 -

It ~~merely remains~~ to cumulate the estate as if it were a final gift. There then would be one exemption and one rate scale. If it were desired to give new inducement to gifts it could be accomplished through special credits. Furthermore, any undue hardships at death could be eliminated through special provisions.

With this loophole of avoidance closed, it would probably be desirable to increase the yield of the estate tax still further through somewhat lower exemptions and higher rates in the lower and middle brackets. The Federal estate tax at the present time applies to a very small proportion of estates and the tax on all but very large estates is relatively small. In my opinion the rates on the largest estates are already sufficiently high and should not be increased.

Blough

DRAFT-12:30 P.M.-4-10-39

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While the national government has been obliged to strengthen its revenue system, the States have been faced with a similar problem. They too have experienced drastic declines in revenue and increasing demands for expenditure. To meet their revenue needs they have reached out for new tax sources. Taxes on incomes, retail sales, alcoholic beverages, tobacco, and chain stores, and a variety of business taxes have been newly imposed in many States. As a result, there has been an enlargement of the group of taxes that are imposed by both Federal and State governments. Transfers of property at death are taxed both by the Federal Government and 47 of the States. Individual income is subject to the Federal income tax and 34 State income taxes. Motor fuel and alcoholic beverages are taxed by the Federal Government and 31 States. Similar duplications exist in many other taxes.

The simultaneous expansion in the revenue systems of both the States and the Federal Government has greatly increased the conflicts between national and State taxes and between the taxes of the various States. The results are increasingly unsatisfactory to everyone. The various units of government find their revenues adversely affected by competing taxes of other governments. The costs of collection are higher in proportion to the revenue than if this competition did not exist. The types of taxes that States have felt obliged to impose often give rise to smuggling across State lines.

- 2 -

necessitating practically the setting up of customs offices by the States. The taxpayer is also adversely affected. He is often subject to two or more taxes on the same income or the same transaction. These taxes are frequently imposed without regard to each other so that the levies are unequal and onerous. For example, in some States combined Federal, State and local gasoline tax levies exceed 11¢ per gallon. The taxpayer must prepare numerous reports which must often be compiled in different ways to satisfy the many requirements of the different taxing authorities.

Although in a Federal system of government the tax structure will inevitably be complex, the existing confusion and conflict can be diminished. A variety of suggestions have been made from different sources. Thus, it has been proposed that uniform returns be used by different States and the Federal Government in collecting the same tax and that uniform apportionment formulas be adopted to avoid taxing the same income or transaction twice by different States. In the case of some taxes it has been suggested that the Federal Government collect the revenue and distribute it among the States. Another suggestion is that the Federal Government leave some of the revenue sources to the States and that the States leave other sources to the Federal Government. Federal collection of taxes accompanied by grants-in-aid to States has also been suggested.

- 3 -

It is high time to consider seriously how the national and State governments can coordinate their taxes in such a manner as to minimize duplications and conflicts, to reduce the taxpayer's cost in complying with the tax laws and to assure adequate revenues to all governments. The existence and seriousness of the problem have been widely recognized and there has been a good deal of talk about it. To date, however, little has been accomplished.

In my opinion, the most fruitful approach to this difficult and complicated problem is through the appointment of a national commission made up of men having the highest possible level of ability and public confidence. They should represent not the Federal, State or local governments as such, but the national interest at large. Their function would be to study the inter-governmental fiscal problem in its many ramifications and report to Congress. I recommend that Congress provide for such a commission.

Magill-Shoup-Blough

4/10/39
(see page 27)

In my statement of _____, I said that the Treasury was ready to supply to the appropriate Congressional committees its recommendations for changes in the tax system, to improve its fairness, to encourage business to go forward, and to meet present budgetary requirements on a better basis. The chairmen of the two Congressional committees have expressed their interest in these objectives, and their desire to receive the recommendations as promptly as possible, for action at this session. Some revenue legislation during this session is a recognized necessity, since the income taxes on corporations expire at the end of the year, and excise and sales taxes yielding about \$500 millions during the summer. I hope that Congress will take this opportunity, not simply to extend the expiring levies, nor simply to adopt the usual series of technical changes to meet particular hardships, but to adopt those few basic reforms which we badly need to put the revenue system on a just foundation. The fundamental reforms which I want to suggest can much better be adopted as a practical matter this year rather than next year; and the encouragement to the taxpayers of the country by their adoption at this time is a factor of real importance under present business conditions.

I wish to divide this statement into two parts: First, a short summary of the fundamental tenets by which a tax system may be judged; and second, a list of the major changes which I recommend for Congressional consideration at this time.

First, Simplicity. The collection of taxes should be as little burdensome to the taxpayer as possible. The Treasury has considerably simplified tax administration by establishing regional agencies to settle controversies locally, and to speed up the work. It is no longer necessary to come to Washington in order to settle an income tax or an estate tax or a gift tax case. I have no illusions about the possibilities of eliminating completely such complexities, as the elaborate provisions dealing with corporate reorganizations, or the even more detailed sections added in 1938 to permit utility companies to reorganize in conformity to the holding company act without unduly heavy tax liabilities. Tax laws cannot be wholly simple in a complex society, and the sections I have mentioned apply to the few cases, not to the many.

The complexities I would like to see eliminated are those in the taxing provisions of general application. We now have four different taxes applicable to ordinary business corporations: an income tax, an undistributed profits tax, a capital stock tax, and an excess profits tax. The income tax is by all odds the most productive as well as the fairest. The undistributed profits tax has been reduced to a point where it no longer

possesses much revenue significance; it mainly serves as a business irritant. The capital stock tax is not a tax on the actual value of corporate property, nor is the excess profits tax really a tax on excessive profits. Both taxes are really based on the guesses of corporate officials as to future corporate income. The corporate tax system would be greatly simplified, and its justice measurably increased, if all four taxes were consolidated into a single flat tax on corporate incomes, with some concession in rate to corporations having less than perhaps \$25,000 net income.

We should not mix taxation and the regulation of the business of the country. Tax laws are complex enough and it is hard to make them fair as revenue producers without giving them the added freight of social control. Of course, any system of tax laws is bound to have important incidental effects upon our economy; and the laws must be so drawn as to prevent evasion. But it is fundamental that the prime purpose of tax legislation should be the raising of the needed revenue with the least possible dislocation of the ordinary business and social life of the country. Whatever governmental regulation is necessary should, as a general working rule, be accomplished by other means.

Our present tax provisions have been so framed as to encourage corporations to acquire capital through borrowing, rather than through the issuance of stock. Corporations are allowed a deduction for interest paid, but not for dividends paid. Interest and dividends are taxed alike to their recipients. A corporation which has \$500,000 of bonds and \$500,000 of capital stock and surplus will pay much less income taxes than one with the same income and assets which has no bonded indebtedness, and \$1,000,000 of capital stock and surplus. I do not think that the tax laws should act as an incentive to the increase in corporate indebtedness. We can improve the situation by giving stockholders a credit against their normal taxes for the tax the corporation has already paid on the profits distributed to them as dividends -- a credit which existed all through the history of the income tax until 1936.

We have sought to discourage holding companies by a tax of about 2½ percent on dividends received by one business corporation from another. The problem here is not one of tax evasion through personal holding companies, a problem solved for the present at least by the whole series of special prohibitive taxes worked out in 1937 on the "incorporated pocketbook", whether foreign or domestic. The question is whether the revenue laws should be founded on the policy of discouraging business men from organizing subsidiary corporations to exploit

- 2 (c) -

new patents or to develop risky enterprises. In my judgment, it is wiser for the tax laws simply to hold the scales even, to withhold any judgment upon the merits or demerits of different kinds of business organization, to leave these matters to legislation which is openly and avowedly regulative. By the adoption of such a policy, issues are kept clear-cut, and we do not run the risk of muddling tax objectives with regulatory policies, to the disadvantage of both.

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Second, Fairness. Everyone agrees as a matter of course that the tax system should be fair, that taxation should be levied in accordance with capacity to pay. Agreement with the broad objective, however, has not always been followed by the specific steps necessary to accomplish it. The imperative budgetary necessities of the present decade have been allowed to override a number of allowances to the taxpayer which were costing money, but which experience has shown are essential to a fair system of taxation. Thus, corporations are allowed deductions for capital losses only to the extent of capital gains in the same year, plus \$2,000 -- an entirely inadequate provision for any corporation which has been forced to sell considerable amounts of its capital assets at a loss.

We would like to see more capital invested in new industries, to put more men to work. It is certainly the part of wisdom to encourage such investment, for we have immense amounts of idle funds, and we have all too many idle men. Yet the income tax law as unfortunately loaded against new investment and risky businesses, not only by the capital loss provisions I have referred to, but by the elimination of provision for offsetting the current operating losses of one year against the operating profits of a later year. A stable business, reporting annual profits, is in no difficulties in this respect; on the other hand a business which has lost \$50,000 a year for two years and has then made \$100,000 in the third year, must pay just as high taxes on the \$100,000 as if every

year had shown a profit, the plain fact is that the business has made no profits at all over the three-year period, and no income tax should be payable where there have been no profits. If the Government wants investment in new businesses -- businesses which cannot guarantee a profit every year -- the least the Government can do is to provide that only net profits will be taxed.

Third, Adequacy. Over the five-year period ending in 1940, for which budgets have been presented, expenditures have exceeded revenues by an average of over \$3 billions a year. In 1938, the Government received the largest total of receipts for any year since 1920; and the expenditures still exceeded receipts by \$1,384 millions. The anticipated budget deficits for the fiscal years ending in 1939 and 1940 are \$4,072 millions and \$3,426 millions respectively. It may be that expenditures can be reduced. It may be that tax rates and provisions are oppressive in some instances, or that the tax system should rest on a broader base. It may be that ways and means can be adopted for a market increase in the national income, and that then the present tax system will produce revenues to balance disbursements. The first essential in my judgment is the formulation of a dependable plan for dealing with our budgetary problems over the period of the next five years. There is little, if any, possibility of balancing the budget for two or three years, but if action to increase revenues and curtail expenditures is

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not taken at this session, the possibility is pushed ahead by one and probably two years more. Mere inaction at this time constitutes a choice of one form of fiscal policy rather than another.

The healthy functioning of the country as a whole depends in the last analysis upon the healthy functioning of the wage-earners and the businesses of the country. We must rely upon business to provide employment for at least the great bulk of our men of working age. We ought therefore to remove any specific obstacles to business recovery which remain in the tax structure, but the problem is much broader than that. When the uncertainty of conditions abroad are coupled with the uncertainties of an unbalanced national budget, and when measures to produce a balance are hopes, not realities, it is not surprising that the man who has saved money, whether a few dollars or a million, refused to take a chance on an investment in anything save the soundest, best established, most stable securities. He knows that business must sometime face new taxes to bring the budget into balance, and he cannot know where they will fall. Since he cannot forecast the future, he marks time. The result is business stagnation, not the steady business advance which has been characteristic of the country.

Second, the maintenance of the Federal budget in its present condition makes tax reform difficult or impossible.

Most of the essential reforms will cause losses of revenue. I believe that the adoption of some of the changes which I want to recommend will promote healthier business conditions, and in the end increased revenue. But changes in the tax system alone will not greatly improve business, and in any event, the effect will not be immediate. It is the part of wisdom, therefore, to plan a tax system more adequate as a whole, at the same time that we act to relieve specific inequities.

We cannot spare the revenue from the expiring excess and sales taxes at this time. At the same time, we must realize that taxes of this sort are not good measures of ability to pay, that they have been increasingly resorted to by the States and cities as well as by the Federal government, and that therefore further increases in them are undesirable. In 1928, the income tax produced \$2,175 millions out of \$2,800 millions of total Federal revenue, or 77 percent. In 1938, it produced \$2,586 millions out of \$5,660 millions of total Federal revenue, or 45.6 percent; in other words, while total Federal receipts were doubled, the income tax increased about 20 percent. Relatively we are depending too heavily upon indirect flat-rate taxes, and not heavily enough upon taxes which are a more accurate measure of ability to pay. The tax system in this respect has moved in the wrong direction.

Under these conditions, the conclusion is inevitable that the base of the income tax should be broadened by lowering

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the exemptions. Further, there should be an increase in the surtax rates applicable to incomes in the brackets in the center of the rate scale, roughly those incomes between \$20,000 and \$100,000. Finally, our studies indicate that the upper surtax rates are too high for the greatest productivity; and that net revenues would be increased by a small reduction therein. The incentives to embark capital in new enterprises is noticeably dampened. When the State and Federal governments together demand a participation in profits of as much as 89 percent, with a much smaller participation in losses

(go on Estate and Gift Taxes
State-Federal coordination)

The merits of the estate tax entitle it to an important role in the Federal tax system. It permits the application of the principle of ability to pay although on a somewhat less exact basis than the individual income tax. It is the best available means for preventing the perpetuation and increasing concentration of great fortunes. As compared to other taxes it has relatively little effect in discouraging enterprise. The contemplation of the distant future is of less importance in determining one's business decisions than the realities of the immediate present. Such effects as there are tend to offset each other. The prospect of estate taxes may discourage

some persons from trying to accumulate fortunes while it may encourage others to accumulate more than they otherwise would in order that they may leave a competence to their dependents.

Changes in the law during the past few years have gone a long way to make the estate tax the factor it should be in the revenue system. The exemption has been decreased to \$40,000 and tax rates have been increased to a maximum of 70 percent on amounts transferred in excess of \$50,000,000. The place of the estate tax in the tax system, however, is still not as large as it should be. In 1928 the tax accounted for ~~1.8~~ percent of the Federal revenues while in 1938 it accounted for ~~6.9~~ percent. As a proportion of total Federal, State and local revenues, estate and inheritance taxes amounted to 2.0 percent in 1928 and 3.9 percent in 1938. One of the reasons why the estate tax does not yet fill the position it should in the tax system is that it is widely avoided by making gifts before death. In an attempt to end this avoidance, a gift tax was imposed in 1932. While the gift tax has reduced the incentive to avoid the estate tax, a large incentive remains. There are two exemptions, one for the gift tax and one for the estate tax. Likewise, there are two rate scales, each beginning at very low rates. A person with a large fortune can reduce his tax markedly by taking advantage of the two exemptions and the two rate scales.

The avoidance cannot be offset merely by eliminating the gift tax exemption and increasing the rates of estate and gift taxes. Inequities among taxpayers would be increased if only these steps were taken. Many persons are not able to dispose of large amounts of their wealth by gift. Some need to retain their wealth to maintain control over their businesses. Others feel that they cannot give away their property because of the uncertainties of the future and the desire for protection in old age.

In my opinion the solution lies in considering gifts and the final distribution at death as a unified series of transfers. At the present time successive gifts are cumulated. It remains merely to cumulate the estate as if it were a final gift. There then would be one exemption and one rate scale. If it were desired to give new inducement to gifts it could be accomplished through special credits. Furthermore, any undue hardships at death could be eliminated through special provisions.

With this loophole of avoidance closed, it would probably be desirable to increase the yield of the estate tax still further through somewhat lower exemptions and higher rates in the lower and middle brackets. The Federal estate tax at the present time applies to a very small proportion of estates and the tax on all but very large estates is relatively small. In my opinion the rates on the largest estates are already sufficiently high and should not be increased.

While the national government has been obliged to strengthen its revenue system, the States have been faced with a similar problem. They too have experienced drastic declines in revenue and increasing demands for expenditure. To meet their revenue needs they have reached out for new tax sources. Taxes on incomes, retail sales, alcoholic beverages, tobacco, and chain stores, and a variety of business taxes have been newly imposed in many States. As a result, there has been an enlargement of the group of taxes that are imposed by both Federal and State governments. Transfers of property at death are taxed both by the Federal Government and 47 of the States. Individual income is subject to the Federal income tax and 34 State income taxes. Motor fuel and alcoholic beverages are taxed by the Federal Government and 31 States. Similar duplications exist in many other taxes.

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Although in a Federal system of government the tax structure will inevitably be complex, the existing confusion and conflict can be diminished. A variety of suggestions have been made from different sources. Thus, it has been proposed that uniform returns be used by different States and the Federal Government in collecting the same tax and that uniform apportionment formulas be adopted to avoid taxing the same income or transaction twice by different States. In the case of some taxes it has been suggested that the Federal Government collect the revenue and distribute it among the States. Another suggestion is that the Federal Government leave some of the revenue sources to the States and that the States leave other sources to the Federal Government. Federal collection of taxes accompanied by grants-in-aid to States has also been suggested.

It is high time to consider seriously how the national and State governments can coordinate their taxes in such a manner

as to minimize duplications and conflicts, to reduce the taxpayer's cost in complying with the tax laws and to assure adequate revenues to all governments. The existence and seriousness of the problem have been widely recognized and there has been a good deal of talk about it. To date, however, little has been accomplished.

In my opinion, the most fruitful approach to this difficult and complicated problem is through the appointment of a national commission made up of men having the highest possible level of ability and public confidence. They should represent not the Federal, State or local governments as such, but the national interest at large. Their function would be to study the inter-governmental fiscal problem in its many ramifications and report to Congress. I recommend that Congress provide for such a commission.

AN TAX STATEMENT

April 10, 1939.
2:30 p.m.

Present: Mr. Gaston
Mr. Blough
Mr. Duffield
Mr. Magill
Mr. Shoup

Magill: What we have done is this. We had a conversation among ourselves as to the general set of topics which we thought should be included in the statement, and I thought it might be somewhat more useful, particularly since the men are going to be working during the course of the week, to outline at least as fully as I could my own theories as to what should go into this statement, not merely in the form of an outline but in the form of a more extended document.

And before we go into this, I may say this, that so far as I can see we are now in this position: that there has been something written up here on certainly the greater part of the topics which I would suppose you'd want to include in the statement, and that it will now be possible for, I should think, primarily Mr. Shoup and Mr. Duffield to take what's been written here and to mold it into a completed rough draft.

H.M.Jr: Have it ready for you Friday.

Magill: And have it ready for me Friday.

Now, I've got a better idea on this Friday thing. It just occurred to me, in view of this delightful day and all. Why don't you go up to the farm over this week-end, away from this hullabaloo here? Nothing would please me more than for me to go up to the farm and go over this with you.

H.M.Jr: I happen to have a Gridiron Dinner this Saturday night. Otherwise your suggestion would be perfect.

Magill: I see.

Now we have here a document which is still pretty rough.

H.M.Jr: But not smutty.

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Magill: Not smutty enough.

We've also got an outline by Brotnar Duffield which I think is a pretty good indication of the order in which the major topics should be presented, but which needs to be filled out quite a bit in detail, because we just - we had lunch together and the outline is the latest product.

Now, are you willing to listen to me read the longer document?

W. J. Jr: Avec plaisir: which means with pleasure. The Saturday evening host liked my French pronunciation, so I'm going to use it freely.

Magill: Now let me say again that I think this is - not a very modest thing to say - I think this will sound worse to you than it is, because it needs quite a lot of connecting language and polishing up and various things put in.

W. J. Jr: well, I'd be overcome if it were perfect, or polished.

Magill: well, it won't be perfect. well, I'm going to read - (to Duffield) leave me alone here, boy - I'm going to read this thing more or less as I think it will finally be, but you may want it some other way.

"In my statement of (blank note), I said that the Treasury was ready to supply to the appropriate Congressional committees its recommendations for changes in the tax system, to improve its fairness, to encourage business to go forward, and to meet present budgetary requirements on a better basis. The chairmen of the two Congressional committees have expressed their interest in these objectives, and their desire to receive the recommendations as promptly as possible, for action at this session. Some revenue legislation during this session is a recognized necessity, since the income taxes on corporations expire at the end of the year, and excise and sales taxes yielding about \$500 millions during the summer. I hope that Congress will take this opportunity, not simply to extend the expiring levies, nor simply to adopt the usual series of

-3-

technical changes to meet particular hardships, but to adopt those few basic reforms which we badly need to put the revenue system on a just foundation. The fundamental reforms which I want to suggest can much better be adopted as a practical matter this year rather than next year; and the encouragement to the taxpayers of the country by their adoption at this time is a factor of real importance under present business conditions."

Then this would go in - something like this:

"I should like first to say that I appreciate this opportunity to present to your committee my views on necessary revenue legislation. You have heard me saying that no year is a good year to suggest a tax bill. Certainly this remark would seem to be an accurate forecast of 1940, a year in which a national election will command the attention of the country. Therefore, my appearance here today may well be my last before this committee on the broad subject of tax legislation. For that reason may I digress a moment to thank this committee and especially its Chairman, Representative Doughton, for the cooperation and consideration which has been extended to me throughout my term in office. Representative Doughton, your committee, Senator Harrison, and the Senate Finance Committee have loyally served the welfare of this country in a manner of which we may all be proud. Working with this committee and with the Senate Finance Committee has been an experience which I shall always remember with pleasure."

(Vociferous applause)

"In order to" - now, I don't know whether ...

H.S.Jr: Did you write that? That's wonderful.

Waglin: Luffield.

(Hearty laughter)

AO, ...

Luffield: Best time I did something like that, he said it sounded like a New York Times editorial.

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- Magill: Nothing in here, I think, is wonderful.
- Now, this next block I read you is the historical block. We've got some question whether this should come next or the next thing after it should come next. I'll read it in this order. It's the historical
- H.M.Jr: Incidentally - may I interrupt you - you don't like to fly, do you?
- Magill: No, but if you give me a Coast Guard plane I'll fly.
- H.M.Jr: Well, find out where you're going to be.
- Magill: I can be here Friday morning, if you want. I'll be down at Columbus Thursday, but I can take a night train.
- H.M.Jr: Columbus - they run in here in three hours, don't they?
- Magill: Oh yes, on a plane.
- H.M.Jr: What? I mean you could come in here and spend a night in bed - fly here. Think about it.
- Magill: All right.
- H.M.Jr: What? I mean you could get in here - I think it's two hours, something like that.
- Magill: I could use one of these nights in bed.
- H.M.Jr: You could get in here and sleep. Seriously.
- Magill: All right, I'll think about it.
- "In order to achieve lasting reforms"
- H.M.Jr: If you want to do it, just let Duffield - call up Duffield. I'll send Burke out for you.
- Magill: "In order to achieve lasting reforms in taxation it is essential to get a proper perspective, a perspective that we are in danger of losing through the close attention necessarily given to tax developments day by day. Before considering specific

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measures I therefore suggest that we look at the development of the tax system during the last ten years and even try to see what possibilities lie ahead in the next five years or so.

"During the period 1920-1930 the Federal tax system was producing about three and a half billion dollars a year. The Great Depression drove the yield down to two billions in 1932 and government expenditures increased. The result was the Revenue Act of 1932, the first of a series of revenue acts all designed to strengthen the tax system in one way or another.

"The 1932 Act put the income tax rates back to the levels prevailing shortly after the War. It also doubled, roughly, the estate tax rates, and imposed a gift tax and a series of manufacturers excise taxes. Nevertheless, so powerful were the forces of depression that the tax revenue did not rise about two billions in 1933. But for the next five years it increased to an extent practically unprecedented in the recent history of national governments, reaching an all-time record for this country of six billions in 1938. Among the measures passed since 1932, about equal shares in achieving this result can be assigned, first, to the taxation of liquor following repeal of prohibition; second, to the social security payroll taxes; third, to the further increases in the income taxes, the estate tax, and the gift tax in 1934 and 1935; and to the processing taxes while they were in existence. Some revenue was also obtained, in the pressure of emergency, by disallowing certain well-grounded deductions, that are recommended below for reinstatement. Finally, the great recovery in revenue has of course been achieved in large part through the recovery in business from the depths of 1932 and 1933.

"Curiously enough, this powerful fiscal engine, built up piece by piece in that past seven years, looks, on the whole, somewhat different from what we might expect it to, in view of the kind of pieces that have gone into it. Despite the great increases in income tax and estate tax rates and the introduction of a gift tax, these taxes produced only 50 percent of the Federal tax revenue in 1938. This

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compares with 68 percent in 1929 to 1931. The fact seems to be that, important as have been the developments in direct taxation in the past decade, they have been in large part but the necessary structural work, with much of the content yet to be added if direct taxation is to play the part it should. This point is especially important because after all the Federal government collects less than half the country's tax revenue, and the state and local tax systems make very restricted use of direct taxes graded to take account of net differences in taxpayers' power to support government.

"As we look forward, certain probabilities take form. To what policy these probabilities should lead may not be entirely self-evident, but it is clear that we must resolutely face the problems that they raise.

"The present tax system is powerful; but it is not so powerful that it will stop all increase in the public debt over the next five years or so, even given some measure of business improvement and some reduction in expenditures. In a year of prosperity, with a national income of some 30 billions of dollars, the current revenues might rise to 3 billions; and, depending on the course of expenditures, a moderate amount of debt reductions, perhaps not more than a billion dollars and conceivably less, could result in such a year. But over a longer period, good years and bad, the present revenue system will result in a substantial increase in the public debt, assuming no radical change in expenditures. In my opinion, it is unreal to talk of balancing the budget next year or even the year after next; but, unless we are to commit ourselves to a philosophy of continuing increase in debt, it will be necessary to enact this year measures that will, within three or four years, bring in added revenue. These measures are indicated in detail below. It is not so much the exact date of budget equilibrium that matters, or even the precision of the balancing, as it is the adoption of a program that commits us to a trend in this direction during the next five years."

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H.M.Jr: Excellent. Is that yours?

Magill: That's Shoup's.

H.M.Jr: This is very funny. Honestly, I hope I strike something that's Magill's.

Blough: The first page was his.

Magill: I'm just an executive here.

H.M.Jr: Oh, golly.

Magill: Don't you think I'm a pretty inspirational figure, though? Look what these boys can turn out when I'm around. I don't even get credit for that.

H.M.Jr: wo, because I think I blew the inspiration into them. I've had a lot of documents around here, but this is beginning to look like something.

Magill: You like that.

H.M.Jr: I think what you did is wonderful, Ros.

Magill: The first page.

Blough: Now we'll get the second page.

Magill: now, I don't know whether I better tell him this is mine or not.

Shoup: Better wait and see.

Magill: This is not going to be mine unless you like it.

H.M.Jr: I like that last page a lot.

Magill: This next paragraph is not right; it will have to be changed. But we needed some kind of introduction here.

"I wish to divide this statement into two parts: First, a short summary of the fundamental tenets by which a tax system may be judged; and second, a list of the major changes which I recommend for Congressional consideration at this time."

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D.W.Jr: May I just stop a moment? I think I ought to just say - "I recommend for your consideration" - is that what I say? I wouldn't use the word "recommend" at all. I'd say, "I bring to your attention," if you don't mind. I wouldn't in any way say "I recommend." I mean if you can paraphrase

Wgill: That's one thing you'll need to cut out.

D.W.Jr: You can paraphrase the word - "I bring to your attention."

Wgill: I think you're right.

"First, Simplicity. The collection of taxes should be as little burdensome to the taxpayer as possible. The Treasury has considerably simplified tax administration by establishing regional agencies to settle controversies locally, and to speed up the work. It is no longer necessary to come to Washington in order to settle an income tax or an estate tax or a gift tax case. I have no illusions about the possibilities of eliminating completely such complexities as the elaborate provisions dealing with corporate reorganizations, or the even more detailed sections added in 1938 to permit utility companies to reorganize in conformity to the holding company act without unduly heavy tax liabilities. Tax laws cannot be wholly simple in a complex society, and the sections I have mentioned apply to the few cases, not to the many.

"The complexities I would like to see eliminated are those in the taxing provisions of general application. We now have four different taxes applicable to ordinary business corporations: an income tax, an undistributed profits tax, a capital stock tax, and an excess profits tax. The income tax is by all odds the most productive as well as the fairest. The undistributed profits tax has been reduced to a point where it no longer possesses much revenue significance; it mainly serves as a business irritant. The capital stock tax is not a tax on the actual value of corporate property, nor is the excess profits tax really a tax on excessive profits. Both taxes are really based on the guesses of corporate officials as to future corporate income. They are particularly burdensome to young and devel-

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oping businesses. The corporate tax system would be greatly simplified, and its justice measurably increased, if all four taxes were consolidated into a single flat tax on corporate incomes, with some concession in rate to corporations having less than perhaps \$25,000 net income."

H.M.Jr: Excuse me - could somebody make a note - you're going to talk about the deficit corporations, aren't you?

Magill: Yes, got that here in just a little while.

"It is fundamental that the prime purpose of tax legislation should be the raising of the needed revenue with the least possible dislocation of the ordinary business and social life of the country. Whatever governmental regulation is necessary should, as a general working rule, be accomplished by other means. Tax laws are complex enough and it is hard to make them fair as revenue producers without giving them the added freight of social control. Of course, any system of tax laws is bound to have important incidental effects upon our economy; and the laws must be so drawn as to prevent evasion. But tax laws are ordinarily not the best means for the accomplishment of social and economic objectives.

"Our present tax provisions have been so framed as to encourage corporations to acquire capital through borrowing, rather than through the issuance of stock. Corporations are allowed a deduction for interest paid, but not for dividends paid. Interest and dividends are taxed alike to their recipients. Thus corporate profits paid out in dividends are taxed twice; interest is taxed only once. A corporation which has \$500,000 of bonds and \$500,000 of capital stock and surplus will pay much less income taxes than one with the same income and assets which has no bonded indebtedness, and \$1,000,000 of capital stock and surplus. I do not think that the tax laws should act as an incentive to the increase in corporate indebtedness. We can improve the situation by giving stockholders a credit against their normal taxes for the tax the corporation has already paid on the profits distributed to them as dividends -- a credit which existed all through the

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history of the income tax until 1936.

"We have sought to discourage holding companies by a tax of about 25 percent on dividends received by one business corporation from another. The problem here is not one of tax evasion through personal holding companies, a problem solved for the present at least by the whole series of special prohibitive taxes worked out in 1937 on the 'incorporated pocketbook,' whether foreign or domestic. The question is whether the revenue laws should be founded on the policy of discouraging business men from organizing subsidiary corporations which frequently are used for such legitimate ends as to exploit new patents or to develop risky enterprises. In my judgment, it is wiser for the tax laws simply to hold the scales even, to withhold any judgment upon the merits or demerits of different kinds of business organization, to leave these matters to legislation which is openly and avowedly regulative. By the adoption of such a policy, issues are kept clear-cut, and we do not run the risk of muddling tax objectives with regular policies, to the disadvantage of both."

H.A.Jr: Is that you?

Magill: Uh-huh.

"Second," This part through here is all mine.

"Second, Fairness."

H.A.Jr: May I say it's very good.

Magill: "Everyone agrees as a matter of course that the tax system should be fair, that taxation should be levied in accordance with capacity to pay. Agreement with the broad objective, however, has not always been followed by the specific steps necessary to accomplish it. As I have already indicated, the imperative budgetary necessities of the present decade have been allowed to override a number of allowances to the taxpayer which were costing money, but which experience has shown are essential to a fair system of taxation. I think the time has come for the restoration of these legitimate allowances. Thus, corporations are allowed

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deductions for capital losses only to the extent of capital gains in the same year, plus \$2,000 -- an entirely inadequate provision for any corporation which has been forced to sell considerable amounts of its capital assets at a loss.

"We would like to see more capital invested in new industries, to put more men to work. It is certainly the part of wisdom to encourage such investment, for we have immense amounts of idle funds, and we have all too many idle men. Yet the income tax law is unfortunately loaded against new investment and risky businesses, not only by the capital loss provisions I have referred to, but by the elimination of provision for offsetting the current operating losses of one year against the operating profits of a later year. A stable business, reporting annual profits, is in no difficulties in this respect. On the other hand a business which has lost \$50,000 a year for two years and has then made \$100,000 in the third year, must pay just as high taxes on the \$100,000 as if every year had shown a profit. The plain fact is that the business has made no profits at all over the three-year period, and no income tax should be payable where there have been no profits. If the Government wants investment in new businesses -- businesses which cannot guarantee a profit every year -- the least the Government can do is to provide that only net profits will be taxed.

"Third, adequacy."

- H. W. Jr: You mean "net profits over a term of years."
- Magill: "... over a term of years." That's got to be polished up.
- Gaston: Speaking about corporate taxes only?
- Magill: I would do it for individuals, too, as far as that's concerned.
- Gaston: I was wondering about that.
- Magill: I can't make that clear.

"Over the five-year period ending in 1940, for which

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budgets have been presented, expenditures have exceeded revenues by an average of over \$3 billions a year. In 1938, the Government received the largest total of receipts for any year since 1920; and the expenditures still exceeded receipts by \$1,934 millions. The anticipated budget deficits for the fiscal years ending in 1939 and 1940 are \$4,372 millions and \$3,426 millions respectively. It may be that expenditures can be reduced. It may be that tax rates and provisions are oppressive in some instances, or that the tax system should rest on a broader base. It may be that ways and means can be adopted for a marked increase in the national income, and that then the present tax system will produce revenues to balance disbursements. The first essential in my judgment is the formulation of a dependable plan for dealing with our budgetary problems over the period of the next five years. There is little, if any, possibility of balancing the budget for two or three years, but if action to increase revenues and curtail expenditures is not taken at this session, the possibility is pushed ahead by one and probably two years more. Inaction at this time constitutes a choice of one form of fiscal policy rather than another.

The healthy functioning of the country as a whole depends in the last analysis upon the healthy functioning of the wage-earners and the businesses of the country. We must rely upon business to provide employment for at least the great bulk of our men of working age. We ought therefore to remove any specific obstacles to business recovery which remain in the tax structure, but the problem is much broader than that. When the uncertainty of conditions abroad is coupled with the uncertainties of an unbalanced national budget, and when measures to produce a balance are hopes, not realities, it is not surprising that the man who has saved money, whether a few dollars or a million, refuses to take a chance on an investment in anything save the soundest, best established, most stable securities. He knows that business must sometime face new taxes to bring the budget into balance, and he cannot know where they will fall. Since he cannot forecast the future, he marks time. The result is business stagnation, not the steady business advance which has been characteristic of the country.

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"Second, the maintenance of the Federal budget in its present condition makes tax reform difficult or impossible. Most of the essential reforms will cause losses of revenue. I believe that the adoption of some of the changes which I want to bring to your attention will promote healthier business conditions, and in the end increased revenue. But changes in the tax system alone will not greatly improve business, and in any event, the effect will not be immediate. It is the part of wisdom, therefore, to plan a tax system more adequate as a whole, at the same time that we act to relief specific inequities.

We cannot spare the revenue from the expiring excise and sales taxes at this time. At the same time, we must realize that taxes of this sort are not good measures of ability to pay, that they have been increasingly resorted to by the States and cities as well as by the Federal government, and that therefore further increases in them are undesirable. In 1928, the income tax produced \$2,175 millions out of \$2,800 millions of total Federal revenue, or 77 percent. In 1938, it produced \$2,586 millions out of \$5,660 millions of total Federal revenue, or 45.6 percent. In other words, while total Federal receipts were doubled, the income tax increased about 20 percent. Relatively we are depending too heavily upon indirect flat-rate taxes, and not heavily enough upon taxes which are a more accurate measure of ability to pay. The tax system in this respect has moved in the wrong direction.

"Under these conditions, the conclusion is inevitable that the base of the income tax should be broadened by lowering the exemptions. Further, there should be an increase in the surtax rates applicable to incomes in the brackets in the center of the rate scale, roughly those incomes between \$20,000 and \$100,000. Finally, our studies indicate that the upper surtax rates are too high for the greatest productivity; and that net revenues would be increased by a small reduction therein. The incentive to embark capital in new enterprises is noticeably dampened, when the State and Federal governments together demand a participation in profits of as much as 89 percent, with a much smaller participation in losses."

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H.A.Jr: May I interrupt you? I'd get the figures from S.L.C. or some place as to new capital - I mean the flotations, you see. I mean I'd throw in some figures there.

Magill: Now, that's the end of mine.

H.A.Jr: Well

Magill: Now we've got two other pieces that should go in here, at least: one as to the estate tax and one as to this state-Federal coordination. Shall I read those?

H.A.Jr: Will you please?

Magill: Blough fixed up these, presented these two.

H.A.Jr: Who did?

Magill: Blough.

"While the national government has been obliged to strengthen its revenue system, the States have been faced with a similar problem. They too have experienced drastic declines in revenue and increasing demands for expenditure. To meet their revenue needs they have reached out for new tax sources. Taxes on incomes, retail sales, alcoholic beverages, tobacco, and chain stores, and a variety of business taxes have been newly imposed in many states. As a result, there has been an enlargement of the group of taxes that are imposed by both Federal and State governments. Transfers of property at death are taxed both by the Federal Government and 47 of the States. Individual income is subject to the Federal income tax and 34 State income taxes. Motor fuel and alcoholic beverages are taxed by the Federal Government and 31 states. Similar duplications exist in many other taxes.

"The simultaneous expansion in the revenue systems of both the states and the Federal Government has greatly increased the conflicts between national and state taxes and between the taxes of the various States. The results are increasingly unsatisfactory

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to everyone. The various units of government find their revenues adversely affected by competing taxes of other governments. The costs of collection are higher in proportion to the revenue than if this competition did not exist. The types of taxes that States have felt obliged to impose often give rise to smuggling across State lines, necessitating practically the setting up of customs offices by the States. The taxpayer is also adversely affected. He is often subject to two or more taxes on the same income or the same transaction. These taxes are frequently imposed without regard to each other so that the levies are unequal and onerous. For example, in some States combined Federal, State and local gasoline tax levies exceed 11¢ per gallon. The taxpayer must prepare numerous reports which must often be compiled in different ways to satisfy the many requirements of the different taxing authorities."

I'd pretty nearly like you to put in that thing I've said to you. I've prepared my own and my wife's tax returns; they are the only returns I prepare. And between New York and the Federal Government I prepare ten returns for my wife and myself. No trusts or anything else.

Blough: You mean ten sheets of paper.

Magill: Yes, I had to make out ten return forms, ten sheets of paper, because you people want two of each, and that was four; I kept a copy of each, which was six; and I have to make two each out for the state government. That makes ten.

Craton: No carbon paper?

Buffield: No carbon paper? That's what I was going to say.

Magill: Yeah! Yeah!

Blough: Of course, if you hadn't wanted to make a separate return, you could have put it in half.

W.A. Jr: I didn't get it. I'm glad you mentioned the carbon paper.

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Magill: had a lot of trouble with the carbon paper.

"Although in a Federal system of government the tax structure will inevitably be complex, the existing confusion and conflict can be diminished. A variety of suggestions have been made from different sources. Thus, it has been proposed that uniform returns be used by different States and the Federal Government in collecting the same tax and that uniform apportionment formulas be adopted to avoid taxing the same income or transaction twice by different States. In the case of some taxes it has been suggested that the Federal Government collect the revenue and distribute it among the States. Another suggestion is that the Federal Government leave some of the revenue sources to the States and that the States leave other sources to the Federal Government. Federal collection of taxes accompanied by grants-in-aid to States has also been suggested.

"It is high time to consider seriously how the national and State governments can coordinate their taxes in such a manner as to minimize duplications and conflicts, to reduce the taxpayer's cost in complying with the tax laws and to assure adequate revenues to all governments. The existence and seriousness of the problem have been widely recognized and there has been a good deal of talk about it. To date, however, little has been accomplished.

"In my opinion, the most fruitful approach to this difficult and complicated problem is through the appointment of a national commission made up of men having the highest possible level of ability and public confidence. They should represent not the Federal, State or local governments as such, but the national interest at large. Their function would be to study the inter-governmental fiscal problem in its many ramifications and report to Congress. I recommend that Congress provide for such a commission."

Now, here's the estate and gift, which should go in, I think, probably before this. This probably would come at the end. You ready?

H.L.Jr: Oh yes.

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McGill: "The merits of the estate tax entitle it to an important role in the Federal tax system. It permits the application of the principle of ability to pay although on a somewhat less exact basis than the individual income tax. It is the best available means for preventing the perpetuation and increasing concentration of great fortunes. As compared to other taxes it has relatively little effect in discouraging enterprise. The contemplation of the distant future is of less importance in determining one's business decisions than the realities of the immediate present. Such effects as there are tend to offset each other. The prospect of estate taxes may discourage some persons from trying to accumulate fortunes while it may encourage others to accumulate more than they otherwise would in order that they may leave a competence to their dependents.

"Changes in the law during the past few years have gone a long way to make the estate tax the factor it should be in the revenue system. The exemption has been decreased to \$40,000 and tax rates have been increased to a maximum of 70 percent on amounts transferred in excess of \$50,000,000. The place of the estate tax in the tax system, however, is still not as large as it should be. In 1928 the tax accounted for "

Wright: One and eight-tenths.

McGill: "... 1.8 percent of the Federal revenues while in 1938 it accounted for ..."

Wright: Six and nine-tenths.

McGill: "... 6.9 percent. As a proportion of total Federal, state and local revenues, estate and inheritance taxes amounted to 2 percent in 1928 and 3.9 percent in 1938. One of the reasons why the estate tax does not yet fill the position it should in the tax system is that it is widely avoided by making gifts before death. In an attempt to end this avoidance, a gift tax was imposed in 1932. While the gift tax has reduced the incentive to avoid the estate tax, a large incentive remains. There are two exemptions, one for the gift tax and one for the estate tax. Likewise, there are two rate scales, each beginning

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at very low rates. A person with a large fortune can reduce his tax markedly by taking advantage of the two exemptions and the two rate scales.

"The avoidance cannot be offset merely by eliminating the gift tax exemption and increasing the rates of estate and gift taxes. Inequities among taxpayers would be increased if only these steps were taken. Many persons are not able to dispose of large amounts of their wealth by gift. Some need to retain their wealth to maintain control over their businesses. Others feel that they cannot give away their property because of the uncertainties of the future and the desire for protection in old age.

"In my opinion the solution lies in considering gifts and the final distribution at death as a unified series of transfers. At the present time successive gifts are cumulated. It remains merely to cumulate the estate as if it were a final gift. There then would be one exemption and one rate scale. If it were desired to give new inducement to gifts it could be accomplished through special credits. Furthermore, any undue hardships at death could be eliminated through special provisions.

"With this loophole of avoidance closed, it would probably be desirable to increase the yield of the estate tax still further through somewhat lower exemptions and higher rates in the lower and middle brackets. The Federal estate tax at the present time applies to a very small proportion of estates and the tax on all but very large estates is relatively small. In my opinion the rates on the largest estates are already sufficiently high and should not be increased."

As I've said to Roy, I think there's a little too much avoidance in that last part.

H. Jrs: That last one is a little rough, anyway.

-agill: Now, as you've noticed there, I originally designed this, when I was thinking out how I'd put it together, as a general statement followed by a series of comments on particular provisions. As it's actually worked out, we've gotten in, I think, most of the things on which you should comment in here, and I

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think in the course of Shoup's work on it tomorrow he'll probably put in most of the rest.

H.W.Jr: You going to have him work this evening?

Magill: Might as well.

Shoup: First time I heard of that.

Magill: I haven't seen what there is over at Keith's tonight.

H.W.Jr: He's got you (Shoup) working tonight. Now, I didn't ask you.

Magill: Now, you've still got depletion and community property. I think you might as well say a few things about tax-exempt salaries and securities.

H.W.Jr: Yes, I think you ought to say there is this big pool of sixty billion dollars of totally tax-exempts, constantly growing.

Magill: Yes. And consolidated returns ought to be stuck in here somewhere, and capital gains - that's the other thing, big thing, that should go in.

H.W.Jr: But that's

Magill: That's it.

H.W.Jr: I think it's a corking good start for one day. There are some things in there that I don't know whether I can yet say that I'd want to sit down and argue about; and when the thing is in smoother form... I don't know whether I'm prepared to accept everything there, and I don't want to take the time now to go into it. But there are a number of things there that - now, for instance, for me to say that I don't believe that the tax route is the way for reform would be something new.

Magill: Oh-huh.

H.W.Jr: Because certainly we've followed that extensively up to now.

Gaston: We depart from that in one particular. I notice in

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our discussion of estate taxes we stress the social principle of preventing the large accumulations.

Magill: Yes, that's one that - I find that one difficulty there.

H.A.Jr: I think - I mean I think what you say is this. I mean on that - just to use this as a measure - that this is philosophy and not - I don't think there is any question that if, for instance, a man believes that bigness is something we should do away with, the way to do it is to pass legislation which will make it difficult for large corporations to do business, and do it aboveboard and not necessarily do it through the tax field.

Magill: That's really the point.

H.A.Jr: And I think that - I know that Warner has been talking about fifty people controlling this country ever since we've been here. And of course, there is - the anti-trust and if this administration is just zero. Now, therefore, people like Oliphant, getting impatient, went at it through the tax route, and inter-corporate dividends was one of the methods to attack bigness, but I mean it wasn't the way to do it.

Now, that's something I want time to think about, you see, because I think that that is very, very important and that, if I say it, would be news. The rest of the stuff - I mean there's a lot of things in there that I want to go into very carefully after the thing is more polished, and that's what I'd like to do. We were joking before. But if it was possible to come back Friday and the thing was ready and polished, then I'd like to mark the things which I have a question mark about and sit down and argue those from a philosophical standpoint, not from the standpoint of - well, any other standpoint.

Magill: "All, that's what I would like to do, if this thing can be shaped up."

H.A.Jr: There are definite things there which I have never said before, and as Herbert said, not all the things "gee" either.

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Blough: We don't all agree.

H.M.Jr: What?

Luffield: we don't all agree.

H.M.Jr: excuse me a second. I don't by any means say that I agree. I haven't had time. There are too many ...

Magill: well, I think it should be said.

H.M.Jr: Are you taking a four o'clock? No, it's all right.

Magill: Just as you will. I can take the five. Doesn't make any difference.

H.M.Jr: (to Akeley) Mr. Magill will be leaving here about 3:30. Hold a car for him for about 3:30, please.

Magill: I won't go unless we

H.M.Jr: No, no, it will be all right for this day. But there is no use today, for instance, or tomorrow getting down - it's much better to have too much in there and throw out some of the things, and all the things aren't in yet.

Magill: That's right.

H.M.Jr: I think the most important thing from my standpoint which would be new and I'd like to say, is that we do - after all, I do believe that we should balance the budget and that it's a question of a five-year plan to balance the budget, and it's at least two or three years off, and the longer the delay the further off it is.

Now, I think this, and I'd like you to get this into the thing - that one of the deterrents that I believe a small business man is worried about is, he doesn't think we're doing any planning here to eventually balance the budget, and I think the fellow is perfectly right. I mean where are we headed to on this deficit question? I mean is there any plan? and if we could show him that we are

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planning in terms of five years to gradually bring our expenses together, I think that's removing one of the business deterrents, and I'd say so; and I don't think that's plain enough.

I know that isn't taxes, but that's fiscal policy, and I want to weave that thing into it. I think that's very important. I don't think there would be any disagreement amongst the five of you on that, would there?

Gaston: Just one point I wanted to raise about that. You can't commit anybody. You talk about planning for budget balancing in the future, and indicate you need more revenue, but of course, you can't commit anybody over a period of five years. And will that be encouraging to business men, to know that you have an idea which is sound and logical and that they know the direction you're thinking, as to where this new revenue should come from, and if you had the power to put your plans into effect it wouldn't hit them badly and it would be reassuring; but there is complete uncertainty as to who is going to do the future planning, and is that reassuring? Doesn't it rather disconcert them, giving them the idea that more revenue has got to be raised and no assurance as to where it's going to be raised?

Magill: No, I think you've got two or three answers. The first one I'd make is this: that whatever you did, for example, on either income or estate tax is really planning for the future, because you don't get the money right away.

Gaston: If it were done now, yes.

Magill: You could do it this minute and you're not going to get the money for several years.

Secondly, if what the Secretary says here is correct, as I strongly believe it is, I wouldn't worry too much about the next Administration keeping it in effect, because I swear I don't know what else they're going to do, for one thing.

And then, in the third place, I wanted to say to the Secretary that I'm very anxious to see him say some-

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thing of that sort, because I don't want to see this appeasement to business program run away with you. Now, that can easily become a program, as we all know, where this tax rate is reduced and that deduction is put in and this exemption is included and the net result is you've got a tax system like a sieve. Now, I think it's important to drive home that "that isn't what I want; I want to see a tax system that will yield more money, but because I want it to yield more money I've got to take out these rough spots; that the way to make it yield more money is to give a decent deduction and a decent exemption and increase the rates if you have to."

H.S.J.: Now, if I may say something - I am in complete accord, and what I want to say on this question of balancing the budget is this: I haven't said anything on this thing since November '37.

Magill: That's right.

H.S.J.: The people of this country are entitled to know where I stand. I want to say something.

and I certainly don't think that it was constructive when Mr. Eccles dared Congress to economize because that happens to be the sentiment.

Now, I think when you're talking along as broad a basis as I'm talking, that this is the time for me - certainly if I say it once in a year and a half, that isn't saying it too often - what is the outcome, where is this thing? I want to know. Now, the fact that I can't and haven't got the authority to enforce this thing - I don't think that that should worry people. But I think people will say, "Well, thank God, Morgenthau at least is pointing the way," and that's all I can do and that's all I want to do in this whole thing: simply point the route. Now, if they don't want to take the Morgenthau route and they want to take the Eccles route or the X route or the Y route, that's their business. At least I have fulfilled what I feel is my obligation, I've pointed the way as to what I honestly believe, after sitting here for five and a half years, is the route that this country

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should take. And I want to say it, right or wrong.

Now, I know - I mean if - I'm worried; I want to know - Herbert Gaston says this morning that we'll reach 50 billion dollars and never go below it in our lifetime. Well now, that scares me to death; that makes me want to say this thing more than ever. Maybe he's right. But at least I could point the way to show that through balances of receipts and expenditures... and I'd say something about the cost of armaments.

Gaston: would you?

H.A.Jr: And the cost of relief.

Gaston: would you be willing to advocate ...

H.A.Jr: Just a minute, please. I mean I'd say something - I mean that these two - I don't know what the proportions are of armaments and relief - you can get them from Fanny Bell - but I think we must use about a third of our expenditures for those two items.

Blough: More than that. We figured it the other day at more than that.

H.A.Jr: Well, that much more. And what we have in this country is only - is duplicated many times in Europe. We have figures now that show last year Germany spent between 60 and 70 percent of her budget for war purposes. I've got all the figures, incidentally, of the principal countries in the world on armaments. I think we can point out in passing that that is where we have the bulk of our expenditures and that if we get a saner world and if this armament race stops, way, overnight one of the biggest expenditures will disappear.

But I think what you (Magill) said - I mean that this is the time to prepare for the thing, and it takes five years to prepare for it. And I think it's time for me to say it, and if I said nothing else I'd consider it worth while going up on the bill just to say that.

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- Magill: To my mind that's the most important thing in all this business, as I've had anything to do with it.
- H.M.Jr: I'm willing to go up on the Hill and say that one thing and march down again, and I'd consider I'd done a year's work.
- Gaston: I agree to your saying it. I just wanted to show what might be the point of attack there.
- I wonder if you would be willing to Now, Gos speaks about putting into effect immediately those estate gift tax rates, which will mean revenue not immediately, but in a year or two. Would you be willing to open up the question of further middle bracket income taxes, to make a start on it now?
- H.M.Jr: Oh yes.
- Gaston: I mean would you be willing to advocate that something be done in that direction now?
- H.M.Jr: I mean that's stuff we can go into. But I mean I like this fiscal approach to it. The A. F. of L.'s said practically this, but haven't said it as well, at their convention.
- Magill: May I say one or two specific things which will help guide these boys? There are two things we've tried to do that are hard to do; that is to weave this philosophy and some of the specific recommendations together. How do you think - what do you think of the balance of it? Do you like more specific stuff, more philosophy, or are you pretty well satisfied?
- H.M.Jr: I got it too fast.
- Magill: Yes, you did.
- H.M.Jr: They can get at me again tomorrow afternoon. I mean you're shooting awful fast.
- Magill: Yes.
- H.M.Jr: And there's some terrifically important things there. I've got - from three o'clock on tomorrow I'll save.

-26-

Shoup: Fine.

H.M.Jr: Three o'clock tomorrow.

Shoup: Come in at three o'clock.

H.M.Jr: I'll save from three o'clock on. But I mean you're shooting too fast, and I can't - and a lot of things, Herbert, I don't know, but as to this fiscal thing, yes. I mean I can't answer that question, nos; I don't know. I've got to live with it more, you know.

Magill: If you want these men to do it and if they can do it, they might send me up whatever rough draft they have tomorrow afternoon.

H.M.Jr: As'll (Shoup) bring it with him.

Magill: And I'll go over it Wednesday. Well, all right.

H.M.Jr: Or put it in the air mail. Want it at your home or office?

Magill: Couldn't make any difference. Either one.

H.M.Jr: Well, Blough, see that it gets there.

Magill: Gene, I'll leave this stuff with you, I guess.

Duffield: All right.

H.M.Jr: I can't answer. All I can say is that for one day's work we've made wonderful progress - I'm delighted - for one day. For one day, I think it's wonderful. This is what I want and this is what I think will contribute to sanity - financial sanity. I mean nobody has to agree to anything for today, but I do think for one day that's wonderful.

In my statement of _____, I said that the Treasury was ready to supply to the appropriate Congressional committees its recommendations for changes in the tax system, to improve its fairness, to encourage business to go forward, and to meet present budgetary requirements on a better basis. The chairmen of the two Congressional committees have expressed their interest in these objectives, and their desire to receive the recommendations as promptly as possible, for action at this session. Some revenue legislation during this session is a recognized necessity, since the income taxes on corporations expire at the end of the year, and excise and sales taxes yielding about \$500 millions during the summer. I hope that Congress will take this opportunity, not simply to extend the expiring levies, nor simply to adopt the usual series of technical changes to meet particular hardships, but to adopt those few basic reforms which we badly need to put the revenue system on a just foundation. The fundamental reforms which I want to suggest can much better be adopted as a practical matter this year rather than next year; and the encouragement to the taxpayers of the country by their adoption at this time is a factor of real importance under present business conditions.

In order to achieve lasting reforms in taxation it is essential to get a proper perspective, a perspective that we are in danger of losing through the close attention necessarily given to tax developments day by day. Before considering specific measures I therefore suggest that we look at the development of the tax system during the last ten years and even try to see what possibilities lie ahead in the next five years or so.

During the period 1926-1930 the Federal tax system was producing about three and a half billion dollars a year. The Great Depression drove the yield down to two billions in 1932 and government expenditures increased. The result was the Revenue Act of 1932, the first of a series of revenue acts all designed to strengthen the tax system in one way or another.

The 1932 Act put the income tax rates back to the levels prevailing shortly after the War. It also doubled, roughly, the estate tax rates, and imposed a gift tax and a series of manufacturers excise taxes. Nevertheless, so powerful were the forces of depression that the tax revenue did not rise above two billions in 1933. But for the next five years it increased to an extent practically unprecedented in the recent history of national governments, reaching an all-time record for this country of six billions in 1938.

(a)

Among the measures passed since 1932, about equal shares in achieving this result can be assigned, first, to the taxation of liquor following repeal of prohibition; second, to the social security payroll taxes; third, to the further increases in the income taxes, the estate tax, and the gift tax in 1934 and 1935; and to the processing taxes while they were in existence. Some revenue was also obtained, in the pressure of emergency, by disallowing certain well-grounded deductions, that are recommended below for reinstatement. Finally, the great recovery in revenue has of course been achieved in large part through the recovery in business from the depths of 1932 and 1933.

Curiously enough, this powerful fiscal engine, built up piece by piece in that past seven years, looks, on the whole, somewhat different from what we might expect it to, in view of the kind of pieces that have gone into it. ^{Dec. 1935} Beside the great increases in income tax and estate tax rates and the introduction of a gift tax, these taxes produced only 50 percent of the Federal tax revenue in 1938. This compares with 88 percent in 1929 to 1931. The fact seems to be that, important as have been the developments in direct taxation in the past decade, they have been in large part but the necessary structural work, with much

(b)

of the content yet to be added if direct taxation is to play the part it should. This point is especially important because after all the Federal government collects less than half the country's tax revenue, and the state and local tax systems make very restricted use of direct taxes graded to take account of net differences in taxpayers' power to support government.

As we look forward, certain probabilities take form. To what policy these probabilities should lead may not be entirely self-evident, but it is clear that we must resolutely face the problems that they raise.

The present tax system is powerful; but it is not so powerful that it will stop all increase in the public debt over the next five years or so, even given some measure of business improvement and some reduction in expenditures. In a year of prosperity, with a ^{natural} natural income of some 80 billions of dollars, the current revenues might rise to 8 billions; and, depending on the course of expenditures, a moderate amount of debt reductions, perhaps not more than a billion dollars and conceivably less, could result in such a year. But over a longer period, good years and bad, the present revenue system will result in a substantial increase in the public debt, assuming no radical change in expenditures. In my opinion, it is unreal to talk of

(a)

balancing the budget next year or even the year after next; but, unless we are to commit ourselves to a philosophy of continuing increase in debt, it will be necessary to enact this year measures that will, within three or four years, bring in added revenue. These measures are indicated in detail below. It is not so much the exact date of budget equilibrium that matters, or even the precision of the balancing, as it is the adoption of a program that commits us to a trend in this direction during the next five years.

I wish to divide this statement into two parts: First, a short summary of the fundamental tenets by which a tax system may be judged; and second, a list of the major changes which I recommend for Congressional consideration at this time.

First, Simplicity. The collection of taxes should be as little burdensome to the taxpayer as possible. The Treasury has considerably simplified tax administration by establishing regional agencies to settle controversies locally, and to speed up the work. It is no longer necessary to come to Washington in order to settle an income tax or an estate tax or a gift tax case. I have no illusions about the possibilities of eliminating completely such complexities, as the elaborate provisions dealing with corporate reorganizations, or the even more detailed sections added in 1938 to permit utility companies to reorganize in conformity to the holding company act without unduly heavy tax liabilities. Tax laws cannot be wholly simple in a complex society, and the sections I have mentioned apply to the few cases, not to the many.

The complexities I would like to see eliminated are those in the taxing provisions of general application. We now have four different taxes applicable to ordinary business corporations: an income tax, an undistributed profits tax, a capital stock tax, and an excess profits tax. The income tax is by all odds the most productive as well as the fairest. The undistributed profits tax has been reduced to a point where it is no longer possesses

- 2 (a) -

much revenue significance; it mainly serves as a business irritant. The capital stock tax is not a tax on the actual value of corporate property, nor is the excess profits tax really a tax on excessive profits. Both taxes are really based on the guesses of corporate officials as to future corporate income. ^{They are particularly burdensome to young and developing businesses} The corporate tax system would be greatly simplified, and its justice measurably increased, if all four taxes were consolidated into a single flat tax on corporate incomes, with some concession in rate to corporations having less than perhaps \$25,000 net income.

~~We should not mix taxation and the regulation of the business of the country.~~ Tax laws are complex enough and it is hard to make them fair as revenue producers without giving them the added freight of social control. Of course, any system of tax laws is bound to have important incidental effects upon our economy; and the laws must be so drawn as to prevent evasion. ^{But} it is fundamental that the prime purpose of tax legislation should be the raising of the needed revenue with the least possible dislocation of the ordinary business and social life of the country. Whatever governmental regulation is necessary should, as a general working rule, be accomplished by other means.

But tax laws are ordinarily not the best means for the accomplishment of social and economic objectives.

-2(b)-

Our present tax provisions have been so framed as to encourage corporations to acquire capital through borrowing, rather than through the issuance of stock. Corporations are allowed a deduction for interest paid, but not for dividends paid. Interest and dividends are taxed alike to their recipients. *Thus corporate profits paid out in dividends are taxed twice.* A corporation which has \$500,000 of bonds and \$500,000 of capital stock and surplus will pay much less income taxes than one with the same income and assets which has no bonded indebtedness, and \$1,000,000 of capital stock and surplus. I do not think that the tax laws should act as an incentive to the increase in corporate indebtedness. We can improve the situation by giving stockholders a credit against their normal taxes for the tax the corporation has already paid on the profits distributed to them as dividends -- a credit which existed all through the history of the income tax until 1936.

We have sought to discourage holding companies by a tax of about 2½ percent on dividends received by one business corporation from another. The problem here is not one of tax evasion through personal holding companies, a problem solved for the present at least by the whole series of special prohibitive taxes worked out in 1937 on the "incorporated pocketbook", whether foreign or domestic. The question is whether the revenue laws

ORIGINAL IN HOUSE COPY

-2(c)-

should be founded on the policy of discouraging business men from organizing subsidiary corporations ^{which frequently are used for such legitimate ends as} to exploit new patents or to develop risky enterprises. In my judgment, it is wiser for the tax laws simply to hold the scales even, to withhold any judgment upon the merits or demerits of different kinds of business organization, to leave these matters to legislation which is openly and avowedly regulative. By the adoption of such a policy, issues are kept clear-cut, and we do not run the risk of muddling tax objectives with regulatory policies, to the disadvantage of both.

- 3 -

Second, fairness. Everyone agrees as a matter of course that the tax system should be fair, that taxation should be levied in accordance with capacity to pay. Agreement with the broad objective, however, has not always been followed by the specific steps necessary to accomplish it. ^{As I have already indicated,} The imperative budgetary necessities of the present decade have been allowed to override a number of allowances to the taxpayer which were costing money, but which experience has shown are essential to a fair system of taxation. ^{which the time has come for the restoration of these legitimate allowances} Thus, corporations are allowed deductions for capital losses only to the extent of capital gains in the same year, plus \$2,000 -- an entirely inadequate provision for any corporation which has been forced to sell considerable amounts of its capital assets at a loss.

We would like to see more capital invested in new industries, to put more men to work. It is certainly the part of wisdom to encourage such investment, for we have immense amounts of idle funds, and we have all too many idle men. Yet the income tax law is unfortunately loaded against new investment and risky businesses, not only by the capital loss provisions I have referred to, but by the elimination of provision for offsetting the current operating losses of one year against the operating profits of a later year. A stable business, reporting annual profits, is in no difficulties in this respect; On the other hand a business which has lost \$50,000 a year for two years and has then made \$100,000 in

- 4 -

the third year, must pay just as high taxes on the \$100,000 as if every year had shown a profit. The plain fact is that the business has made no profits at all over the three-year period, and no income tax should be payable where there have been no profits. If the Government wants investment in new businesses -- businesses which cannot guarantee a profit every year -- the least the Government can do is to provide that only net profits will be taxed.

Third, Adequacy. Over the five-year period ending in 1940, for which budgets have been presented, expenditures have exceeded revenues by an average of over \$3 billions a year. In 1938, the Government received the largest total of receipts for any year since 1920; and the expenditures still exceeded receipts by \$1,384 millions. The anticipated budget deficits for the fiscal years ending in 1939 and 1940 are \$4,072 millions and \$3,426 millions respectively. It may be that expenditures can be reduced. It may be that tax rates and provisions are oppressive in some instances, or that the tax system should rest on a broader base. It may be that ways and means can be adopted for a marked increase in the national income, and that then the present tax system will produce revenues to balance disbursements. The first essential in my judgment is the formulation of a dependable plan for dealing with our budgetary problems over the

- 5 -

period of the next five years. There is little, if any, possibility of balancing the budget for two or three years, but if action to increase revenues and curtail expenditures is not taken at this session, the possibility is pushed ahead by one and probably two years more. Here inaction at this time constitutes a choice of one form of fiscal policy rather than another.

The healthy functioning of the country as a whole depends in the last analysis upon the healthy functioning of the wage-earners and the businesses of the country. We must rely upon business to provide employment for at least the great bulk of our men of working age. We ought therefore to remove any specific obstacles to business recovery which remain in the tax structure, but the problem is much broader than that. When the uncertainty of conditions abroad are coupled with the uncertainties of an unbalanced national budget, and when measures to produce a balance are hopes, not realities, it is not surprising that the man who has saved money, whether a few dollars or a million, refuses to take a chance on an investment in anything save the soundest, best established, most stable securities. He knows that business must sometime face new taxes to bring the budget into balance, and he cannot know where they will fall. Since he cannot forecast the future, he marks time. The result is business stagnation, not the steady business advance which has been characteristic of the country.

- 6 -

Second, the maintenance of the Federal budget in its present condition makes tax reform difficult or impossible. Most of the essential reforms will cause losses of revenue. I believe that the adoption of some of the changes which I want to recommend will promote healthier business conditions, and in the end increased revenue. But changes in the tax system alone will not greatly improve business, and in any event, the effect will not be immediate. It is the part of wisdom, therefore, to plan a tax system more adequate as a whole, at the same time that we act to relieve specific inequities.

We cannot spare the revenue from the expiring excise and sales taxes at this time. At the same time, we must realize that taxes of this sort are not good measures of ability to pay, that they have been increasingly resorted to by the States and cities as well as by the Federal government, and that therefore further increases in them are undesirable. In 1928, the income tax produced \$2,175 millions out of \$2,800 millions of total Federal revenue, or 77 percent. In 1938, it produced \$2,586 millions out of \$5,660 millions of total Federal revenue, or 45.6 percent. In other words, while total Federal receipts were doubled, the income tax increased about 20 percent. Relatively we are depending too heavily upon indirect flat-rate taxes, and not heavily

enough upon taxes which are a more accurate measure of ability to pay. The tax system in this respect has moved in the wrong direction.

Under these conditions, the conclusion is inevitable that the base of the income tax should be broadened by lowering the exemptions. Further, there should be an increase in the surtax rates applicable to incomes in the brackets in the center of the rate scale, roughly those incomes between \$20,000 and \$100,000. Finally, our studies indicate that the upper surtax rates are too high for the greatest productivity; and that net revenues would be increased by a small reduction therein. The incentive to embark capital in new enterprises is noticeably dampened, when the State and Federal governments together demand a participation in profits of as much as 89 percent, with a much smaller participation in losses.

(go on Estate and Gift Taxes
State-Federal coordination)

April 10, 1939

For the Secretary

Murray Hansen, Washington representative of the Investment Bankers Conference, Inc., spent a week in New York City recently, mostly in touch with investment bankers and other financial people.

At breakfast a day or two ago he volunteered the information that he had been surprised at the number of people who commented with a high degree of favor on Secretary Morgenthau. He reports that they seem to be uniformly of the opinion that the Secretary knows what he is doing and that he is doing the right thing, and is proving to have very real ability in the Treasury field.

Upm

DIVISION OF SAVINGS BONDS

April 10, 1939.

To: The Secretary

From: Mr. Bryan

Literally, in many millions of letters mailed to date, and in approximately 150,000 letters now going out from this Division every business day, the Secretary, over his personal signature, has asked for "your criticism and any constructive suggestion you may desire to make".

These personally addressed letters reach into every religious, racial and political group and fraternity, and answers are received from every part of this Nation and some 30 foreign countries.

Generally when you ask for it you get it, and this Division has viewed criticisms ranging from mild admonition to violent vituperation of many of the officials, acts and policies of the Administration. Also, numberless suggestions have been made--many of them of actual value, and some of them adopted.

While serious concern--yes, genuine anxiety--is shown over Government spending and the increasing public debt, there is scarcely a word criticizing Savings Bonds, and, almost without exception, our mail reveals only friendship and admiration for the Secretary. This continuous approval and response from one of the greatest of modern audiences can mean but one thing--a Nation-wide vote of confidence seldom given to any public official.

Obviously, the public feels that the Secretary has a single purpose, "to aid recovery, and to that end to do the best that can be done in his job". "No presidential aspiration is suspected of controlling the act or coloring the purpose". "Henry Morgenthau is an able and sincere servant of the people".

AND FURTHER:

"You occupy such a high and important post in our Government and have handled your duties with such outstanding success that it must be a matter of extreme satisfaction to you to see your department

- 2 -

moving along to greater and greater accomplishment."
- Howard B. Bishop, Treasurer, Calvary Church,
Summit, New Jersey.

"...permit me to say that I greatly appreciate the efforts of the Treasury to distribute U. S. bonds among the citizens, and I rejoice to learn that your efforts are crowned with a good measure of success."

- Rev. Cluf Tandberg, Dover, New Hampshire.

"Thank you for your nice friendly letter telling me of the benefits of Savings Bonds..."

- Mrs. Clara B. Sage, Delavan, Wisconsin.

"...I think your plan is the only one for the average individual who wants to buy Governments."

- J. H. Ellis, Lincoln, Nebraska. - Broker.

"I read in the Reporter with a great deal of interest your report of the results of your Direct Mailing Campaign on behalf of the sale of United States Savings Bonds. It is a great report and I want to congratulate you on the results you have accomplished."

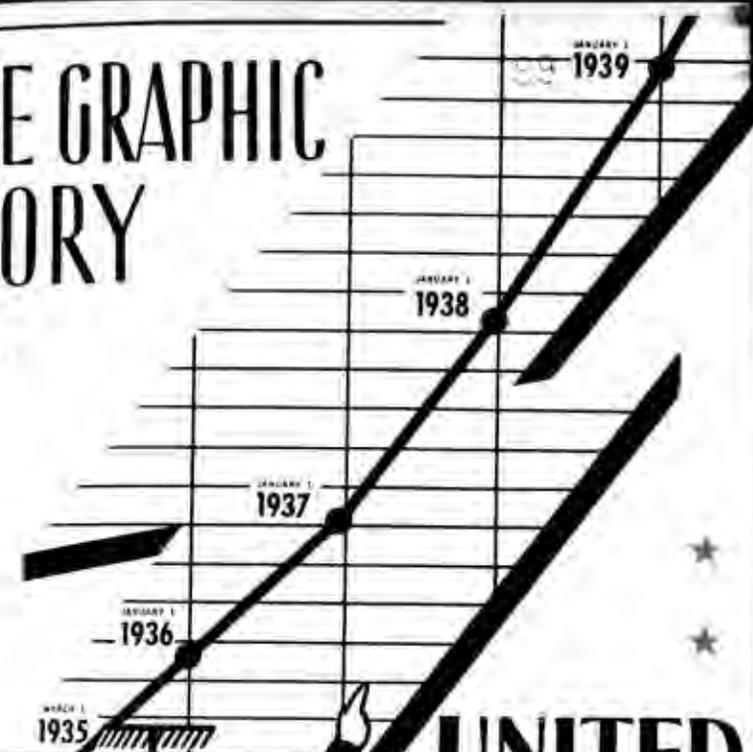
- R. E. Fort, Jr., Nashville, Tennessee.

"...I think your personal letters calling attention to the desirability of this kind of investment have been a very fine thing, both for the Government and for the individual."

- E. L. Keenan, Lansdowne, Pennsylvania.



THE GRAPHIC STORY OF



UNITED STATES SAVINGS BONDS



Why More Than One Million People Have Invested More Than One Billion Dollars In United States Savings Bonds.



Safety of principal and interest; desire to own a government bond.



Increasing in value every year adds 33 1/3 percent to investment in 10 years.



No price fluctuation because Savings Bonds are redeemable for fixed cash values.



Two may own a United States Savings Bond which either co-owner may redeem.



Beneficiary may be named to whom bond is paid in event of death of owner.



Bonds are registered and duplicates are issued if lost, stolen or destroyed.

PAGE TWO

Reasons Given By Individual Owners For Systematic Saving Through Savings Bonds—And Amounts Invested.



Retirement



Emergency



Cash Estate



Education



Home Building



Dependents



Travel, Recreation

Each disc represents \$50,000.000 maturity value of Savings Bonds

UNITED STATES SAVINGS BONDS have made investment history. In America no other single security is held by as many owners. Since March 1, 1935, and through February 1, 1939, more than 1,500,000 people have bought more than 8,150,000 Savings Bonds with a maturity value in excess of \$2,260,000,000. A questionnaire sent to all owners of Savings Bonds has provided the information upon which the pictorial statistics on this and following pages are based.

SAVINGS BONDS are treasured possessions in a million American homes. They are primarily intended for citizens desiring to lay aside funds in small amounts for the future. To safeguard them for this use, no one owner may hold more than \$10,000, maturity value, as issued in one calendar year. Savings Bonds have five denominations (maturity values): \$25, \$50, \$100, \$500, and \$1,000. Their respective purchase prices are \$18.75, \$37.50, \$75, \$375, \$750.

PAGE THREE

Why More Than One Million People Have Invested More Than One Billion Dollars In United States Savings Bonds.



Safety of principal and interest. Beside to own a government bond.



Increasing in value every year adds 3 3/4 percent to investment in 10 years.



No price fluctuation because Savings Bonds are redeemable for fixed cash values.



Two may own a United States Savings Bond which either co-owner may redeem.



Beneficiary may be named as whom bond is paid in event of death of owner.



Bonds are registered and duplicates are issued if lost, stolen or destroyed.

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Retirement



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Cash Estate



Education



Home Building



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Travel, Recreation



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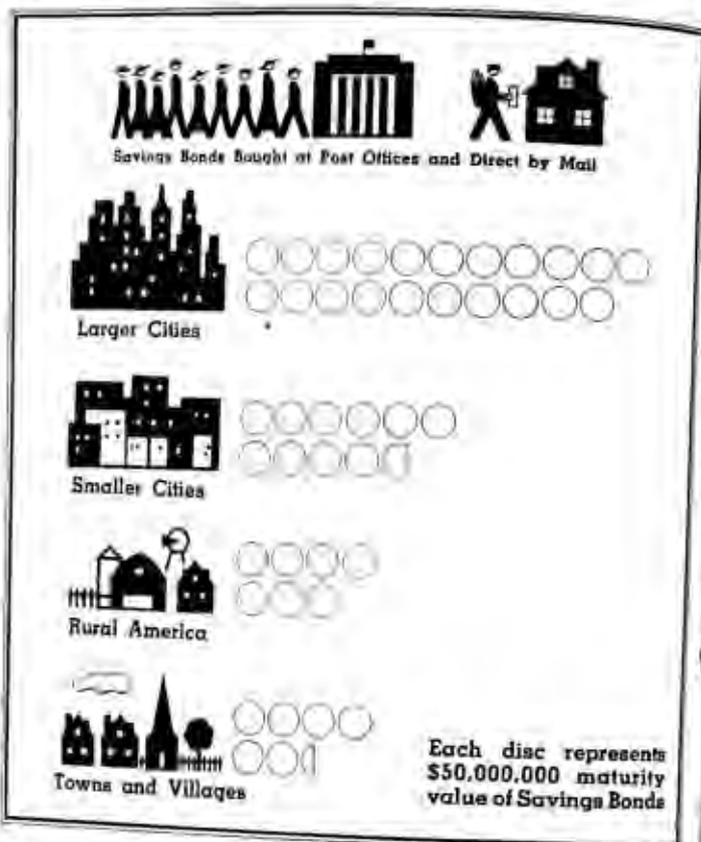
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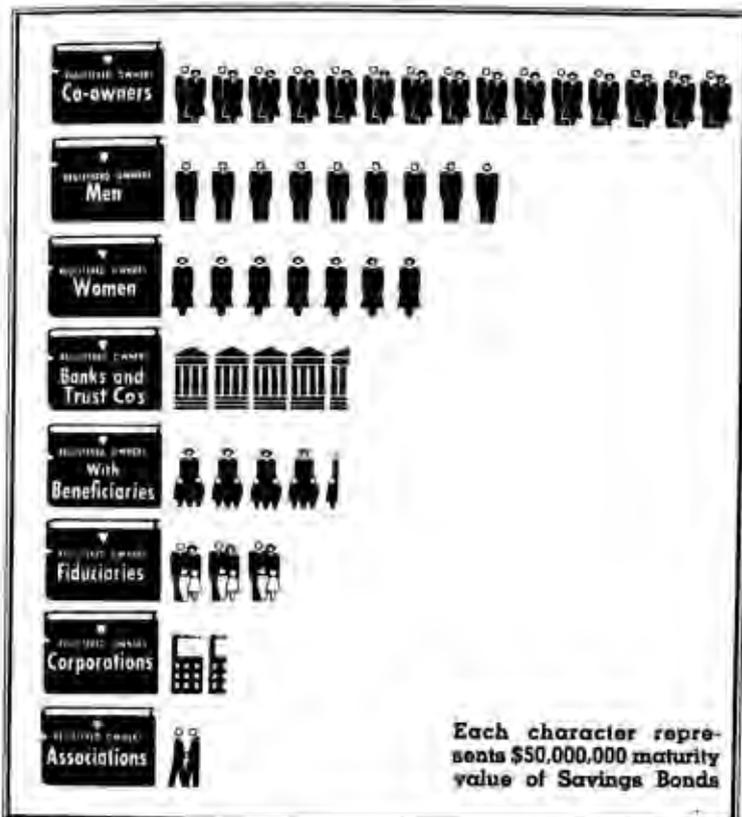
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PAGE THREE

The Nationwide Distribution Of Savings Bonds Is Made Through 16,000 Post Offices And Direct By Mail.



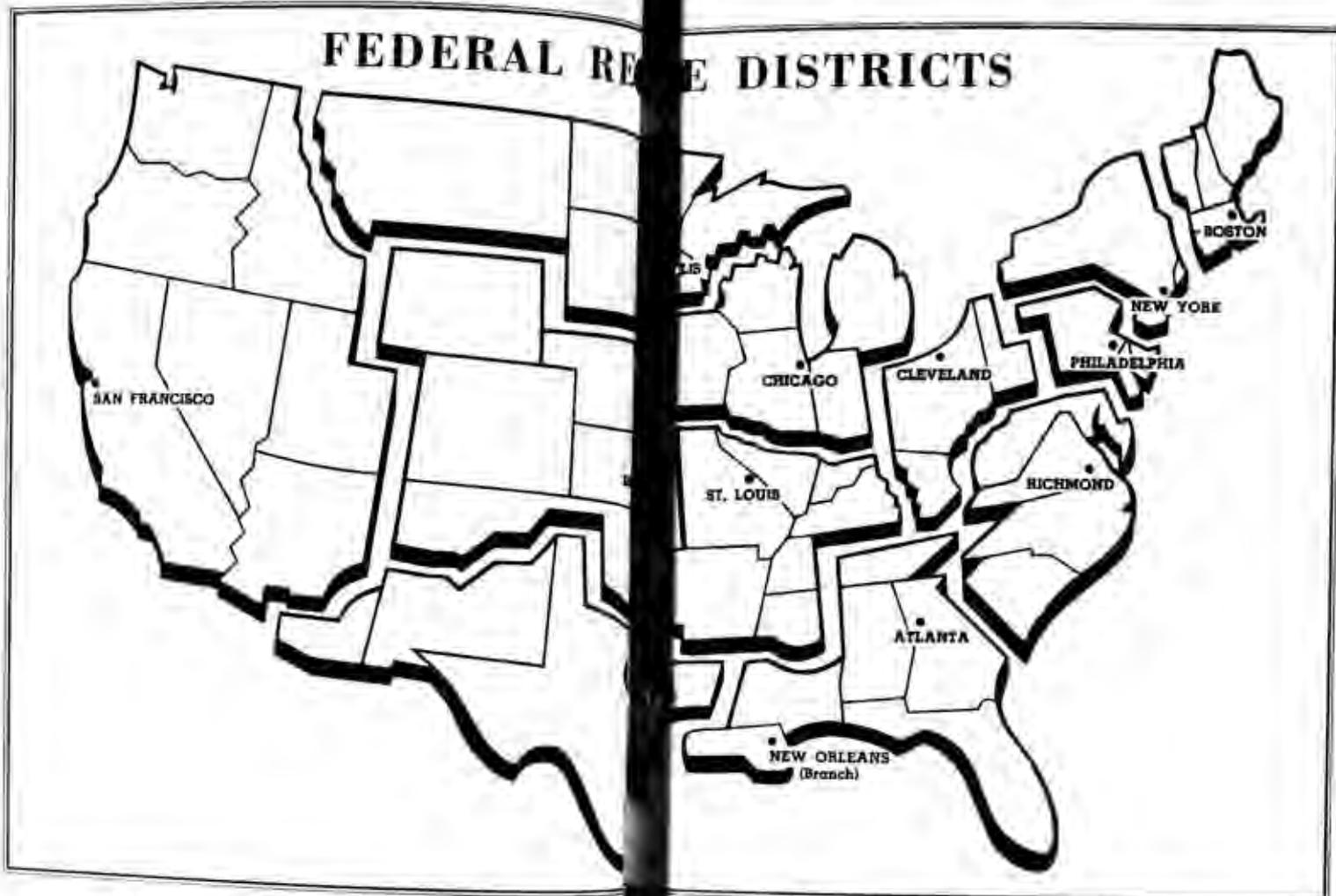
How Savings Bonds Are Registered On The Records Of The United States Treasury At Washington, D. C.



UNITED STATES SAVINGS BONDS are sold on a discount basis. For example, instead of paying \$25 for a \$25 bond and receiving interest at stated intervals, you pay \$18.75 for a bond of \$25 face value. Held for 10 years the bond matures, and, upon due surrender, you will receive a Government check for \$25—a 33-1/3 per cent increase on your original investment of \$18.75 which is equivalent to an annual interest yield of 2.9 per cent compounded semiannually.

A SAVINGS BOND may be owned and registered in the name of a man, woman, child, corporation, fiduciary, or any other legal entity. Normally no distinction is made in bond ownership between an adult and a minor. Two individuals, but not more than two, may own a Savings Bond as co-owners, and either may redeem the bond; or, a beneficiary may be designated to whom the bond will be paid or reissued in the event of the death of the owner.

FEDERAL RESERVE DISTRICTS



ACTING as fiscal agents for the United States, the Federal Reserve Banks issue Savings Bonds purchased by mail in their respective districts. Likewise, they will hold any Savings Bonds presented for safekeeping and, normally, will redeem Savings Bonds presented for payment.

SAVINGS BONDS are direct obligations of the United States Government. They may be purchased at all of the larger and many of the smaller post offices or direct by mail from any Federal Reserve Bank or the Treasurer of the United States at Washington, D. C.

The Smaller Income Groups Own The Great Majority Of All United States Savings Bonds.



Skilled Workers



Clerks



At Home



Salesmen



Teachers



Professional

Each figure represents ownership of 100,000 bonds



Executives



Students



Farmers

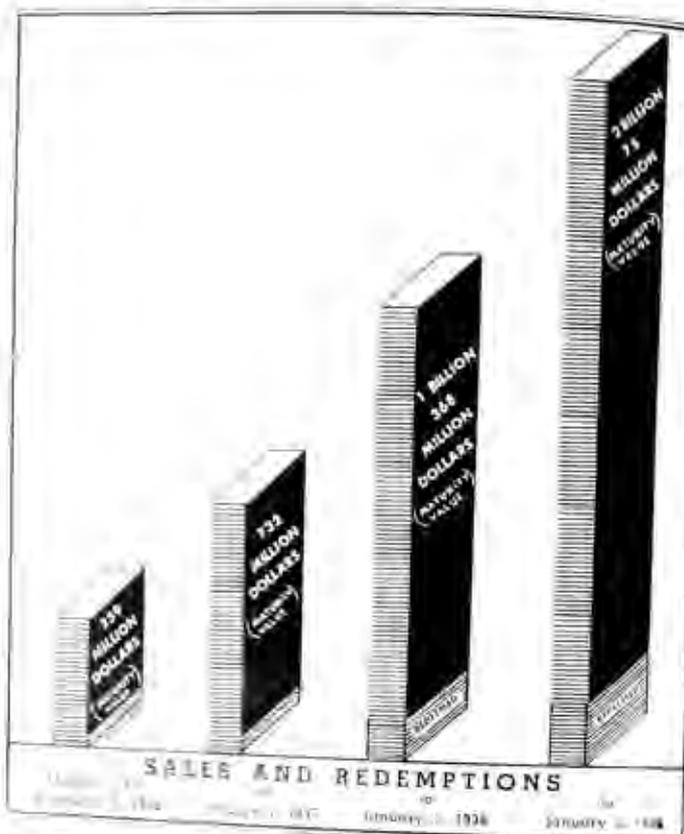
Each figure represents ownership of 100,000 bonds

SAVINGS BONDS are intended for the small investor, and the small investors own them. Men and women from the small salaried groups, with their children, hold the big majority of Savings Bonds. Most of these are buying Savings Bonds out of current income, and the bonds are the nucleus of funds for the education of children, the purchase of homes, emergencies, and for old age security.

Savings Bonds bought systematically under the Regular Purchase Plan, more fully explained in the enclosed order form, can be made to meet many of the uses of an annuity. Neither age nor condition of health need be considered to enroll under this plan; also, without obligation or penalty, you may continue as long as you like and discontinue whenever you please. You may increase or decrease the amount of Savings Bonds you regularly buy, change the intervals of purchase, or you may cease purchases altogether and begin again whenever you desire.

Whatever you may do under the Regular Purchase Plan, the bonds bought are the individual property of the registered owners and may be redeemed for cash at any time after 60 days from respective issue dates. The cash redemption values are never less than the purchase price and increase at the end of the first year and each six months thereafter until each bond matures in 10 years for 33-1/3 per cent more than you paid for it.

**The Cumulative Sales And Redemption
Of Savings Bonds Since First Offered On
March 1, 1935 - To January 1, 1939.**



THE redemption of a Savings Bond is not difficult, and may be readily made. In a Savings Bond the majority of owners of a security to be put aside until it matures and brings funds for some definite need. Less than 11 per cent of the total cash value of bonds sold have been redeemed after more than 4 years' sale. An average of one million seven hundred and fifty thousand dollars' worth of Savings Bonds is purchased each business day.

**The Great Majority Of United States
Savings Bond Owners Are Systematic
Investors In These Securities.**



MORE than 72% of the investors in United States Savings Bonds are making repeat purchases. The Regular Purchase Plan offered by the Treasury permits you to select the investing program suited to your needs. You may purchase Savings Bonds each week, each month, or at other regular intervals of your choice, and you may plan with confidence for days of leisure ahead—for the enjoyment of sunny days without concern of immediate tomorrows.



TABLE OF REDEMPTION VALUES OF UNITED STATES SAVINGS BONDS

ISSUE PRICE	\$18.75	\$37.50	\$75.00	\$375.00	\$750.00
Redemption values after the issue date:					
First year . . .	\$18.75	\$37.50	\$75.00	\$375.00	\$750.00
1 to 1½ years .	19.00	38.00	76.00	380.00	760.00
1½ to 2 years .	19.25	38.50	77.00	385.00	770.00
2 to 2½ years .	19.50	39.00	78.00	390.00	780.00
2½ to 3 years .	19.75	39.50	79.00	395.00	790.00
3 to 3½ years .	20.00	40.00	80.00	400.00	800.00
3½ to 4 years .	20.25	40.50	81.00	405.00	810.00
4 to 4½ years .	20.50	41.00	82.00	410.00	820.00
4½ to 5 years .	20.75	41.50	83.00	415.00	830.00
5 to 5½ years .	21.00	42.00	84.00	420.00	840.00
5½ to 6 years .	21.25	42.50	85.00	425.00	850.00
6 to 6½ years .	21.50	43.00	86.00	430.00	860.00
6½ to 7 years .	21.75	43.50	87.00	435.00	870.00
7 to 7½ years .	22.00	44.00	88.00	440.00	880.00
7½ to 8 years .	22.50	45.00	90.00	450.00	900.00
8 to 8½ years .	23.00	46.00	92.00	460.00	920.00
8½ to 9 years .	23.50	47.00	94.00	470.00	940.00
9 to 9½ years .	24.00	48.00	96.00	480.00	960.00
9½ to 10 years .	24.50	49.00	98.00	490.00	980.00
Maturity value .	25.00	50.00	100.00	500.00	1,000.00

TREASURY DEPARTMENT

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INTER OFFICE COMMUNICATION

DATE April 10, 1939

TO Secretary Morgenthau
FROM W. H. Hadley

Review of the Government Market
For the 3-week Period Ending April 8, 1939

During the three weeks just completed, the government market has been influenced by two divergent forces. Although the piling up of excess bank funds has acted to force prices upward, several European developments have tended to force prices down. The net result was that governments closed Saturday, April 8th, about 1/4 point above March 18th. The latter date, however, was the recent low following the German absorption of Czechoslovakia. Every time the European picture tends to clear, government prices bound quickly upward. As a result, the underlying tone of the market, considering only local factors, is firm.

During the past week, Treasury bonds were off about 1/4 point, guaranteed issues were down about the same, while Treasury notes were 1/8th point lower.

Dealers' Portfolios

During the three weeks, dealers' holdings moved through a narrow range. Although at one time Treasury bond holdings were up as much as \$18 million above present figures, they closed the period only \$3.6 million below the holdings of March 18.

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Dealers' Portfolios
(in millions)

	<u>Week ended</u> <u>March 18</u>	<u>Week ended</u> <u>April 8</u>	<u>Net Change</u>
Treasury bonds	36.0	32.4	- 3.6
Treasury notes (1 year)	32.3	29.6	- 3.7
Treasury notes (1-5 years)	9.9	14.0	+ 4.1
Treasury bills	10.7	5.1	- 5.6
H. O. L. C. bonds	9.9	6.3	- 3.6
F. F. M. C. bonds	<u>4.2</u>	<u>11.2</u>	<u>+ 7.0</u>
	103.0	97.6	- 5.4

Dealers' volume figures indicate only moderate activity. During the last week, Treasury bond volume has averaged about \$90 million daily.

New Security Issues

The only new corporate bonds of any consequence offered in the market were issues of \$22.5 million National Distillers and \$17.5 million Northern States Power on March 21 and 22 respectively, both of which were well received. Since then there has been only one other large offering, a \$24 million issue of convertible debentures by Commonwealth Edison. These latter, however, were offered to stockholders and, therefore, did not come into the market directly. The only large offering expected in the near future is a \$40 million 3% issue of 1959 by Texas Corporation, which may be offered during the coming week.

Corporate Bond Market

The general trend of the corporate bond market over the period has been downward, as a result of general uncertainty and of a sympathetic movement with the stock market. Although highest grade bonds lost about 1 point and medium grade bonds about 3 1/2 points, the averages remain slightly above the lows of January 26, which date marked the beginning of

the recent upward movement. The principal losses during the three weeks were in medium and speculative grade rails.

Treasury Investment Accounts

The only transaction in the market for Treasury account during the three weeks ending April 8th was the sale of \$2.5 million Treasury bonds of 1941 for Postal Savings. This leaves a balance of \$7.5 million to be sold of an original \$10 million sell order placed with the Federal Reserve of New York. Other transactions included \$13 million investment in Special 2's for Postal Savings, bringing the total Special 2's held by this account to \$88 million. There were also purchases of \$4 million Special 2's for account of Government Life which now holds \$15.3 million of these notes.

Federal Reserve System Account

Transactions by the Federal Reserve System account was limited almost entirely to replacement of maturing Treasury bills. Of the \$124,720,000 bills maturing in the three week period, \$30,840,000 were replaced by various Treasury notes and the balance of \$93,880,000 by new and other Treasury bills. In addition, there was a \$10,120,000 switch between two Treasury bill issues.

RE TAX STATEMENT

April 10, 1939.
9:30 a.m.

Present: Mr. Gaston
Mr. Duffield
Mr. Blough
Mr. Magill
Mr. Shoup

H.M.Jr: Well, what I asked you gentlemen down for was to assist me, in strictest of confidence, to prepare a statement for me to make before ways and means. I don't know how much time I have. Mr. Gaston or Mr. McNeynolds said they thought I might have two or three weeks, which would be very good. But I thought I might try to do this this week.

Now, I thought I'd talk at you people and tell you what I have in mind, you see.

Magill: Good.

H.M.Jr: I don't know whether we had a tax bill which the Administration was responsible for in '33 or not. I'm not familiar with it.

Magill: There wasn't any, no. The N.I.R.A. had some taxing provisions in it, but that's all.

H.M.Jr: But the way I thought we'd approach it was something like this: Mr. Roosevelt's been President for six years. Now let's take a look at what we've accomplished during the last six years through taxes. What was the problem? In '33 our revenue was two billion dollars. We had the necessity of increasing it to six billion dollars. How did we accomplish this?

And then list the various ways that we accomplished the increasing of the revenue from two billion to six billion. Then I'd go on to talk about what we've done to stop the various loopholes.

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In other words, I'd like to make a - oh, if you want to call it - a statement of accomplishment from '33 to date of what we've done, you see, the things that we've - the various steps that we've taken and now we've accomplished them, etc., etc.

And then, for instance - then I'd say - I don't know when those darn nuisance taxes were put on, I mean

Gaston: In '32.

H.M.Jr: ... - and what we've done to remove those, see? I'd forgotten they were done in '32.

Then I say, "This is what we've done."

Now, this will undoubtedly be my last opportunity to address this new Congress, because no one would be so foolish to think we could do it next year - to review the tax program. "And as I said in November '37..." - then I'd like to bring in at that point what I said in November '37, where I end up and say, "If we have made any mistakes, I am ready to say so publicly." and I say, "I stand just where I stood in '37.

"Let's take a look at - in this vast accomplishment, where we have unquestionably tripled our revenue, you can't help but do certain things which are unfair and which are deterrents." And then go down the list and say one thing after another that we think are deterrents.

Now, there are two ways of doing this thing. We could, for instance, say that "I think that when you tax a man 79 percent that that's too much and you should only tax him 60 percent."

Or you can say that "the present tax rate on the higher incomes, in my opinion, discourages a man of wealth from taking any risks, and therefore I recommend that the Congress re-examine that and study at what level they, in their opinion, think it should be set to encourage a man who is in the higher brackets to put his money to work."

Magill: I like that better, don't you?

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H.M.Jr: "hat? I do too.

I like the tone of the article which has been done for Fortune; there were a number of things in it which I'd like to crib - not as to their specific recommendations, but as to their tone.

So far so good?

Magill: Uh-huh.

H.M.Jr: "hat? Shoup?

Shoup: Yes. Later, when there is a lot more discussion, I'd have something to say about the historical part of it.

H.M.Jr: Well, let me just take a look at what I underlined that I like here. I take it you gentlemen have seen this Fortune article.

Magill: No, I haven't. Have you (Shoup)?

Shoup: I've not seen it yet.

Gaston: I haven't. Mr. Blough has.

H.M.Jr: Here it is. Fifty pages. You can boil it down to three.

Magill: Who did that - Buell?

Gaston: It's a symposium. Lot of different people submitted memoranda; then he synthesizes the various memoranda. Yes, Buell.

H.M.Jr: Well, this isn't the tone, but this is the sort of thing. "Moreover, corporate profits are taxed twice if paid out in dividends. The corporation pays the tax on the profits as part of the corporate income, and the stockholder pays a tax on such profits in the form of dividends. In contrast, bond interest is taxed only once."

I mean that isn't the thing, but - here, I underlined this. "Moreover, the capital stock and excess

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profits taxes are burdensome to young and developing enterprises. These taxes yield comparatively little revenue; and some of us believe they are not only inequitable but carelessly administered. Young enterprise and business generally would be helped by the repeal of these two taxes."

were they make the statement, for instance - "The first Fortune 500 table reached the conclusion that long-term recovery is being held back, partly because the prospects of profit are much less than during the pre-depression."

Then here's the whole program.

"1. The adoption of the carryover of losses, and the study of the principle of averaging income.

"2. The adoption of the consolidated return in so far as closely related enterprise under common parent companies is concerned.

"3. Experiment with more reasonable allowances for depreciation.

"4. Elimination of any unfair methods of tax accounting."

They say that Sweden abandoned its experiment with the undistributed profits tax a number of years ago.

Shoup: I don't know whether Sweden

Magill: Then it's Norway that still has one.

Gaston: Didn't they adopt the British scheme, which is an undistributed profits scheme in reverse?

Magill: I don't know what Britain has.

Gaston: Britain has that 27% normal and then give you credit on the individual tax, don't they?

Shoup: Yes.

H.M.Jr: I thought this statement was interesting. "We wish to reiterate that excessive taxation upon the rich

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levied in the name of social justice may have the effect of continuing unemployment. If so, such taxes are paid for not by the rich but by the poor."

Nice statement.

Well, what I want to get over is this. I think, looking at it in a broad way, that this whole thing - my approach wants to be from the standpoint of recovery; that here we've got this vast, backed-up, pent-up, money - banks loaded with money. I don't believe we've ever given private enterprise a chance to go to work. I honestly believe that one of the reasons why they haven't gone to work is on account of the present tax structure; there are certain things which are deterrents.

We're faced, I think, with two alternatives. Either we're going to fix the taxes so that - as best we can to encourage the people to risk their money and let them finance; or the only other alternative is more deficit financing. And while I'm here I want to make one last effort to encourage private capital to go to work, because it will be my last chance. It's the last chance of this administration to do it - now.

And this whole unemployment thing - unless we do encourage private capital to go to work, the only other way is bigger and bigger appropriations by the Government.

Now, that's my whole philosophy. I could talk about it a week; it wouldn't change any.

And I'm responsible for the tax structure and I want to put it squarely in the lap of Congress and I want to point out what I think the deterrents are, suggest possible remedies. I'd like to keep it as general as possible, without being too specific, but still do it It was the President who suggested giving them four alternatives on the Social Security, and I knew beforehand the one they'd take: the one with no tax rise. Well, if we could be as clever about it as

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we were in Social Security, why, I'd be very happy. Having had fifteen people work on the Social Security statement, I can say it was damn good, and I'd like to have this one as good.

But I mean when you get through and done - I mean that was the way - you have four alternatives, but sort of point to the one that you think.

But the reason that I am so determined and so anxious and want to do this so much is that - I mean I can't see anything else but either make it worth these fellows' while... And as I've told the President, I'm willing to go just as far as it's honorable to go. He asked me point blank whether I was willing to let the Baruchs and those people make more money, and so forth and so on, and I said yes, but I also pointed out that I had never broken bread with Mr. Baruch, which is more than anybody in the White House can say, because they've all accepted his hospitality or invited him.

And if this is a capitalistic system, why, I want to try and make the thing work. And the thing that I always said to you - the thing I was afraid of was that I had one foot on a horse called "Capitalistic System" and the other one on a horse called "State Socialism," and as the two horses diverge I fall between them and am trampled down by both. I think that's the thing we face today - neither one thing nor the other. And, believing in the capitalistic system and having been here now since the fall of '33, I am certainly going to put the combined knowledge and research - not only Treasury, but people like yourself (Magill) - at the disposal of the Ways and Means Committee.

Now I'm ready to be questioned.

Magill:

Well, the main thing that I would like to get from you I think you've given us, and that is, you might say, now you want this statement formulated and what you want in it. So far as the particular matters in the tax system which we would regard as business deterrents, I don't think that there are any great differences of opinion among any of us. I'm sure there isn't among any of us here in this room.

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Now, Mr. Hanes's office gave me when I was here on Friday a set of memoranda from the Business Advisory Council and the N.A.M. and the Chamber of Commerce. Well, they sound just like that Fortune business, and they also sound like the Magill-group report, as far as that's concerned. I mean the boys - I'll put in this qualification: that each time the boys work in something special of their own that's going to do somebody a particular piece of good; but the general equitable objectives I don't think there's very much question about.

- H.M.Jr: everybody seems to be - but what's happened is that we find ourselves in the position where we've been out-traded and we've gotten down to about one thing, and that is that all of the taxes on corporations should be combined into one and we should have a tax of 21 or 22 percent, graduated.
- Magill: You don't need that much.
- H.M.Jr: And carryover on corporate taxes. That's about what it's boiled down to.
- Blough: A few other things of the same general character.
- H.M.Jr: Well, with that
- Blough: That's right.
- H.M.Jr: Now, for me to go up on the Hill and talk for that would be just plain nonsense.
- Magill: Now, some of the things you have mentioned on your history proposition - I think you want some history; I'm not sure that I would advise you as an individual to put in very much history, for this reason: I don't think that your history is going to be particularly attractive, and I don't think it's going to do you any particular good.
- H.M.Jr: May I interrupt you there?
- Magill: I think you're going to be admitting a whole lot of blunders; that's about all it may amount to.

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H.M.Jr: May I interrupt you there?

Magill: Surely.

H.M.Jr: The reason that this statement on Social Security was such a great success - I said, "I said in 1935 that I recommended that we should have this reserve, and so forth and so on. I said this in 1935 and I was wrong." Now, when I said that and put that in, that specifically I was responsible, I just cut the ground right from under everybody and nobody could come back after reading the statement and say, "Well, why didn't Morgenthau say he did it?" And there wasn't been a single criticism because I took it right out from under ... - "I did it."

Now, I'd much rather get up there and say, "Yes, I did recommend the...." - let's take the worst one from the standpoint of the Chamber of Commerce and the rest of them.

Magill: Undistributed profits.

H.M.Jr: The undistributed profits.

"Yes, I did. Why? Because we felt that..." - what was it, B- ... - was it 530? What was the section?

Magill: 520 and 104.

H.M.Jr: Whatever it was - "... the old ones wouldn't work and here was the situation we were faced with: private holding companies, etc., etc., and we felt that this was the way to get this distribution, get this money in circulation. Well, it didn't work that way. Therefore, in 1938 we got the following legislation through which will take care of that situation." You tell me there is something we got through.....

Magill: '37.

H.M.Jr: Whatever it is - ... which will take care of that situation.

But, Ros, I think it is much better to say, "Yes, during my time I made that mistake, I made that mistake, I made that mistake."

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- Gaston: Of course, there is this to be said in your favor: they didn't adopt your recommendations on undistributed profits tax; what was passed was wholly different.
- H.M.Jr: I think it's much better to say, "I did this; I did this that was wrong."
- Blough: Excuse me - may I
- H.M.Jr: No, I mean because the fact I was responsible for putting it in - we were faced with the thing. "Well, I'm the fellow that recommended the big reserve." I'm trying to find out who sold it to me. "But I did it; I'm the head of the Treasury."
- Gaston: I still think it was right.
- H.M.Jr: What?
- Gaston: I still think it was right.
- H.M.Jr: Well, that's over the dam.
- Blough: But in that Social Security speech - in that statement you pointed out that there was some knowledge you couldn't have had at that time ...
- H.M.Jr: Right.
- Blough: ... which you have now, so that it wasn't something that was a mistake at that time, but something that you didn't have information on on which to make a different decision.
- H.M.Jr: Well, if you can find that, all right, but I'm telling you gentlemen I'm not afraid to get up and say that during my tenure of office certain things were passed that I recommended and I now say they're wrong. I'm not afraid to say it. I'd much rather say it than have somebody else say it. I mean it doesn't bother me, nos. See? I mean the purpose is this - I mean if at that time - I mean if we can say, "Well, this is the information we had," it's very much nicer; but if I made a blunder I think it's much better tactics to say so.

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- Magill: Well now, do you want a kind of a complete history?
- H.S.Jr: I thought so.
- Magill: As a matter of fact, you've done a good many things in the way of tax revisions that I think all of us here would still think are right.
- H.S.Jr: I think so. Now, I don't care whether it's five thousand words or
- Magill: I think the '34 act is pretty good. As a matter of fact, I doubt if you'd recant much on the '37; at least, I don't think I would.
- H.S.Jr: For instance, I forgot that the '32 - the nuisance taxes were passed under Mr. Hoover. I don't think it's generally realized that we've tripled the revenue. In that process tax deterrents have arisen.
- I want to say something which - Doughton has been Chairman how long?
- Magill: He wasn't Chairman in '32. I don't know just when he did go in. Chrisman was Chairman at the time the nuisance taxes were passed.
- H.S.Jr: I want to pay a tribute when I first get up to Doughton and Pat Harrison - splendid cooperation, so forth and so on.
- Gaston: Doughton, Pat Harrison, and Warner were principally responsible, I think, for that '32 act.
- H.S.Jr: The ones I've worked with. I want to get up and say, "Now gentlemen, here I've worked with the Ways and Means Committee under Chairman Doughton and the Senate Finance under Pat Harrison, and during those times, in combination with the Treasury, in combination with these Committees, we have accomplished the following." You see?
- Magill: Are you willing to say another thing on your history? I think, speaking broadly, one of the

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worst features of the tax system is this: You collected in 1928 pretty nearly as much from the income tax as was collected in 1938. Notwithstanding all the increases in rates and exemptions and everything else, in 1938 there was collected - I think it was about 20 percent more from the income tax than was collected in 1928 - very much the same. In the meantime the nuisance taxes were more than doubled - the amount of collections.

In other words, the reason why put another way, in 1928 77 percent of the Federal revenue collections were income taxes; in 1938 it got down to 40 percent. So it's just another way of saying that in the meantime the nuisance and sales and what not taxes have gone up about three billion and had doubled....

Gaston: Two-thirds of it alcohol and tobacco.

Magill: Well, not quite.

H. S. Jr: That's very interesting.

Magill: ... while the income tax has stayed the same. In other words, the tax system has gone in the wrong direction in ten years.

H. S. Jr: I think we ought to say that.

Magill: I think so too. Just how much that's going to apprise business, I don't know, because what it looks forward to is more income taxation.

H. S. Jr: well, look, we've got a combination job to do. On the big broad front that I'm talking about, this statement will not and should not please everybody. Everybody should find some objections to it. But, on the other hand, everybody should find something good in it.

Magill: Oh yes, no question about it.

H. S. Jr: see what I mean? And on this broad front, I should think the President would be pleased with it.

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I feel this way. I'm going to talk in the greatest of confidence. I'll come back to business appeasement in a minute. I have a responsibility and after five years what I've learned here through the assistance of the staff and the Under Secretaries, and so forth - I should put it at the disposal of Congress. and this saying "It's never a good year to have a tax bill" - you (Magill) and I desperately tried to do it year after year and we weren't permitted to do it. I'm not going to end after seven years in the Treasury and not have taken this accumulation of knowledge and put it at the disposal of the Congress. I'm just going to do it.

Magill: Sure, I think you should.

H.W.Jr: Now, out of this thing - it may not in the short run, for the next month or two, start off the wheels of the factories turning at a hundred percent, but if it's a good statement it ought to over a period of four or five years help.

Magill: well, that's really what I wanted you to see. In other words

H.W.Jr: See?

Magill: I don't want you to be misled into thinking, as I've seen some documents around here indicate, that you make this statement and suggest that this and this and this be done and immediately business is going to burst into flame. I think that isn't going to occur.

H.W.Jr: well, it can't. There are too many other things.

Magill: I'm not arguing for a minute that these things should not be advocated, should not be done. But I don't want you to be put in the position of saying, "Well, boys, if you just do this, everything will be all right."

H.W.Jr: Well, that would be silly.

Magill: Yes.

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H.M.Jr: I mean I'm tickled to death to look back after ten years and look forward for five years. That's the best you can do, isn't it?

Magill: That's what you should do.

H.M.Jr: Take a look at the last ten years and take a look at the next five. "Gentlemen, let's take a look at the last ten years and let's take a look at the next five." It would be a very good way to start, wouldn't it?

Now, the disagreeable things, certainly, like the depletion on the oil wells that you say loses us a hundred million dollars a year, ought to be in. The fact that eight states permit community property certainly ought to be in. The estate and gift tax should be consolidated. See? I've been doing more work since you've left than when you were here on this thing - because you did it so ably I didn't have to do it.

Magill: Thank you.

H.M.Jr: So ...

Magill: Not a very good teacher, is what it looks like to me.

H.M.Jr: You left your material. You left your mark behind you - you and Shoup. No question we should point to the middle brackets as the only place the fat is left. No question we should try, if possible, to double the number of people that pay income tax and make them Federally tax conscious. You can't overlook the fact that, if the figures are correct, less than 50 percent of the taxes collected are collected by the Federal Government, and when we're talking about something we're only talking about less than 50 percent of the taxes that the Federal, state and county and city must get together, and ...

Magill: Are you willing to advocate definitely legislation by Congress at this time to set up a commission to do this state and Federal job?

H.M.Jr: Definitely.

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Magill: I think you should do it.

Gaston: Yes.

H...Jr: Definitely. No, I think what you're saying -
"Let's take a look at the last ten years and let's
take a look at the next five."

Gaston: Of course, there is one trouble. Some question
comes up there; if you're going to take a look at
the next five, this thing is going to be prospec-
tive. I think most of us would say that you ought
to look forward to an increase in the yield of the
taxes; that is, more taxes on the basis of any
particular year's earnings. That is, the strength
of the tax structure ought to be increased, will
have to be increased. I don't know whether you
want to take that subject or not.

H...Jr: I think what you might say is this. You could
leave a paragraph - lift it out if necessary -
"If, for instance, Congress is going to consider
increasing the agricultural appropriation by four
or five hundred million dollars, I feel sure that
they will want to consult the Ways and Means
Committee as to how to offset this by increased
taxes." I mean something ...

Magill: If I may say so, I'd rather do it in what I gather
is Herbert's way. Now, you recall that last year
I fought all through the year on this line: that
we must not decrease the Federal revenues and,
on the other hand, we mustn't increase them any;
we must come out just exactly even with what the
present tax system produces. Well, that's a highly
theoretical objective, if I may say so. I don't
think that we're ever in the world going to get the
Federal expenditures down below something like seven
billions of dollars. I also don't think that you can
dependably consider that you're going to have 75 or
80 billion dollars of national income year after
year, so that you can depend on the present system
to produce year after year the amount of money which
you're going to have if you're going to
balance the budget.

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now, personally, I feel just as I know you did when I first came down here, that this balancing the budget ought to be much more nearly a reality than it is now.

H.M.Jr: True.

Agill: And that the one big thing which can be done to increase business confidence is not to balance it next year - you can't balance it in the next two or three years, but you can now take measures which will lead to a balance. And the great trouble, I think, at the present time is that nobody sees any such measures on the horizon.

Now, that's the sort of thing, it seems to me, that you ought to say. This business of believing that somenow or other you're going to get an 80 billion dollar national income and, furthermore, that it's going to continue year after year at 80 billion dollars, is just believing in fairies, if you're talking in terms of the present price level.

H.M.Jr: Would you get that statement I saw in the Sunday Times - evidently National Industrial Board, was it, that said that only 67 percent of the dollars spent - something - just a little box.

Luffield: I'll look for it.

H.M.Jr: What was it, National Industrial

Gaston: National Industrial Conference Board. It came out about Friday or Saturday morning. We ought to have that full report, because that box isn't very intelligible.

Shoup: I think I have that here.

H.M.Jr: What day is it, Shoup?

Shoup: It's - let's see - got everything except the day.

Gaston: Let's look at the date on one of these dispatches.

Shoup: April 6 and April 7.

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- Gaston: It came out on the seventh; the date of the report was the sixth.
- Magill: You want us to get to work.
- H.M.Jr: Before you do, I want to let Shoup talk a little bit. What do you think, Shoup?
- Shoup: About the ...
- H.M.Jr: I mean what we're talking about - what are your ideas how I should approach this?
- Shoup: Yes. Well, I just have one or two specific comments first, and that's with respect to the history. The facts, as I recall, seem to be that as far as the trebling of the revenue
- H.M.Jr: The what?
- Shoup: ... as far as the trebling of the revenue is concerned, that the major part of that was due to the 1932 Act, which not only imposed the nuisance taxes but also made the biggest single increase in income tax rates that any Act in our history has ever made and formed the basis for the big revenue yields from the income tax in later years. A considerable part of the trebling was, of course, due to business recovery that occurred; and then, a part, but I think perhaps on the whole a minor part, of the increase in yield was due to laws passed after March 4, 1933. Now, by minor I don't mean negligible; I just mean perhaps less than half. And the biggest things were the liquor tax,
- Gaston: Three big things: your increased rates of '32, your business recovery, and your liquor taxes; and those were the three big things.
- Shoup: Yes. So I merely put out a comment that perhaps the trebling of the revenue would not be as good a point to start with as possibly some other things. Then on the other points I don't think that at the moment I have anything to add to what's already been said. I feel strongly that we shouldn't try to give the impression, as Mr. Magill warns against, that

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there would be any big upturn in business merely because net loss carryover was allowed or something like that.

Gaston: There is a business mirage that prevents that. That is to this effect: that there is going to be a change of administration; a new administration will be very kind to business, and everybody can go ahead. The reason that is a mirage is, first, that there may not be a change of administration and, second, that any administration is going to have to, if they're going to accomplish the two things They're conflicting things: balanced budget, decreased taxes; they just don't go together one with the other.

Group: And, moreover, I'd like to reemphasize the point made that even assuming we get this 30 billion dollar income now and then, which we presumably won't get unless there's a feverish speculative activity, which the Government is more or less committed to oppose, I presume - even if we get it it is not likely that in such a year there will be more than a modest amount of debt reduction, if any, so that over the years, under the present system, with the present expenditure trends as they now appear, the debt runs like - well, like this: up, and then level for a year, up and then maybe down, and then up; that kind of a cycle. That, I think, is something the public doesn't realize. I don't think people generally think of it that way. They tend to think of the possibility of an 30 billion dollar income and they somehow have the idea that with that we then get a reduction and that cancels the debt increase in other years. I think possibly that is the man on the street's reaction.

W.W.Jr: I don't think they've ever thought of it that way that you ...

Group: Well, if not the man in the street, the business man.

W.W.Jr: I don't know about the business man or the man in the street, but most of the people here in Washington have done a lot of wishful thinking, and they just

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hope and pray that this thing will work out all right. How we're going to get 80 billion dollars or how we're going to reduce the debt, nobody knows, and I haven't made my contribution.

- Gaston: The fact is the debt
- H.M.Jr: I haven't made my contribution, and that's why I want to do this thing. This is to be my contribution as far as this whole thing. I don't care how many words it is or how broad it is, or how pleasant or unpleasant, you see.
- Gaston: A realistic prophecy is that the debt will go above 50 billion dollars before it stops and it will never get below 50 billions in our lifetimes.
- H.M.Jr: Well, I don't know, but
- Shoup: That's all I have to say at the moment.
- H.M.Jr: Well, do you think from the very brief talk here that this is the way to approach it?
- Shoup: Yes, I think so.
- H.M.Jr: Blough?
- Blough: I'm immensely encouraged by this general approach. I'm very happy to see you take it. I have only one point. We tried to write the history the other day, and it looked so ghastly when we got done that we thought it was a Republican campaign document; so we put it in a footnote of that little preliminary statement, just for that reason. And
- Magill: Don't Republicans read footnotes?
- Blough: Well, for the Secretary. And I just put out a little word of warning: that it may be difficult to write the history in an attractive form.
- H.M.Jr: Well
- Blough: I think ...
- Magill: Well, I don't think this

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- H. J. Jr: I mean I - the way I feel is, it may be a bitter pill for me, but I'm here and I ought - I said in '37 I would admit my mistakes. I don't see why that should make it look like a Republican document.
- Blough: I don't mean the mistakes - I think that's a minor aspect of it - but the increases in rates, the successive increases in the tax rates, and the extension of the taxes to other sources, makes a little discouraging reading. It's much pleasanter to talk about the increased strength of the revenue system than it is about increasing the rates from 3 to 22 percent.
- Leggill: I think you can meet part of that, Roy, in a way that I believe the Secretary probably has in mind. That is, if you - I wouldn't suppose that for purposes of his statement the best way to present the history - maybe he disagrees with me - would be to present it as one block, as one unit, but, rather, if you were talking - it came time to talk about corporation taxes, you'd say, "In 1936 I recommended the undistributed profits tax in such and such a fashion and Congress adopted such and such an undistributed profits tax. The results were not what we expected in this and this way, and therefore I think such and such ought to be done."
- H. J. Jr: "But as to what we were getting at, what we were trying to accomplish was to avoid the pouring of this money under the form of a corporation."
- Leggill: Well, your objective was even better than that. Your objective, as you started out with it, was the same objective that you've got today, and that was the simplification of the corporate taxes. That's where we started on this thing, as you may recall.
- Gaston: Treating them as withholding taxes, which they originally started to be.
- Blough: I think if you put the emphasis on that sort of thing, you wouldn't be involved in the trouble I suggested, but if we get to tracing the increases in rates and things like that, that that makes a

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rather unattractive pill for the

Gaston: I think the real defense - Mr. Blough has brought out a real point - we have increased the burden of taxes tremendously, and there is a defense to that. Why have we done it? To support and make possible the broad humanitarian program of this administration. It gets down to a point of, was the program of this Administration justifiable, is it a worthy thing, the things for which we have raised this great amount of revenue? And our answer must be, "Yes, it was."

H.M.Jr: Oh yes. Well, I'll say that.

Snoup: You're again outside the liquor tax.

Magill: I don't think you ...

H.M.Jr: Look, if this thing was easy, I wouldn't ask you gentlemen to come down here. The fact remains I've never attempted to do something like this - nobody for Mr. Roosevelt has, I mean.

Magill: Well, you have attempted to do it.

H.M.Jr: Well, let's put it this way. We've attempted to do it, but I never was permitted

Magill: Haven't been able to do it.

H.M.Jr: I'm going to do it now. And you people were here for a couple of years; this is your life's work.

It just leads me to one other thing. Is there anybody else around the country that we ought to bring into this thing who could contribute anything? Is this man we had down from Harvard - would he be at all helpful?

Magill: Who's that?

Gaston: McGuire.

H.M.Jr: McGuire?

Magill: No, I don't think - he's a lawyer, primarily a lawyer. He hasn't got any I don't think of anyone.

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H.M.Jr: now about what's-his-name over on the Board of Tax Appeals?

Magill: Traynor?

H.M.Jr: No, I wasn't

Boston: Oppen?

H.M.Jr: Oppen.

Magill: Oppen.

H.M.Jr: would Clarence be helpful?

Magill: Well, I doubt it; I don't know.

Blough: I don't know him.

H.M.Jr: Well, of course, he went all through this at Oliphant's elbow.

Traynor?

Magill: No, I don't think so. Do you think of anybody, Shoup?

Shoup: You mean someone to sort of help on the details of the thing?

H.M.Jr: No, on the question of the philosophy. Got enough people here in the Treasury on details.

Shoup: Of course, I've always drawn a good deal of ideas and guidance from Professor Haig at Columbia.

Magill: I don't think Haig is available for this purpose, do you?

Shoup: I think perhaps not. But I didn't want to let the thing go by without mentioning him.

H.M.Jr: How about the man from Wisconsin that I didn't take?

Shoup: Groves?

Blough: I know Groves very well. He'd certainly do no harm

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in a meeting of this kind, and I think he'd be very valuable. At the same time, his philosophy might not be quite in harmony with that at present in this room.

H.M.Jr: Have you (Magill) worked with Groves closely?

Magill: I don't know him; I never met him.

Duffield: He taught me school.

H.M.Jr: I don't think - maybe it would be better not to.

Magill: My own feeling is that what we need is more people on the order of Gaston and Duffield than anyone else. As I have said, I don't think there is much disagreement as to the concrete tax ideas; that part is not hard; but the job of casting this in a broad form which can be understood by the intelligent layman, which really clicks - that's a real job.

H.M.Jr: Well, before - Herbert, you want to say anything as to how we should approach this, other than what we have said?

Gaston: No, I think I've said a good deal. I've got a general idea of what we want to do.

H.M.Jr: Gene?

Duffield: The only thing I would say is, I think it's the right approach, and in support of that I don't think you need to worry too much about emphasizing the point Mr. Gaston makes, of needing to raise the revenue. I frankly was surprised, on this trip of mine, at the utter lack of objection to the level of taxation and the repeated statement: "Taxes are high; we know they've got to be high; we're willing to pay them. Let's just iron out some of these things." I mean that was just universal, and it surprised me to death. I must have seen the wrong people; I don't know.

Blough: Well, I'm surprised ...

H.M.Jr: You were in Minneapolis and Des Moines?

Duffield: I was in Minneapolis; Madison, Wisconsin; Woodstock, Illinois; Newton, Iowa, - you told me to stay out of

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big cities - St. Louis and Memphis.

Magill: I don't know why anybody should object to the level of taxes.

Suffield: The level of taxes was just something that wasn't as such objected to.

H.S.Jr: Well now - I see - well, how do you like this approach?

Suffield: I think it's fine. I agree with Mr. Magill that the sort of things that you hear everywhere - I mean the sort of things that are suggested you hear everywhere. Sort of general agreement.

H.S.Jr: Well now, that doesn't bother me. It's the method.

Now, as I understand, today you're (Magill) mine; and when are you coming back again?

Magill: (Laughs) Just a traveling man.

H.S.Jr: Now, just look at the accommodations; and you were to come down every Wednesday after the 15th of September.

Magill: I never agreed to that, you know; I commuted for twelve months.

H.S.Jr: No, you said you'd come down - what was it, every week or every other week?

Magill: I never said it at all.

H.S.Jr: What?

Magill: Never said it at all.

H.S.Jr: Didn't you? I thought you did.

Magill: Oh, let's talk this afternoon.

H.S.Jr: Well, I understand that you (Shoup) can stay a couple of days.

Shoup: I can stay until tomorrow night, Mr. Morgenthau.

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I have to be back on the job during Wednesday and at least Thursday morning. But I can be here tomorrow.

Magill: I want to see you get this out. I'll give you time one way or another.

H.W.Jr: What I was thinking - as I say, if we could get this thing started nicely, then you could take a look at it Friday. But I mean this is a hard thing and I should think that you'd be vitally interested in this; you have a big stake in this.

Magill: I would think so too.

H.W.Jr: I think you'd be almost as much interested as I am. And when would you gentlemen like to meet with me again this afternoon? The only appointment I can't break is, I have press from 4 to 4:15. Would you want to come in ...

Magill: For my part, I'd be glad to see you at 2:30 or 3.

H.W.Jr: When? You would?

Duffield: What are we to bring back?

H.W.Jr: Well, an outline.

Duffield: An outline? Not a full statement.

H.W.Jr: Yes. Do you want to get the four o'clock? Is that what you have in mind?

Magill: I think so, if that's possible. We'll see how it works. I've got classes tomorrow and next day, too.

H.W.Jr: Well, let me just - you say when you would like to come in. I'll have to change the day around. When would you like to come in?

Magill: Well, I don't know. I can give you an outline at 2 o'clock, as far as that's concerned.

H.W.Jr: Well ...

Magill: Do you want to make it 2:30?

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- H.A.Jr: all right. Now I'll have to change this. 2:30:
Magill. Well, I'll take care of the rest. O.K.
- Magill: Now, this is mechanics, but for my part I would
much prefer to work on this thing alone; I think
I can do it better. Now, that would seem to indi-
cate that what we might try to do is either two
or three of us write something that we think will
be suitable for you, or else we divide it up in some
kind of a way.
- H.A.Jr: Why don't you, when you get to that - what room are
you using?
- Magill: Miss Chaucney suggested I use Mr. Taylor's old
office.
- H.A.Jr: Who is down there to help you?
- Magill: I think his girls are still there. They've typed
out a thing for me this morning.
- H.A.Jr: Do you want this stuff?
- Magill: I've got the same thing. I haven't got the Fortune
thing.
- H.A.Jr: I don't think you have what James wrote me and what
Blough wrote me.
- Blough: I have a copy of that here.

TREASURY DEPARTMENT

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INTER OFFICE COMMUNICATION

DATE April 10, 1939

TO Secretary Morgenthau
FROM Mr. White
Subject: Mr. Riefler's memorandum on financing
(An abstract of the article is appended.)

There is a real need in the United States for medium-term credits to small and medium sized business concerns.

The solution to this problem probably will require a type of financial mechanism which is different from any which has yet operated in this country. This new financial institution may be modeled in part on features of the following:

The Installment Finance Companies, which have developed methods of handling a large volume of notes without intensive investigation, have an appropriate financial and administrative structure, and have successfully reconciled centralized control with local responsibility. In addition, the experience of group banking systems may provide a clue to the type of organization needed, since it combined local responsibility and management with centralized ownership and access to outside funds.

Comment:

Mr. Riefler believes that the problem of providing facilities to finance small business can be solved by private banking institutions, and without direct participation by the government. This is a much debated point. However, it is clear from Mr. Riefler's memorandum that the result of private financing would be the further subordination of small industry to non-local large private financial companies.

There are two bills now before Congress which are designed to provide financing facilities to small concerns which may be of interest.

1. The Mead Bill (S.1482)

This is a simple and very effective plan. It provides for the insurance, by R.F.C., of a designated type of industrial loan, in much the same manner that F.H.A. now insures mortgages on new homes.

Secretary Morgenthau - 2

2. The Voorhis Bill (H.R.4857) and Logan Bill (S.1743)

This bill envisages the creation of a new government agency which will provide facilities for the extension of medium term loans to small concerns, and provide credit insurance to the newly-created organizations of a semi-private nature which would actually grant the loans.

Abstract of Paper by Professor Riefler on Medium-Term Credits
in the United States

(1) History

The problem of agricultural medium-term credits which had been chronic ever since the post-war agricultural depression was finally more or less solved by the organization of the Farm Credit Administration in 1933 to coordinate agricultural lending institutions. The small industrial and commercial entrepreneurs whose need for medium-term credits is most difficult to satisfy used to obtain them before the depression from small local unit banks. With the weakening or failure of these banks the problem has again become acute. The conservative local banks which are those which have served are unwilling to lend. Neither non-local private lending institutions nor the R.F.C. and Federal Reserve banks have been able adequately to meet the genuine demands of small industry.

In Riefler's opinion the core of the financial problem of medium-term credit has now been approached but has not yet been reached.

(2) The main lessons of our experience are:

(a) The term "medium-term credit" is much too vague and must be broken down by categories of borrowers and types of use required. For instance, agriculture is a separate problem which requires separate handling. Medium-term credit, therefore, should easily cover only the financial needs of the small and local industrial and commercial entrepreneur.

(b) These needs have long existed and had access to funds in the past, though not openly, but in the form of mortgages and short-term industrial and commercial loans. This practice is undesirable both for the borrower and the lender.

(c) There is genuine economic and social justification for creating medium-term credit facilities. The need for the continuance of small industry is universally agreed upon.

(d) But the problem has unusual difficulties because the loans required are essentially loans of capital and not credit and the need is really for the provision of equity capital. The average size of the loan is too small to justify meticulous investigation and too large to apply routinized procedure. In the past the local unit bank was in the best position to cope with the problem and non-local banks have been unable to fill the gap.

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(e) The fact that the real need is for advances of capital rather than of credit leads to the following conclusions:

(1) It is an extremely difficult field for direct Governmental advances because of the inefficacy of routinized procedures such as those used by the Federal Reserve Banks and the R.F.C.

(2) A financial institution specializing in advances of this character should not be confined to the loan of funds.

(3) A lending institution should have a capital ratio higher than customarily prevails among banking institutions (about 10 percent) as the risks involved are too high. Therefore, the ratio of capital to deposits should be about 25 to 40 percent.

(4) They should have access for at least part of their resources to non-local sources of funds.

(3) Riefler's Conclusion

The problem has not yet been solved. Public agencies and private non-local agencies have been unable to fill the gap left by the retirement of the local unit bank from this field. The real solution demands a new financial mechanism to which the large installment finance companies approach most closely, though so far their procedures and standards are too highly routinized. Also the revival of forms similar to those of the group banking system might help.

MR. MORGENTHAU'S OFFICE TO--

Mr. Hanes	Mr. Oliphant
Mr. Gibbons	Mr. Gaston
Mr. Taylor	Mr. McReynolds

Mr. Alexander	Mr. Harper
Mr. Allen	Mr. Helvering
Mr. Bartelt	Mr. Irey
Mr. Batchelder	Mr. Julian
Mr. Bell	Mr. Kilby
Mr. Berkshire	Mr. Lockhead
Mr. Bernard	Miss Lonigan
Mr. Birgfeld	Mr. Maxwell
Mr. Blough	Adm. Peoples
Mr. Broughton	Miss Reynolds
Mr. Bryan	Mr. Rose
Mr. Cannon	Mrs. Ross
Mr. Davis	Mr. Sloat
Mr. Delano	Mr. Spangier
Miss Diamond	Miss Switzer
Miss Flanagan	Mr. Tarleau
Mr. Graves	Mr. Thompson
Mr. Haas	Mr. Upham
Mr. Hall	Mr. White ✓
Mr. Hanna	Mr. Wilson

Dr. White:

The Secretary asked that Dr. Riefler's letter be sent to you with the request that you let him know if there is anything in it he should know about. Thanks.

H. S. Klotz
c

THE INSTITUTE FOR ADVANCED STUDY
SCHOOL OF ECONOMICS AND POLITICS
PRINCETON, NEW JERSEY

See file
2-11-39

January 9, 1939

The Honorable Henry W. Morgenthau, Jr.
The Secretary of the Treasury
Washington, D. C.

Dear Secretary Morgenthau:

I have returned from the meeting of the Finance Committee at Geneva and will be glad to come to Washington to tell you about it at your convenience. One of the main topics on the agenda was the problem of intermediate or medium term credits to industry. Mr. Royall Tyler of the League Secretariat had written to each member of the Committee prior to the meeting for their thoughts on the subject. As this problem has been acute with us in this country for a long time, I undertook to write a long memorandum giving my experience with the subject. At the meeting this memorandum proved to be the most comprehensive one which they had received. Other members in general checked with my observations, particularly Sir Frederick Phillips. He said that the British experience subsequent to 1921 in providing for advances to small industries proved the necessity of providing equity capital as well as loans. In view of the discussion the League Secretariat was authorized to make a specific investigation in various countries on the subject of intermediate credits and to report on these investigations during the next meeting in June.

In subsequent conversation with Tyler I learned that you had expressed a personal interest in this subject of intermediate term credits when he saw you here last Spring. I am accordingly enclosing a copy of my memorandum to him for your information.

I had a rather interesting time during the few days that I was in London and Paris, but missed greatly Butterworth and Cochrane who were here at that time.

With all good wishes for the New Year, I am,

Very sincerely yours,
Winfield W. Riefler
Winfield W. Riefler

Enclosures

C O P Y

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October 29, 1932

Mr. Royall Tyler
The League of Nations
Geneva, SWITZERLAND

My dear Tyler:

Thank you for your good letter of October 6th. I have written Mr. Loveday that I am planning to be present at the meeting of the Delegation on Depressions on December 5th.

I am also very glad to give you my thoughts with respect to the problem of intermediate or medium term credits as it has appeared in this country. It is a subject to which we have had to devote considerable thought in recent years. Although I am not too familiar with its historical aspects, I suspect that in reality it has been with us for a long time, and that the need and desire for medium term credits, particularly on the part of the small entrepreneur and farmer, constituted an important motivating factor in the early movement for the prohibition of branch banking in the United States. At any rate, the emergence of a unitary banking structure did have the effect for a long period of submerging the problem of providing specifically for intermediate or medium term credit needs as such. Up to the war these needs were on the whole fairly adequately met by our existing financial machinery, either through the open capital market, the mortgage market, or the unit bank. In recent years, however, largely as a result of the banking crisis, the problem has emerged in striking form, particularly with respect to the farmer and the smaller industrial entrepreneur.

At first I thought I could say that I had to say on the subject in the body of this letter, but my remarks have required so much space that I have finally decided to convey them in the enclosed memorandum.

Sincerely,

Winfield W. Riefler

MEDIUM TERM CREDIT
IN THE UNITED STATES

The adequacy or inadequacy of existing financial arrangements for meeting the medium term credit needs of large industrial borrowers has never arisen in the United States in acute form. These borrowers are sufficiently important to have access to the large private banking houses, to the open security markets, and to the large commercial banks in the financial centers. They are in a position, therefore, to finance their medium term credit needs either on direct loans from the large private banks or the large commercial banks, or by selling notes in the capital market, (provided the issue is of sufficient size to justify the expense of underwriting). As such firms also frequently maintain regular banking connections with a considerable number of the larger banks in the smaller financial centers, they are also in a position to shift short term loans from bank to bank and thus meet their medium term credit needs without any individual commitment running longer than the customary credit term. Except for periods of genuine credit stringency, therefore, or periods when the capital markets have been relatively closed to new financing, these larger industrial borrowers have not been particularly conscious of a need for more adequate facilities for the financing of medium term credit needs.

The farmer and smaller industrial entrepreneur, on the other hand, are not in a position to use the open capital market and have historically relied mainly on their local unit bank for financing of their medium term credit needs, the loan sometimes being secured by a short term mortgage on their real property assets, (a demand mortgage or a mortgage running for 1, 3, or 5 years), and sometimes taking the form of a short term promisory note (90

-2-

days to 6 months). These notes were frequently unsecured, but it was not unusual in the case of small incorporated industrial concerns for securities of the firm to be hypothecated as collateral. Frequently the notes also were secured by the personal endorsement of local individuals of wealth who were personally interested in the borrowing enterprise. Although the term of these notes was short — 90 days to 6 months — it was the expectation of both borrower and lender that they would be renewed on maturity.

These arrangements left much to be desired from the point of view of sound credit procedure, but, during periods characterized by relative economic security, they did have the effect of providing an efficient and flexible mechanism for intermediate or medium term credit advances to borrowers of moderate means. The local unit bank was thoroughly integrated in the life of its community both as to management and ownership, and the operations of potential borrowers for intermediate term credit were intimately known to the directorate, which in fact was frequently directly interested in the ventures being financed. Assuming honest management, the local unit bank, therefore, was uniquely situated to pass judgment on the legitimate medium term credit needs of these types of borrowers.

The glaring inadequacy of these procedures became equally apparent with the advent of the serious credit strains which have accompanied recent depressions. The most publicized defect, of course, was the appearance, in a fairly large number of cases, of situations where the local bank was weakened by over-extensions of credit to borrowers directly or indirectly affiliated with the management of the bank. Eliminating these situations, the almost complete absence of liquidity in medium term credits of this type proved to be highly

embarrassing elements in bank portfolios during periods of drain. After banks subject to drains through the clearings had exhausted their liquid open market assets, they found their medium term local loans completely unsuited either for hypothecation or realization. From the point of view of hypothecation they found that potential outside lenders, unfamiliar with local conditions, were usually unable to form any considered judgment on the worth of local loans to local concerns, the value of which depended neither on the ability of the concern to finance payrolls and purchase materials to meet orders on hand, nor on the orderly liquidation of stocks of merchandise, but rather on such intangible factors as potential opportunities for expansion, management, and the ability of that management to adjust to changing future conditions. When hypothecated, therefore, even the better of these loans were marked down at extremely heavy discounts. It was equally found that realization on these loans, in times of crisis, was difficult if not impossible. Their value, irrespective of whether they were secured or unsecured, rested essentially upon the operations of the borrowers as going concerns. In case attempt was made to take possession and to realize on the security, they were found to have little immediate value. In the case of farm mortgages this was due to the general agricultural depression; in the case of mortgages upon small industrial properties, because of the special purpose value of the physical assets underlying the mortgage; and in the case of pledged securities, because these securities, representing stock in small local concerns, were essentially unmarketable.

The attempt to realize on small industrial medium term loans, moreover, had other repercussions which, though less publicized, exerted strong tendencies toward accentuating the depression. Although essentially medium term loans, contracted to finance medium term operations, they were written, as noted above, in the form of short term loans with the expectation on the part

of both borrower and lender that they would be renewed at maturity. During periods of stability this practice appears to have operated in the direction of conservative finance, in that the lending bank, though expected to renew the loan, was not legally obligated to do so and was in a position in consequence to exert continued pressure on the borrower in the interest of conservative financial operations. During the crisis, on the other hand, this practice proved definitely deleterious. Banks in straitened circumstances and particularly closed banks in the hands of receivers, were reluctant to renew these loans and brought heavy pressure to bear looking toward their repayment as they fell legally due. The result was that small entrepreneurial borrowers found themselves pressed for repayment of commitments long before the industrial operations, which had originally constituted the occasion for borrowing, were matured. They were forced, in consequence, to make heavy sacrifices at a most inopportune time, a phenomenon which has had persistent after effects in a dampening of the spirit of enterprise and an accentuation of the tendency toward the maintenance of an exceptionally high degree of liquidity among industrial firms.

These phenomena constitute the background for the problem of medium term credit facilities for agricultural and small entrepreneurial borrowers as it appears in the United States today. The problem, itself, first became acute in the case of agricultural borrowers during the agricultural crisis of 1920-1923. At that time the sudden collapse of prices for farm products, coming at a time when farmers as a group were heavily overextended, resulted in a wave of failures among small unit banks in predominantly agricultural communities. Lax standards in extending credits and overchartering of banks, frequently on insufficient capital, constituted ~~is~~ major factors in this collapse,

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but as the debris was cleared away three things became apparent, one, that agricultural producers could make relatively little use of genuine short term loans, — their production cycle was longer than industry and required correspondingly longer loan commitments; two, that much of the short term paper in banks specializing in loans to agricultural producers was in reality intermediate credit paper in that it was expected as a matter of course by both borrower and lender that the loan would be renewed on maturity; and three, that failures were exceptionally high among those banks which specialized in these loans. Recognition of this situation led to the first organized attempt in this country to meet directly the legitimate needs of agricultural borrowers for intermediate credit in a form which would not collapse during a crisis and leave both the local unit bank and the borrowing farmer in an impossibly weakened position. In the plan adopted at that time, the banking laws were amended to permit banks openly to make, and the Federal reserve banks to rediscount, agricultural paper of longer than 90 days maturity. Provision was also made by the Federal government for the organization of intermediate credit banks to serve agricultural borrowers, such banks to have access to the open market for the sale of debentures to obtain funds with which to finance their operations. These measures were enacted into law in 1923.

Admirable as was the diagnosis of the problem facing both farmers and unit banks located in agricultural communities at that time, the intermediate credit banks provided for found little opportunity to function during the immediately ensuing years. This was due largely to simultaneous developments in the farm mortgage field which had the effect, temporarily, of diverting the most pressing needs for intermediate agricultural loans into the mortgage market.

Prior to the crisis of 1920-23, the Federal government had made provision for a more adequate system of long term agricultural mortgage credit through the organization of the Federal land banks and joint stock land banks, but due to certain impediments, largely legal in character, these institutions had not been in a position to function effectively until after the post-war crisis had made its appearance. At that time, however, they entered into operation and made available non-local funds for long-term agricultural mortgage loans at interest rates and on terms more favorable than had previously prevailed. At the same time, the larger insurance companies in search of outlets for an expanded volume of investment funds adopted the policy of increasing their farm mortgage loans. Under the impetus of these forces farmers made little use of the new system of intermediate credit banks. They preferred, on the whole, to consolidate their debts into long term mortgages contracted with non-local lenders. As a result they were able to pay off their local banks out of non-local funds without recourse to the new intermediate credit facilities.

Specific requirements for agricultural medium term credit played a smaller part in the more recent crisis of 1930-34. That crisis was so severe and reduced the net income of so many farmers to negative figures that all forms of agricultural credit provided by private lenders collapsed under the strain. The situation was so serious that it required direct intervention on the part of the Federal government armed with direct access to the Federal credit to restore an orderly functioning to the market. As early as 1930, failures were widespread among banks located in agricultural regions and credit curtailment in force in many banks which remained open. By 1931, all types of institutions dealing with farm mortgages were having difficulty and new mortgage money was difficult to obtain. Under these circumstances, the Federal government through the Farm Board, the

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Farm Loan Board, and the Reconstruction Finance Corporation at first organized a variety of emergency institutions to alleviate different types of agricultural credit stringency, and later, in 1933, organized the Farm Credit Administration to make a fundamental attack upon the whole problem of agricultural credit. This organization backed by direct access to Federal funds took direction over all of the different federally sponsored institutions dealing with agricultural credit and reorganized them into a coordinated system of agricultural lending institutions capable of meeting all types of needs for agricultural loans.

Since 1933, therefore, the problem of medium term loans in the United States has narrowed down largely to loans for small industrial entrepreneurs. Coincident with the financial and industrial crisis of 1930-34, local banks, as noted above, found themselves embarrassed by their possession of such loans and small industrial borrowers on their part found renewals of loans of this character more difficult to negotiate and new loans much more difficult to obtain. Since the crisis of 1933, this situation has been alleviated somewhat by a return on the part of many individual banks to their traditional lending practices with respect to credit demands originating in the medium term loan needs of small industrial borrowers. By and large, however, a void has been created in our financial facilities which has not as yet been successfully filled. It has been created, first, because the more conservative local banking institutions, i.e., those which were most liquid during the crisis and were least involved in loans of medium term character, have on the whole shown by far the greater tendency to survive, and second, because bankers in general are loathe to recommit themselves heavily in types of loans which brought them the greatest difficulties during the crisis.

A further factor of considerable magnitude has also operated

during recent years, namely, a breakdown in the whole network of local financial relationship upon which the successful advance of medium term funds to local entrepreneurial borrowers was formerly based. The small local entrepreneurial borrower is not likely to be in a position to meet readily objective standards for medium term lending. If he is to represent a good credit risk over a medium term period, it is preferable that he should be expanding. If he is expanding, however, he is probably short of capital, his equity in the enterprises is somewhat extended, and his tangible assets are more likely than not to consist of special-purpose plant and equipment that would be of negligible value on an auction basis. The real basis of medium term credit in such cases rests on the personal financial strength of the backers of the enterprise as well as on the lender's judgment of its potential possibilities and the quality of its management. Prior to the crisis, when the bank was owned and operated by the most substantial citizens of the community, it was more than likely that the bank would have among its own stockholders the responsible backers of those local industrial enterprises that were most in need of medium term credit for expansion. To a certain extent, therefore, the ultimate cushion of risk both for the bank and the local industrial enterprises went back to the same group of leading local interests. During the crisis this cushion of risk became seriously impaired for bank stockholders and directors in general were compelled by circumstances to draw very heavily on their private resources, first, to make good assessments on their bank stock in desperate efforts to maintain the solvency of their banks, and later to make good on the double liability which at that time was attached to holders of bank stocks. After the crisis, therefore, the losses which these local interests had sustained as stockholders and responsible directors in the

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various local banks were frequently sufficiently large to impair the value of their endorsement on the notes of the local enterprises in which they were interested. In other words, the community of interest and of financial responsibility that had previously given great strength to the local unitary banking system that prevailed in this country was completely wrecked in many communities by the banking crisis itself. As a result, the banking crisis in and of itself, seriously impaired the financial standing of those groups in each local community upon whose credit the soundness of local medium term industrial advances had formerly been based, and local enterprises that had once represented favorable medium term credit risks were no longer in a position to qualify for such advances.

Several attempts have been made to narrow the void in previously existing credit facilities thus created. Large national manufacturing concerns, such as the automobile companies, have in some cases organized themselves to make available medium term credit facilities to their local dealers. The installment finance companies also, in some cases, have entered the business of financing purchases of industrial equipment on an installment basis. The most ambitious attempts to fill the void, however, have been made by the Federal government. As early as 1932, the appearance of credit stringency in various localities at a time when the national money market was quite liquid led the Federal reserve banks to seek and to obtain permission to make commercial loans directly to industrial and commercial borrowers. They were able to conclude only a small volume of these loans, however, since very few of the applicants were able to meet the high standards for commercial or industrial advances that had been written into the law. By 1934, it was becoming generally recognized that such credit

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stringency as existed was not due to the unavailability of credit for needs that met acknowledged credit standards, but rather to the unwillingness of banks to continue to make borderline loans. In that year, consequently, the law was amended to permit both the Federal reserve banks and the Reconstruction Finance Corporation to make industrial loans on quite liberal terms as to maturity, interest charges and collateral, provided that they conformed to the test of possessing full and adequate security. Both institutions received a relatively large number of applications as a result of these amendments to the law, but again found only a relatively small number that could meet the standards established. Recently the Reconstruction Finance Corporation has been able to make a somewhat larger volume of advances of this kind by adopting the definition that such advances need have only reasonable security.^{1/} Meanwhile, several attempts have been made to encourage the commercial banks to relax the more rigid credit procedure which they had adopted as a result of the crisis. In 1935, the banking laws were amended to permit the Federal reserve banks to rediscount, under certain conditions, all types of paper presented by their members provided this paper met the test of soundness. More recently examination procedures have been revised to distinguish more sharply between "slow" assets and "doubtful" assets in the portfolios of banks. As a result a bank can now make a medium term credit loan as such and still meet examination requirements and also be in a position to rediscount this paper with its Federal reserve bank, provided always that the paper qualifies with respect to assurances for its ultimate repayment.

^{1/} In 1935 and 1936 the Federal Housing Administration in its efforts to restore activity to the construction trades, undertook to insure lenders against losses on installment loans contracted for the purpose of modernizing real properties. Certain categories of these loans, i.e., those made available to commercial and industrial concerns for the modernization of their real property, met needs that might ordinarily have been classed as medium term credit demands.

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Although it is too early to state what the ultimate effects of these measures may be, it is my personal judgment that they have approached, but have not yet reached, the core of the financial problem posed by demands for medium term credits. I do believe, on the other hand, that we are now in a position to define much more definitely what we mean by the problem of medium term credits and to state some, at least, of the requirements which a solution of that problem must meet. The main lessons which we have learned from our experience can be itemized as follows:

A. The term "medium term credit" is much too vague. It must be broken down by categories of borrowers and by types of financial aid required. From the point of view of categories of borrowers, there is likely to be no problem of medium term credit as such with respect to large borrowers. If such borrowers have access to open capital markets where they can sell their securities and to large banking institutions for financing their ordinary credit needs, these sources of funds taken together habitually afford sufficiently flexible financial facilities to meet all needs for medium term credit as such. If large potential borrowers do not have access to open capital markets or to large banking institutions, they are faced with a general problem of lack of financial facilities, of which the need for specific medium term credit facilities would constitute only a minor part.

It is likewise confusing to deal with agricultural needs for medium term credit separately from general agricultural credit requirements. The basic conditions under which agriculture functions vary so basically from those characteristic of commerce and industry, that they require a completely separate approach with respect to sound and adequate financial facilities. For example,

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institutions specializing in industrial lending, either on short term, medium term, or long term, do not gain from that experience wisdom in the granting or withholding of their respective types of credit to agricultural producers. Institutions specializing in agricultural credit as such, on the other hand, are much better situated to deal with all types of credit needed by agricultural producers.

Finally, the phrase "medium term credit" as customarily used does not refer to the medium term credit needs of individuals or consumers, though these needs are widely existent, e.g., installment credit needs, and needs for credit to repair and modernize homes. The real area covered by the general phrase medium term credit, when this phrase is used to define a current problem, usually narrows down to the provision of facilities for medium term financing to small and local industrial and commercial entrepreneurs.

B. These needs have long existed and have had access to funds in the past. They have not, however, been recognized openly nor have they had access to sources of funds organized for the purpose of meeting the specific and peculiar requirements of medium term financing. Instead, these loans have been concealed in the form of mortgage loans or in the form of short term industrial and commercial loans. Such practices are definitely deleterious from the point of view of economic stability, deleterious both to the lender and the borrower; to the lender because loans of this character do not conform to the standards of, nor afford the security expected in, mortgage loans or short term commercial and industrial loans; to the borrower because at times of economic pressure, when in any case the hazards of successful management are high, there may be added to these hazards pressure to repay outstanding financial debts at a time and in

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a period that bears no relation to the original purpose of the commitment. If an advance of medium term credit to a small industrial borrower is justified, it is justified by the fact that he proposes to use the funds productively in an operation which will require a medium term period — 2 years, 5 years, possibly 8 years — to justify its extension, i.e., to liquify the original loan with interest and with profit. There is ordinarily no time within that period when the loan can be called without embarrassment to the borrower nor without undermining the original operation upon which the advance of the funds was justified. It is a matter of prime importance, therefore, that when credits for medium term purposes are advanced, they should openly take the form of medium term credits with terms for amortization or repayment conforming to the expected liquidation of the operation which the funds were originally advanced to finance. By this means the portfolio of the lending institution is made to reflect the genuine character of the assets upon which its solvency is based, and the economic system as a whole is protected against wholly unnecessary accentuation of the strains that are inherent in the cyclical fluctuations of business movements.

C. There is a genuine economic and social justification for creating facilities to make medium term funds available to small entrepreneurial applicants. Current opinion is uncertain and in a state of flux with respect to many of the problems of large as compared with small industry. It is weighing the advantages of mass production against the growth of practices that appear monopolistic; the advantages of highly specialized, centralized controls as compared with the flexibility of decentralized operations; the effects on our population of the growth of large, highly congested urban areas. It is significant that in the heat of this debate there is no important body of opinion that

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advocates the dissolution of small industries. It is generally recognized, rather, that the continued existence of a fair proportion of small industrial organizations is necessary to the economic health of a free economy. There are, for example, distinct social advantages in maintaining open the spirit of individualism and enterprise that are characteristically associated with small entrepreneurial concerns; there are also many localities and areas in the modern economic world that can only be organized efficiently by the small entrepreneur, i.e., areas of resources and demand that require for their successful organization the detailed and intimate knowledge of local conditions which only the small entrepreneur can furnish. We cannot forget, finally, that the industry which is outstanding above all others in the world today in the efficiency with which it has adapted productive resources to human needs, the automobile industry, was developed entirely by small entrepreneurs. It is important, therefore, from the point of view of public policy, to make sure that the evolution of our financial mechanism in the direction of more specialized procedures and more soundly organized mechanisms does not also have as an unforeseen by-product the result of withdrawing from the small entrepreneur a source of financial accommodation which is necessary to his survival.

D. The establishment of credit procedures calculated to minimize risk in medium term loans to small entrepreneurs is attended by unusual difficulties. In fact, the specific relevant considerations attending each loan application are so various and differ so widely from one applicant to another as to make any routinized procedure hazardous and essentially inapplicable. For example, these loans are not comparable to commercial loans to finance receivables or goods in transit, or stocks of merchandise awaiting sale, nor to industrial loans to finance payrolls and purchases of raw materials needed to make up goods to meet

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orders already on hand. They do not, in general, therefore, fall into categories where their validity can be justified by quick reference to easily ascertainable facts and their repayment more or less guaranteed by insistence upon definite documentary assignments. On the contrary, in the majority of cases, these applications are for loans that are essentially loans of capital. Very often in fact it would be improper to grant these applications in the form of loans at all, in as much as the need of the enterprise is rather for equity capital, or at the least for an increase in its equity capital coincident with and supplementary to the borrowing of medium term funds. This means that the institutions advancing medium term funds must be in a position to make a balanced judgment concerning all of the imponderable factors that in the end will determine the profitability to the borrower of the proposed advance. In other words, the institution advancing medium term funds to small borrowers should actually be as careful and meticulous in its procedures as the investment banker who undertakes to underwrite an issue of securities for flotation in the capital markets. It should also be in a position to form a judgment on the same range of elements of risk. Unfortunately, however, the average size of medium term credit loans is simply too small to justify the expense of this type of meticulous investigation. At the same time these loans are too large, and the loss involved in any one default would be too great, to justify the lender in resorting to more routinized procedures such as are successfully used to minimize risk in the case of personal loans, installment loans, and mortgage loans on homes.

It is for these reasons that in American experience the local unit bank has been in a better position to pass judgment on medium term advances to small industries than other potentially competing financial institutions. The local

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unit bank simply did not have to make an extended investigation of a local applicant for a medium term advance because it was already, as a matter of course, in intimate touch with his business. It is for this reason also that non-local lenders have been relatively unsuccessful in filling the void left in recent years by the partial withdrawal of the local bank from this field. Outside private lenders who have experimented with these loans report that the expenses of preliminary investigation and also of following up the loan after it has been made are frequently prohibitive, unless, as in the case of automobile companies that finance their local dealers, the outside lender is already in a position because of other contacts to be intimately in touch with the borrowing enterprise.

E. The fact that the real needs for medium term advances on the part of small entrepreneurial borrowers usually correspond more closely to needs for advances of capital than advances of credit and frequently border on a need for equity capital, leads to four further major conclusions with respect to the type of financial organization which could most properly specialize in advancing funds to meet this need.

First, it is an extremely difficult field for direct governmental advances. Experience has shown that governmental financial institutions can supplant private lending agencies with a considerable degree of success in the case of advances which are adapted to routinized credit procedures. In these cases the government can protect itself and its operating personnel against corruption and undue pressure for advances by applicants possessing political influence through the adoption of centralized controls and the promulgation of definite credit standards which all applications must meet. In the case of advances of

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a capital nature, however, i.e., advances which frequently border on equity funds, the adoption of definite credit standards centrally established frequently has the effect of eliminating automatically a great portion of those applications which constitute the main need for this type of advance. The experience of the Federal reserve banks and the Reconstruction Finance Corporation with industrial loans in this country has amply demonstrated this point. Both institutions found that the great majority of the applications simply did not provide that type of security or the relative certainty of favorable outcome which a conscientious civil servant desires and needs if he is to be in a position to justify the impersonal nature of his decision to advance funds. The great majority of the applications, rather, were of a type which ideally needed consideration by a private lending institution that would be risking its own funds and its own capital on the outcome of the advances which it granted.

Second, a financial institution specializing in advances of this character should not be confined to the loan of funds. Provision should also be frankly made for the advancing of equity capital, that is, the purchase of common stock in the enterprise desiring additional financing. Such purchase might be made as an alternative to a loan, or as supplementary to it. In this way, the borrowing enterprise would be protected against over-extension of its equity and the institution advancing medium term funds would be in a better position to average its gains against its losses.

Third, the lending institution advancing medium term funds should have a capital ratio higher than customarily prevails among banking institutions in the United States. At present in this country, commercial banks endeavor to maintain a ratio of capital equal to at least 10 per cent of their deposit liabilities.

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Ratios as low as these are safe when the assets of the lending institution are closely guarded against risk. A moderately high degree of risk, however, is almost inevitable in the case of institutions advancing medium term funds, if these institutions are really to serve the need that exists among small enterprises. To make such lending sound, therefore, the lending institution should protect itself by maintaining a higher capital ratio, say, between 25 to 40 per cent.

Finally, any mechanism created to meet the need for medium term advances to small enterprises should have access for part of its resources at least to non-local sources of funds. It should be able to obtain funds to finance its operations by, for example, the sale of its debentures either to outside banks or in the capital markets. This is necessary for a variety of reasons, (a) to avoid the necessity of relying upon funds as unsuited to medium term advances as those represented by local deposit accounts, (b) to have access to cheaper sources of medium term funds than is customary in expanding communities that are relatively deficient in savings, and (c) to avoid a general freezing of credit in periods of industrial stagnation when a particular locality as a whole may be under severe pressure and subject to serious drains through the exchanges.

Conclusion

These five main heads summarize most of our experience with this problem to date. As I have indicated above, I do not believe that we have solved it as yet in the United States. Our traditional approach, through the use of the local unit bank, had the advantage that that bank was in a prime position to judge quickly and without undue investigation the legitimacy of a given credit application. It could also follow the subsequent fortunes of the borrowing enterprise

without undue effort. Because of the fact that its own stockholders, with their double liability, were also likely to be personally interested in the fortunes of the borrowing concern, it conformed in an indirect and concealed fashion to many of the equity requirements noted above, i.e., losses on these capital loans many of which bordered on equity commitments, were balanced in a sense by equity gains on successful loans, not gains openly and legally to the banks as such, but effective none the less because they accrued to the stockholders back of the bank. The weaknesses of this system, however, were equally apparent, (a) in the writing of medium term commitments in the form of short term notes, (b) in the exclusive reliance upon local funds to meet capital requirements in an expanding community, (c) in the tying up of deposit money in non-liquid medium term commitments, (d) in the low capital ratio characteristics of banks of deposit, and (e) in the ever present possibility that unjustified advances would be made to enterprises in which the ownership of the bank was personally interested. The attempts, on the other hand, to fill the void left by the withdrawal of the local unit bank from this field have been only partially effective because public agencies have not been in a position to advance equity funds directly nor to make capital loans which border on equity advances, and because most non-local private agencies have found that the costs involved in the investigation and control of these advances is too great.

A real solution of the problem therefore, requires a type of financial mechanism different from any that has yet operated in this field in this country. Among our existing financial institutions the large installment finance companies approach more generally than any other to the type of organization that

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might be expected to specialize successfully in this field in that they are capitalized at a much higher ratio than banks, their financial standing is high, and in deriving their investment funds they are able to supplement their own capital by the sale of debentures carrying very low rates to a wide variety of banks and also in the open market. Of all financial organizations operating on a national scale in this country, furthermore, the large installment finance companies come nearer than any other to having that kind of intimate local contact and intimate knowledge of local conditions that is a prime prerequisite of success in the field of small medium term credits. These same companies, however, have achieved their present high credit standing and success in large part because the installment finance business lends itself to highly routinized procedures and standards under which a central office management is in a position to keep highly decentralized lending outlets under effective centralized control. They have not, therefore, met management tests as different as those which would be posed were organized financial institutions to undertake to specialize in medium term credit loans.

The group banking systems which flourished in this country in the decade prior to 1929 may also carry a clue to the answer to this problem. In these systems which, from the point of organization, fell halfway between a unit banking system and a branch banking system, there was combined through a variety of devices a certain degree of local responsibility and local management on the part of the local component banks with centralized ownership and the possibility of centralized access to outside funds. As commercial banking systems, these organizations had a bad record during the crisis and have properly been subjected to heavy criticism. It may be, however, that their experience has some positive contributions to make toward the problem of organizing a financial mechanism really capable of meeting the needs that exist for medium term advances.

January 12, 1939.

Dear Mr. Riefler:

On behalf of the Secretary I am acknowledging your letter of January 9th. Mr. Morgenthau is away from Washington on a brief vacation, but we expect him back in the office the first part of next week, and I am sure he will be most interested in reading your letter and the material you enclosed.

Sincerely yours,

H. S. Klotz, ✓
Private Secretary.

Mr. Winfield W. Riefler,
The Institute for Advanced Study,
School of Economics and Politics,
Princeton, New Jersey.

GWF/dbs

April 10, 1939
9:01 a.m.

HMJr: Hello.
Ronald Ransom: Good morning, Mr. Secretary.
HMJr: How are you?
R: Fine. Glad you're back in town.
HMJr: Well, I'm back; I'm not glad.
R: Well, I don't blame you. You see -- you see I didn't go to Europe.
HMJr: No. I called up Chairman Eccles at his home and he didn't answer.
R: He's out of town.
HMJr: Are you acting?
R: Yes.
HMJr: Well, I just want to ask him three questions, and if you're acting I'd like to ask them of you, if I may.
R: Certainly, sir.
HMJr: In this morning's paper for the first time I see this communication from the Board.....
R: Yes.
HMJr:to the two committees.
R: Yes.
HMJr: One to the Senate and one to the House.
R: Yes.
HMJr: And inasmuch as I have a press conference this afternoon, I wanted to ask whether during my absence the Board informed anybody in the Treasury that this was going to be done.
R: Well, not to my own knowledge.

HMJr: I see. Well, I didn't know anything about it. I thought that the Board might have extended that courtesy to us. And might I ask another question -- did this -- did this statement that went up on the Hill -- did this -- I mean, clear through the White House?

R: Now that I don't know. I would guess that it did not. If it did, it cleared through Mr. Eccles, and I would be quite definitely sure that it did not do that.

HMJr: And the third thing that I was going to tell Eccles was that the President has a Fiscal and Monetary Committee.

R: Yes.

HMJr: And inasmuch as most of this is devote -- devoted to fiscal and monetary matters, I don't understand why he didn't take it up at a meeting of the Fiscal and Monetary Committee.

R: Well now, that I can't answer because of course you know I've never attended any of those meetings, nor do I know exactly what the scope of their authority may be.

HMJr: But, frankly, I just can't understand how the Board could send a communication like that without at least doing the Treasury the courtesy of telling them it was going up. I feel very badly about it. I mean, that is, not about the statement, but the discourtesy.

R: Well, I regret that, of course, as you know, very much indeed. But may I give an explanation of it; that it is a combination -- a repetition of two things which the Board has already said. In its annual report, as you know, it surveyed the whole field of banking legislation and of banking problems as the Board saw them at the present time. In the second place, in answer to one of the innumerable bills about which we are constantly receiving inquiry, we sent out a statement on price stabilization which I don't know whether you saw or not; I don't recall whether that was issued before you left town.

HMJr: I read it in the paper.

R: Yes. Well now, those two things are, in effect, combined in this statement, the principle purpose of which is to say that we do not think that we can very intelligently continue to answer these innumerable requests for reports on bills, a very sweeping effect, unless we are enabled to answer them somewhat as a whole, and that while we very definitely believe that our statement on price stabilization is sound and is correct, that, at the same time, while it has received considerable favorable press comment, just between you and me, it has received some quite unfavorable comment in other quarters. And what we are attempting to say in this latest statement is that our own views are just as much subject to review in our opinion as the views of anyone else on these questions, but we don't want them reviewed piecemeal. Now, I will tell you this, if I may, that the thing which precipitated this is the Brown Bill, about which you may or may not know. I don't know whether you do.

HMJr: I -- I'm familiar with it.

R: The Brown Bill apparently has, what I would say, was very substantial and influential backing in the Senate. It doesn't appear to us, any of us, at the moment to be anything like a fair solution of the problem. Speaking for myself, as I've said to you repeatedly, I don't want to come to final conclusions unless forced to do so, until the whole matter has been very objectedly and judiciously discussed. I don't think the Brown Bill does anything more than to destroy the Comptroller's office, and I have a feeling that the long record of that office is something which should not be lightly disposed of by a bill, the final and point of which seems to me to not only destroy the continuity of that office, but to begin working on the Federal Reserve System like Mr. Hitler worked on Czechoslovakia. If you take Sudetenland, it won't be long before you take the rest of it. Now, faced with the -- not the Brown Bill in of itself, because bills being introduced don't necessarily disturb anybody's peace of mind, but -- but what appears to be the feeling in Congress that it's time to act pretty quickly on this. We were told a week ago that hearings would be had within two weeks and it was expected that the Senate would act on the Brown Bill at this session. We thought it well to again remind Congress that that isn't the way we think these things should be approached.

HMJr: Well you see, I may be all wrong, but the President, besides the Fiscal and Monetary Committee, he has a committee on banking.....

R: Yes.

HMJr: And we are working like hell on it, and last year we didn't succeed in revising the examination report.

R: Yes,

HMJr: And made a very, I think, a constructive.....

R: Good job.

HMJr:good job in spite of Mr. Eccles. But we did do it all inside.

R: Yes.

HMJr: And today the thing is working along and it -- it's helpful. Now, you people make these moves.....

R: May be what?

HMJr: You make these different moves.....

R: Yes.

HMJr: I'm treated as though I was Secretary of the Treasury of -- of another country -- I -- I don't think that the Board can point to any important move that I've made where you are vitally interested that you are not informed.

R: I could not myself.

HMJr: I consulted the Chairman on all --several times on the Social Security thing. He wrote me a letter congratulating me on it.

R: Yes.

HMJr: Any move that I make, I make here with the cards up. I -- I don't think I've made any without letting you people know. We certainly haven't made any on the Brown Bill, and I've got nothing to do with it, and nobody in the Treasury has got anything to do with it. I think you know that.

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R: Oh, certainly.

HMJr: Now.....

R: I don't think it would be any more your choice than it would be mine.

HMJr: Now, in this morning's Wall Street Journal, which may be just another story: It says -- I just read it -- it says that Senator Wagner was talked to last night and he knows all about this and is going to introduce a resolution along these lines.

R: That I -- that I don't know. The only thing I know about Senator Wagner is that some two months or more ago.....

HMJr: Well let me just.....

R: Surely.

HMJr: Read one paragraph which has nothing to do with bank examinations, which is strictly a Federal Reserve, Treasury question.

R: Yes, sir.

HMJr: The answer is "That powers over the supply of currency and banks reserves are divided between the U.S. Treasury and the Federal Reserve. 'While it appears to have been the intent of Congress that the Federal Reserve System have the responsibility for regulating the supply and cost of money, including currency and bank deposits, the powers over this supply -- the powers over this supply possessed by the Treasury now outweigh those of the System.'

Now that's got nothing to do, and -- it's just -- it -- well, I just like to feel that I'm here working for Mr. Roosevelt and I'm a member of the team; and this just makes me feel as though I was a rank outsider. And after all, this is a Board matter and I take it that you people have individual opinions, and I'm sorry that you treat me like an outsider, that's all.

R: Well, I'm terribly sorry that that is your deduction from that.

HMJr: Well, that's the way I feel.

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- R: And it may be a perfectly reasonable deduction.
- HMJr: And you think -- no reference is made to what this committee did last year on getting these bank reports more uniform, and it looks as though -- I may be wrong-- as though this was all a prearrangement with Senator Wagner.
- R: But that -- that's wrong, Mr. Secretary.
- HMJr: I don't know. You read the Wall Street Journal then.
- R: Well -- well.....
- HMJr: And, as I say, I have to get my information -- like the time you people increased the reserves, I had to read it in the newspapers the first time.
- R: Well, as far as any confidence with Senator Wagner -- I have had none whatever, and many months ago he had lunch with us and.....
- HMJr: Well, as far as I'm concerned.....
- R: In a most general way.
- HMJr:no matter how shabbily you people treat me, I'm not going to wash the Administration with a Republican and -- but I called up Mr. Eccles first to tell him and -- you're not -- he's not there, I'm telling you.
- R: Well now, I'm not going to.....
- HMJr: I mean, there's plenty of things that I could say. It isn't the Federal -- it isn't the duty, or necessity, or obligation, as Secretary of the Treasury, to bring it to the Federal Reserve's attention that they ought to remove the President of the Federal Reserve of San Francisco and things like that, and there are all kinds of things that I could say. And.....
- R: You mean the Chairman, not the President.
- HMJr: The Chairman of the Federal Reserve at San Francisco. Why the hell did the Secretary of the Treasury have to do that? And when all the information is available to the Board.....

- R: That information that you gave us on that particular gentleman was not available to us until you gave it to us.
- HMJr: You didn't know that he.....
- R: No.
- HMJr: owed eight or ten or twelve million dollars?
- R: Oh, we knew what he owed but we were assured that it was amply secured. That he was a stockholder was information which was wholly new.
- HMJr: Well, you had the same bank reports that I -- bank examinations that I did.
- R: Well, we didn't get -- that information -- in some way that didn't reach us. Perhaps it should have but it didn't, and when it did, I think you'll agree with me, that you got pretty quick action on that.
- HMJr: That -- well, anyway, I'm going to -- at my press conference, all I'm going to say, unless I change my mind, and if I do I'll let you know, that -- I'm simply going to say that the Federal Reserve Board -- that the first I knew about it was when I read about it in the newspapers. They didn't do me the courtesy of showing it to me in advance; and that's all. It's too bad, Ronald, I've tried my best, and after all, Eccles has won. Now, if Eccles doesn't like me and doesn't want to cooperate, you fellows over there ought to -- I -- I've never thought that that went for the whole Board.
- R: Well, it doesn't -- I don't think it goes for him, Mr. Secretary, frankly.
- HMJr: I mean, I never thought it went for you.....
- R: It doesn't -- it doesn't go for any member of the Board.
- HMJr: And -- but I don't see why the Board, as individuals, can't assert their own individual authority and why they've got to do things like this to me.
- R: Well, I.....
- HMJr: There are so many important things at home and abroad that need help, and this just -- all this does is just

completely upset me, and it doesn't put anybody to work; it doesn't help recovery one bit.

R: No, nor do I think the Brown Bill does either.

HMJr: No.

R: Now -- now we are confronted with a.....

HMJr: No, if, for instance, supposing we together didn't like the Brown Bill.

R: Yeah.

HMJr: Supposing Mr. Jesse Jones didn't like the Brown Bill.

R: Yeah.

HMJr: Or anybody else.

R: Yeah.

HMJr: And we went to the President and say, "We think the Brown Bill is wrong." I think we could kill it. But we can't do it by cutting each others' throats.

R: Well, I don't think that statement is designed for any remote sense to.....

HMJr: Well, I wish you'd repeat this conversation to the Board members for me.

R: Oh, surely.

HMJr: And I want you to tell them just how I feel.

R: I certainly wouldn't attempt to answer you in specifics until I reported it to them, because that is Board action and no individual.....

HMJr: Yeah.

R: ..Man's action.

HMJr: Yeah.

R: And I will certainly do that this morning, and if you would like me to after doing that I'll call you back.

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HMJr: I'd appreciate it.

R: O. K.

HMJr: Thank you.

April 10, 1939
10:40 a.m.

HMJr: This is Henry Morgenthau.
Preston Delano: I'm glad you're back, sir.
HMJr: Thank you.
D: Did you have a pleasant trip?
HMJr: Yes.
D: The particular reason I'm bothering you is that in regard to this letter that was drafted to be signed by Mr. Giannini and presented to us here.....
HMJr: Yes.
D:in relation to -- you remember that April 6th letter.
HMJr: Yes.
D: I want to explain that I -- I've tried to clear it with Eccles and with Leo Crowley.
HMJr: Yes.
D: But they are both out of town.
HMJr: Yes.
D: And have been since that date, and I have dates with both of them in the morning.....
HMJr: Yes.
D:when they return.
HMJr: Yes.
D: And I thought I'd tell you that so that you would understand why I haven't done it up to the present time.
HMJr: I see.
D: And the other thing, the letter of criticism -- you asked for a copy of our latest letter of criticism to banks.

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HMJr: Yes.

D: We are laboring with that, and I think we'll have it out by tonight.

HMJr: Good.

D: It isn't just a question of copying the letter that we've written; we haven't got the letter out yet.

HMJr: I see.

D: We've been sort of laboring in the vineyard with it because we want it to be very carefully drawn.

HMJr: Fine. Well, then when you're ready tomorrow why don't you give me a ring and I'll go over ^{it} with you personally.

D: All right, sir. I'll have that letter and -- and just as soon as I clear with Eccles and Leo on this other matter, why I'll -- I'll call you.

HMJr: What did you think of the Federal Reserve Board's statement that they sent up on the Hill this morning?

D: I didn't see it, Mr. Secretary.

HMJr: Well, I didn't either until I read it in the Times -- in the Times.

D: Oh, I -- I must get that. I.....

HMJr: Yeah.

D: They -- they sent it up this morning?

HMJr: A statement, yes -- on -- covering fiscal and monetary and bank examination.

D: Oh, is that so? Well, that whole question is very much up now at the moment, and when Mr. Hanes comes back I'd very much like to have a little conference with you on that.

HMJr: Yeah. I'd like to have -- I'd like to know where you stand yourself, and how you feel about it.

D: Yes. Well, I -- I'm -- I'll be glad to discuss it any time, Mr. Secretary, that you want.

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HMJr: Fine. Well, when Mr. Hanes gets back let's talk about it.

D: I thought it would be -- that would be preferable.

HMJr: That's right. O. K.

D: Good bye.

HMJr: Thank you.

D: Good bye.

TREASURY DEPARTMENT

INTER OFFICE COMMUNICATION

DATE April 10, 1939

TO Secretary Morgenthau
FROM Mr. White

Subject: Proposed Steps that can be Taken by the Administration in the Present Acute International Situation

I. Without additional legislation

1. Imposition of countervailing duties against numerous imports from Italy. There already exists enough evidence of a bounty on Italian imports to justify an immediate announcement of countervailing duties.

2. Requirement that goods from Manchuria and the occupied areas of China be marked "Chinese areas under Japanese military occupation" or some shorter variant. (This is permitted under Section 2 of the Customs Administrative Act of 1938.) The feasibility of the step has not been discussed.

3. The application of Section 338 against imports from Japan. (Revival of Mr. Cliphant's memorandum of October 12, 1936.)

4. Application of Section 338 against all imports from Germany. (This is a more drastic step. The factual basis for such action exists.)

5. Preparation of steps to be taken against imports from Albania. (Not important quantitatively, but important as a gesture. We are second to Italy in Albania's export market. Our total imports from Albania in 1938 were \$150,000.)

II. Measures which could be taken which require additional legislation.

1. Your suggestion of acquisition of strategic materials through international cooperation and for international prohibition of export of those materials to aggressor nations.

(The preliminary report on these proposals is ready.)

Secretary Morgenthau - 2

2. Accumulation of stocks of vital raw materials, calling for an expenditure of several hundred million dollars which could be acquired without additional borrowing. (We have a memorandum on this proposal.)

3. Embargo on the export of scrap iron as a defence measure.

4. Program outlined in my memorandum to you of March 31, 1939.

(not necessary
get copy from W.H.A.)

April 10, 1939

11:55 a. m.

Present:

Dr. White
Mrs. Klotz

HM, Jr: This is ultra-confidential.

I am going to ask the President whether I can bring down four people to the Treasury: Tom Smith, Basil Harris, Mr. Earle Bailie and Mr. E. R. Stettinius. The purpose is I have got a job for each one of them in case there is a world war -- Mr. Smith, to look after banking for me; Harris, to look after shipping and Customs; Earle Bailie, foreign exchange and the stock exchange, and Stettinius, the purchasing.

My thought is each one will come down and have his desk and have his whole organization set up, so if there should be a war the organization is there and all he has to do is come down here. I am going to get the President's O. K. so I can begin to function. They would be able men in the Treasury and two are entirely familiar with the Treasury and Stettinius has worked in the Government. But each one come down and they will be here long enough to get the thing running so if, for instance you may not know it -- the Treasury takes over the running of the Panama Canal. We run the Panama Canal. Things like that are just unbelievable. Of course, we take care of foreign shipping and it's just enormous. These men will discover fields that I have not.

Dr. White: And one other man. As long as you are asking, you might as well

HM, Jr: I went over this last night with Gaston and McReynolds and they thought it covered the field, but you can't tell.

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The pretty part of the idea is to have them come down and make what I call "a trial run" and get themselves so they would know what would flow to them and not just have it at the last minute. I know there is no such preparation anywhere. But I thought it was a pretty good idea. Of course, I have not talked to these people, but the complexity of the thing, when you get into it, is enormous.

Dr. White: Would Harris take Coast Guard?

HM, Jr.: No, that goes ordinarily to the Navy. It's transferred.

It's largely Customs and shipping and seizing of the boats and handling of the ports, and that whole business and that whole business, which is enormous. And each one of these people will say 'I want this one to help me' and they will be building up people they know in their field to come down. Gives them time to turn around.

Have you some reports for me?

(To Mrs. Klotz) I want to spend enough money to buy the necessities of war to make it impossible for Germany to go to war. I thought with the spending of not too much money we could control supplies so they can't buy.

(Dr. White handed the Secretary a memo entitled "Preliminary report on the possibilities of depriving the aggressor countries of needed strategic war materials. Copy is attached hereto.)

Dr. White: The summary is on the first page. In short, I don't think your first idea, by itself, will be sufficient.

HM, Jr.: Let's take oil.

Dr. White: Each one is treated separately toward the end.

The idea is very excellent if you can do both together,

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but if you just attempt to buy up any one of these materials or several of them -- take oil, for example. It's very doubtful if you could buy enough to accomplish your purpose. It would have to be accompanied by your second idea. The two together, I think, would be very effective. You would have to have Russia, United States and Great Britain, those three countries, to do the trick.

HM, Jr: What countries:

Dr. White: Great Britain, the United States and Russia.

HM, Jr: And you need Holland.

Dr. White: Holland, I am assuming, would follow. I am assuming Holland would follow Great Britain, just as Venezuela would follow the United States, and so on. On the oil situation, the United States, Russia and Venezuela produce 75% of the oil, and then if you get

HM, Jr: What page are you on?

Dr. White: Page 6. Bottom of page 6.

HM, Jr: (Reading) "The United States, Russia, Venezuela, together produce 75 percent of total oil output."

For Heaven's sake!

Dr. White: And then each one of the small countries could be taken care of. They produce an additional 10%. And that would leave too little for the other countries, although some of the other prospects are even better than oil.

HM, Jr: You say other things are easier?

Dr. White: To give you some idea: Germany needs 95% of your natural petroleum. She is supposed to produce about two-thirds of her requirements synthetically. So the War Department told me. From other evidence, I think that is somewhat exaggerated, but she needs a substantial amount. She needs 75% copper, needs 50% lead, 25% sulphur, 100% cotton, 95% bauxite, 10% zinc, 100%

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rubber, 95% manganese, 100% nickel, 100% chromite, 95% tungsten, 75% wool, 70% phosphates, 100% tin, 100% antimony, 100% mercury, 100% mica. Those are now important commodities and it's easy to control some of them.

HM, Jr: You are on page 5?

Dr. White: Yes. I was reading that list on page 5.

HM, Jr: Where does chromite come from?

Dr. White: Chromite? We did not go into chromite yet. Tungsten, they are supposed to have a big supply. 60% war stock, according to the War Department.

HM, Jr: In Germany?

Dr. White: In Germany.

HM, Jr: Nickel?

Dr. White: Nickel, they haven't got, and very easy to prevent them from getting it. You see, the British Empire produces 95%. The only other spot is New Caledonia, where Japan has mines.

HM, Jr: I think I am right that my thought -- of course, they call these sanctions.

Dr. White: Economic sanctions, equivalent to what they attempted with Italy.

HM, Jr: And didn't! I got the whole record. Look up how many times the sub-committee of the League of Nations on Oil was going to meet and how many times England called it off. Twice they were to meet on oil sanctions. They could have done it, and each time England backed down and this thing -- if England means business now, this is the way to find out. Put it right in her doorstep and say, All right, if you mean business, let's go after it. We would have to make a deal with Mexico.

Dr. White: So much the better. Clean that situation up.

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HM, Jr: But this thing could be done. How much do you say?

Dr. White: \$150,000,000 a month. That's just for buying.

HM, Jr: You don't need any money. You could do it with an agreement. I said if it would cost a billion dollars, it is cheap. If I am right that if -- right now I am not convinced that England and France mean business -- but if we went to them and started on oil (because I would only have to do business with about three people in the United States on oil, Standard Oil, Texas Oil and I don't know who the other is; they control; they are in the Roumanian fields, wherever England is) and right from here, in two weeks, I could find out whether England meant business on oil and if the President says he wants to do something other than just words and it was known that England and the United States "in case of war you don't get the stuff; if you don't stop this monkey business you don't get it" -- then what?

Dr. White: Well, I think you have got hold of something good here.

HM, Jr: Good? Come on! Raise it a little bit! Raise your ante!

Dr. White: Well, we did. We did in the paper and then cut it down and understated it because we did not want to be too enthusiastic.

HM, Jr: Do you know anybody who has got a better idea to stop war?

Dr. White: I don't know of anybody who has as good.

HM, Jr: I didn't do a thing while I was down South!

Dr. White: It's feasible. The only problem is a political one.

HM, Jr: This is just 100% opposite from Barney Baruch.

Dr. White: I think he's just crazy.

HM, Jr: I don't think he's crazy.

Dr. White: What I mean, he's just dead wrong, and dead wrong in such an important way -- it could not function.

HM,Jr: Is this in shape to give the President, as a preliminary.

Dr. White: I would prefer to have it re-written.

HM,Jr: Well, let's just see how much time he gives to me.

Dr. White: If you say it is just a preliminary survey.

HM,Jr: I don't know anybody that has anything else and I don't know whether England means business.

Mrs. Klotz: Then you will accomplish at least one thing: you will know where they stand.

Dr. White: We have gone over the field to know it is feasible; that the only problem is whether the President wants to push it and whether England and Russia can be drawn in, but so far as sources of supply are concerned, so far as Germany, Japan and Italy's needs are concerned, so far as expense that would be involved, so far as machinery that would have to be set in operation, it's feasible. Don't mean to say it's easy. It's difficult. But it's feasible. The rest is question of policy. The President does not for a moment in making his decision have to know whether it's feasible.

HM,Jr: Phil La Follette told me, in great confidence yesterday that Oumansky told him since Munich or whenever it was that Litvinof made the statement -- at Geneva it was -- they wanted to do something with England and that from that day to this they have not heard a thing. Phil La Follette was at the house yesterday.

Dr. White: I think there are so few people around, in important places, who appreciate what it means if Hitler has another victory or two. What it will mean to us, to America.

HM,Jr: But the point I got is -- I listened to Hull

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and the President today. I could see evidently the President said something yesterday about trade that upset Hull. And when I call up and say I want to do something in the Argentine, Feis answers me, "I don't think you can bring pressure in now because on the meat situation it might be the last straw to break Mr. Hull's trade treaty," and I felt like saying "Thank God for that!"

Dr. White: They are bungling this Latin-American thing. They are not doing anything in the Latin-American situation.

HM, Jr: I know that.

Dr. White: Just got a cable about Chile about two days ago. Did you read it?

HM, Jr: No. But the Argentine thing, the President has had that in his own hand for two years. Just a question of a little frozen meat. That's all. And I spoke to the President and he said, "I will take care of it" and I said -- I could not say, You have said that for two years -- so I said, Why don't you invite them up here?

Harry, I just have not gone stale. And now is the time to do the thing, because we got this neutrality thing, but the trouble is nobody has a neutrality policy and here's a policy.

Dr. White: Which would make the neutrality policy unnecessary.

HM, Jr: Here's a policy.

Dr. White: The biggest argument against it and one you will have to meet will be the one they will say it will precipitate war.

HM, Jr: My attitude, as always, on all of this stuff, that we have taken the other angle for five years and we are out.

Dr. White: I agree with you. And here's a brief memo -- I don't know whether you would be interested in that for the moment. (Memo entitled "Proposed steps that can be taken by the Administration in the Present Acute

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International Situation," copy attached.) Various things that we could do.

HM, Jr: Is this separate?

Dr. White: Yes. That's countervailing duties and other things. Those are minor.

HM, Jr: Harry, I will be seeing you, but

Dr. White: I am awfully glad you are pushing this, but you are going to meet with a lot of opposition, but you are right.

HM, Jr: I won't fight the President on it because I can't fight him on it any more on this sort of thing because this is a Presidential matter, but I will fight anybody else if he says this is O. K.

Dr. White: He is on your side?

HM, Jr: He's on my side and business conditions in this country are on my side.

How do the Leon Hendersonites and the rest of those boys feel these days?

Dr. White: They feel the New Deal is on the way out, pretty generally and pretty rapidly. General consensus. And that a strong foreign policy could snap them back.

April 8, 1939

Secretary Morgenthau

Mr. White

Subject: Preliminary report on the possibilities of depriving the aggressor countries of needed strategic war materials.

Summary

What are the possible measures short of complete military blockade which could prevent the countries from obtaining necessary strategic materials?

You have suggested two possibilities for preliminary examination:

1. Purchase and accumulation by leading non-aggressor nations of strategic materials.
2. Prohibition by international agreement of exports of certain of these strategic materials to aggressor nations.

The aggressor countries and their allies (Germany, Austria, Czechoslovakia, Italy, Albania, Japan, Spain, Hungary, Manchoukuo, parts of China) would, in the event of major conflict, need imports of roughly \$100 million per month of the following strategic materials:

Manganese	Rubber	Manila fiber
Copper	Petroleum	Tungsten
Tin	Nickel	Cotton

(There are several other items important strategically but not important quantitatively. Some of them will be taken up later.)

None of these commodities could be obtained in adequate amounts for the group as a whole except from countries outside those enumerated above.

In our opinion the measure -- if combined with the principle of the first proposal -- is effective, practicable, and relatively inexpensive. The real issue is whether it is yet politically feasible.

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1. The first proposal is for the United States, either alone or together with Great Britain and France, and possibly some smaller countries, to accumulate large stocks of these materials and thereby reduce the world supply available to the aggressor nations.

A survey of the consequence of such a step leads us to the tentative conclusion that if taken alone its efficacy lies far more in its political implications than in its economic or military effects. It does not appear that this method will either prevent the aggressor countries from obtaining adequate materials to conduct a war nor will it raise the cost of the materials to the aggressor countries enough to embarrass them seriously.

The political importance of such a step is that the United States would be taking common measures with the democracies of Western Europe against aggression. Germany fears greatly the industrial and economic might of the United States actively placed on the side of the European democracies.

The proposal taken by itself has the following disadvantages:

(a) The aggressor countries would still be able to obtain enough of the most important strategic materials to carry on a war. The increased demand for those commodities would before long call forth increased supplies and at the same time curtail consumption for industrial uses. The price of those materials, would, if it is true, increase substantially, yet not enough to reduce their foreign exchange resources sufficiently to interfere seriously with their purchases.

(b) Several of the aggressor countries doubtless have outstanding contracts which would provide additional stocks at current prices.

(c) The program would be expensive to democratic countries. In order to leave inadequate supplies for the aggressor nations they would probably have to purchase and withhold from the market at least \$100 million of material a month and possibly twice that amount.

(d) It would disrupt markets for peacetime consumption of these commodities. In all of these materials the industrial uses are far more important quantitatively than military uses.

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Though these disadvantages weigh heavily against the proposal solely as a device to deprive aggressor nations of needed materials serious consideration should be given to the accumulation of strategic materials by the United States on other grounds. In the event of war abroad, exports to the United States of certain vital raw materials from Asia may either be stopped or made subject to the will of Japan. Accumulation of certain vital raw materials should be undertaken not only to insure the amount of materials necessary for adequate defense, but to prevent our economy from being disorganized by the cutting off of the source of supply of needed raw materials as a consequence of a major war.

The materials which we must have and which we must obtain from areas vulnerable to foreign naval interference include tin, rubber, manganese, tungsten, manila sisal, mica and raw silk.

A one or two year supply of these materials could be obtained with an expenditure of about several hundred million dollars. Incidentally, increased purchases of that magnitude would help stimulate our exports. These purchases could be financed in any of several ways which would not involve an increase in the deficit.

2. The second proposal you wished to have examined is an attempt to secure an agreement among as many of the non-aggressor nations as possible to prohibit the exports to aggressor nations either directly or indirectly of as many of the important strategic materials as would be feasible.

A preliminary survey indicates that this proposal is feasible.

- (a) The sources of supply of at least eight of the vital strategic materials which the aggressor countries (taken together) must import are almost completely under the control of the United States, the British Empire, France, Russia, Netherlands and Belgium. For several additional major items the inclusion of one or two more countries would make the control complete.
- (b) The value of the imports by the aggressor nations of those materials is not so large as to make it impracticable for the leading non-aggressor countries to bear the expense or burden incident to such a program.

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Methods of compensation or purchase can be devised which will eliminate opposition by small countries and private corporations based on fears of economic loss.

(c) The aggressor nations would be extremely vulnerable to what would virtually amount to an embargo of vital materials. These countries must import substantial quantities of these materials not only to maintain their military strength but to prevent a sharp deterioration in their economy.

(d) In the case of nickel, tin and oil (if Russian and Mexican oil could be taken care of) relatively a few corporations control the international market and effective cooperation could be easily obtained.

The difficulties of the plan are:

(a) It would be essential to have the enthusiastic support of the British Empire and of Russia.

(b) England, France and Russia must be willing to give military guarantees to the smaller countries cooperating. This is particularly true of the Netherlands and Rumania.

(c) The great majority of the people of the United States must be in favor of that degree of American participation in foreign affairs involved in the plan.

(d) The principal argument that will be used against this measure is that its adoption would precipitate war.

(e) To be effective, the steps taken must be such as will prevent shipments of strategic materials from non-cooperating countries from reaching the aggressor nations.

(f) The period of negotiations should not be long enough to permit the aggressor nations to accumulate such larger stocks.

Conclusion:

In our opinion the measure -- if combined with the principle of the first proposal -- is effective, practicable, and relatively inexpensive. It is a measure which comes under the "quarantine-the-aggressor" principle of the President's Chicago speech. The real issue is whether it is yet politically feasible.

Any step in the direction of this proposal will have a powerful political effect in raising the morale and encouraging the democratic countries to make firm stand against further aggression. Even discussion -- if official -- of the proposal would be a help in that direction.

The following briefly outlines the situation with respect to the more important commodities:

A preliminary survey of the resources and needs of the aggressor nations indicates that none of them produces adequate amounts of many of the important strategic materials.

Germany, when fully organized for war, must either import, have substitutes for, or have stocks of the following essential raw materials:

95% of natural petroleum	10% of zinc	75% of wool
75% of copper	100% of rubber	70% of phosphates
50% of lead	95% of manganese	100% of tin
25% of sulphur	100% of nickel	100% of antimony
100% of cotton	100% of chromite	100% of mercury
95% of bauxite	95% of tungsten	100% of mica

Italy, Japan (and their allies) can supply Germany only with sulphur, zinc, lead, mercury and some copper.

The situation with respect to Italy is even worse and with Japan, equally bad. Japan must import:

35% of her iron	100% of her bauxite	100% of her wool
55% of her oil	50% of her zinc	75% of her potash
5% of her copper	100% of her rubber	75% of her phosphates
80% of her lead	50% of her manganese	90% of her antimony
80% of her cotton	100% of her nickel	75% of her tin
		90% of her mercury

Of these items her allies could supply Japan with nitrate, potash, zinc, lead and mercury.

These figures indicate that measures which would be ineffective against the British Empire, the United States or Russia are feasible against the present aggressor bloc.

Before any conclusions may be finally drawn with respect to the efficacy of my proposal, we need more information with respect to the stocks on hand in the aggressor nations and their needs during the conduct of a major war. We have some information on these points, but not enough.

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(a) Nickel

The British Empire produces 95 percent of the total. Japan owns nickel ore mines in New Caledonia, but New Caledonia is under French control. Therefore, it would seem to be relatively easy to prevent the direct export of this metal to the aggressors.

(b) Manganese ore

This (according to the men in the Navy Department with whom I spoke) is one of the three most important of all the strategic materials. The chief sources of manganese are Russia (along the Black Sea), the British Empire, Brazil and Cuba. The best quality manganese comes from Russia. Numerous countries (see Appendix) produce small quantities.

Of these smaller countries, Rumania, Hungary, Bulgaria, produce approximately 50,000 tons, and Japan produces 70,000, Italy 25,000, making a total of approximately 200,000 tons that would be available to the aggressor countries from within their own group. Whether 200,000 tons a year would be enough to keep the aggressor powers adequately supplied is doubtful but we need more information on this point. Judging from the fact that the stock pile recommended for the United States by our military authorities is 1 million tons of ore, and that German imports were around 400,000 tons in 1938, an annual supply of 200,000 tons for all the aggressor nations seems inadequate.

(c) Copper

Leading copper producers are United States, the British Empire, Chile, Belgian Congo, Russia. These five groups together produce 90 percent of total world output. Japan, Yugoslavia, Spain and Germany together produce roughly 200,000 tons a year. Together, Japan, Italy and Germany imported double that amount in 1937.

(d) Oil

The United States, Russia, Venezuela, together produce 75 percent of total oil output. The British Empire, Iran, the Netherlands East Indies, Mexico, Colombia, produce an additional 10 percent. Italy produces virtually none; Germany and Japan together, about 8 million barrels, or less than 1/2 percent of the world output, Poland, 4 million barrels and Argentina, 17 million barrels.

HDW:lrs
4/10/39

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Germany, however, produces a high grade synthetic fuel which is reported (by the War Department) to supply two-thirds of her current needs. To judge from the continued increase in petroleum imports from 1935 thru 1938 this is doubtful. Japan and Italy, however, so far produce only negligible quantities of synthetic fuel, though they are increasing their capacities. It appears that Germany cannot supply herself and certainly not the other aggressor countries. Germany is reported to have large stocks on hand.

In order to bar enough exports to the aggressors, the oil from Rumania, Mexico, Venezuela, Colombia and Russia would have to be included in the agreement.

In the case of oil there is another possibility that presents itself. It may be possible to operate through controlling companies. It would probably be found that a few large oil companies control the supply of oil even outside the United States, British Empire and Russia. Therefore the approach might be through the companies in those countries outside of the three mentioned.

(e) Tungsten ore

The bulk of tungsten ore is produced by China, British Empire and the United States. But Portugal produces 2 million tons (almost as much as the United States) and Germany is reported (by the War Department) to have accumulated an enormous stock pile equivalent to 60 percent of the world stock of tungsten ore which she obtained from China. More information would be necessary before you can conclude whether anything can be accomplished by the prohibition of tungsten from export.

(f) Tin

The aggressor nations produce very little tin. The British Empire, Bolivia, and the Dutch East Indies, Siam, China, produce 95 percent of the total tin output. Germany, Italy and Japan imported 20 percent of the 1938 output, and almost that in earlier years. If they do not have adequate stocks on hand and if the enumerated countries would agree to prohibit exports of tin we have here a commodity which might well lend itself to such agreement. According to the War Department it is of first rank importance for numerous uses in military purposes.

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(g) Rubber

Germany, Italy and Japan produce no natural rubber. Their imports in 1937 constituted about 18 percent of the total world output of natural rubber. The British Empire, the French Empire and the Netherlands Empire together account for 94 percent of the total world output. The only two countries outside of these three empires that produce substantial quantities of rubber are Siam, which produces 4 percent, and Brazil, which produces 1 percent. It is reported that Germany will be 25 percent self-sufficient by means of synthetic rubber at the end of 1939 and 50 percent self-sufficient at the end of 1941.

(h) Cotton

Cotton linters are essential in the manufacture of powder. For Japan, Germany and Italy cotton would also be essential for their export industries and home consumption. These three countries imported 40 percent of the total world imports in 1937. The United States, the British Empire and Russia produce three-fourths of the world raw cotton. China did produce about 10 percent and a portion of that output is in areas under Japanese control. Brazil produces about 7 percent. It is very doubtful whether Japan or Italy have large stocks of cotton on hand, though it is reported that there were substantial stocks in Germany.

There are numerous other strategic war materials but either they are produced in adequate quantity among the aggressor nations (e.g., raw silk, sulphur, bauxite, optical glass) or they are very unimportant in total value (e.g., quartz crystal, molybdenum, etc.). In a more comprehensive report it would be necessary to study numerous of these minor commodities (for example, quartz crystal, is essential in radio equipment and is found only in Brazil; manila fiber has no substitute, is absolutely essential in merchant marine and is found only in the Philippines and Sumatra; mica has no satisfactory substitute for important electrical uses; only known sources India and Madagascar; hides and wool are essential important and costly items which the aggressor countries import in large amounts.

(Appended are some tables of source of supply and of imports of leading strategic war materials.)

HDW:lrs
4/10/39

Rubber

	<u>Present Production</u>	<u>Present Stocks</u>	<u>Apparent Consumption or</u>
	<u>(Long tons)</u>		<u>imports in 1937</u>
Germany	-		115,008
Italy	-		24,820
Japan	-		62,182

Leading producers of rubber in 1937

Netherland Indies	431,646	British Empire	596,463
		Malaya	469,960
French Indo China	43,399	Ceylon	70,359
		Sarivak	25,922
Siam	35,551	North Borneo	13,213
Brazil	15,576	India	9,777
		Burma	7,232

JSH:lrs
4/10/39

Copper ore

	<u>Present Production</u> <u>(In metric tons)</u>	<u>Apparent Consumption or</u> <u>Net Imports in 1937</u>
Germany	28,000	263,000
Italy	417	80,000
Japan	100,000	210,000

Leading producers of copper ore in 1937

United States	760,000	British Empire	489,000
Chile	413,000	Canada	249,000
Belgian Congo	150,000	Northern Rhodesia	180,000
U. S. S. R.	93,000	Australia	20,000
Mexico	46,000	Cyprus	17,000
Yugoslavia	42,000	Union of S Africa	12,000
Peru	36,000	British India	11,000
Spain	30,000		
Norway	23,000		
Cuba	13,000		
Finland	12,000		
Sweden	8,000		

Tin

	<u>Present Production</u> (In long tons)	<u>Apparent Consumption or</u> <u>Imports in 1937</u>
Germany	100	15,800
Italy	443	4,618
Japan	2,210	11,000

Leading producers of tin in 1938

Bolivia	25,371	British Empire	61,773
Netherlands		Malaya	43,247
E. Indies	21,001	Nigeria	7,305
Siam	13,616	Burma	3,990
China	11,250	Australia	3,600
Belgian Congo	7,316	United Kingdom	2,000
Poland	1,819	Union of S. Africa	558
French Indo		Uganda	374
China	1,575	Southern Rhodesia	267
Argentina	1,335	Tanganyika	263
Portugal	800	S. W. Africa	169

 ISH:LES
 4/10/39

Nickel

	<u>Present Production (in metric tons)</u>	<u>Apparent Consumption or Imports in 1937</u>
Germany	300	14,000
Italy	-	2,500
Japan	-	8,000

Leading producers of nickel in 1937:

New Caledonia	6,830	British Empire	103,183
U. S. S. R.	2,000	Canada	101,963
Norway	1,505	British India	1,220
Greece	1,255		

JSH:lrs
4/10/39

Tungsten ore

	<u>Present Production</u>	<u>Apparent consumption or imports</u>
	(In metric tons)	
Germany	-	
Italy	-	
Japan	2,000	

Leading producers of tungsten ore in 1937

China	17,805	British Empire	7,675
United States	3,175	British India	5,300
Portugal	1,948	Malay States	1,200
Bolivia	1,802	Australia	900
Argentina	702	Southern Rhodesia	275

JSH:uh
4/10/39

Manganese ore

	<u>Present Production</u>	<u>Apparent consumption or imports in 1937</u>
--	-------------------------------	--

(In metric tons)

Germany	242
Italy	25,000
Japan	70,000

Leading producers of manganese ore in 1937

(In metric tons)

U. S. S. R.	3,000,000	Chile	5,000
Brazil	253,661	Bulgaria	3,000
Cuba	131,299	British Empire	<u>2,132,661</u>
French Morocco	79,113	British India	826,498
China	51,545	Union of	
Rumania	50,749	South Africa	631,194
United States	43,000	Gold Coast	535,838
Hungary	25,000	Egypt	134,972
Philippines	12,206	Northern	
Netherland Indies	8,600	Rhodesia	2,379
Sweden	6,000	Australia	2,000
Turkey	5,200		

JSH:mb
4/10/39

Crude petroleum

	<u>Present Production</u>	<u>Apparent consumption, or imports in 1937</u>
(In thousand barrels)		
Germany	4,300	40,000
Italy	109	17,500
Japan	3,614	35,000

Leading producers of crude petroleum in 1938

(In thousand barrels)

United States	1,212,530
U.S.S.R.	217,535
Venezuela	191,593
Iran	74,154
Netherland East Indies	60,165
Rumania	48,800
Mexico	38,861
Colombia	21,315
Argentina	16,900
Peru	16,045
Poland	3,790
British Empire	<u>41,209</u>
Trinidad	17,750
British India	9,648
Bahrain Island	8,361
Canada	7,450

JSH:mh
4/10/39

Raw cotton

	<u>Present Production</u>	<u>Apparent consumption or net imports in 1937</u>
(In thousand bales)		
Germany	-	1,500
Italy	20	500
Japan	216	4,200

Leading producers of cotton in 1938

United States	18,746
China	3,600
U.S.S.R.	3,482
Brazil	2,205
Peru	424
Mexico	326
Argentina	281
Turkey	157
Iran	156
Belgian Congo	141
British Empire	7,697
British India	4,867
Egypt	2,282
Uganda	314
Egyptian Sudan	234

April 10, 1939

Secretary Morgenthau

Mr. White

Subject: Proposed Steps that can be Taken by the Administration in the Present Acute International Situation

I. Without additional legislation

1. Imposition of countervailing duties against numerous imports from Italy. There already exists enough evidence of a bounty on Italian imports to justify an immediate announcement of countervailing duties.
2. Requirement that goods from Manchuria and the occupied areas of China be marked "Chinese areas under Japanese military occupation" or some shorter variant. (This is permitted under Section 2 of the Customs Administrative Act of 1938.) The feasibility of the step has not been discussed.
3. The application of Section 338 against imports from Japan. (Revival of Mr. Clichant's memorandum of October 12, 1938.)
4. Application of Section 338 against all imports from Germany. (This is a more drastic step. The factual basis for such action exists.)
5. Preparation of steps to be taken against imports from Albania. (Not important quantitatively, but important as a gesture. We are second to Italy in Albania's export market. Our total imports from Albania in 1938 were \$150,000.)

II. Measures which could be taken which require additional legislation.

1. Your suggestion of acquisition of strategic materials through international cooperation and for international prohibition of export of these materials to aggressor nations.

(The preliminary report on these proposals is ready.)

4/10/39 - Original to Secretary

Secretary Morgenthau - 2

2. Accumulation of stocks of vital raw materials, calling for an expenditure of several hundred million dollars which could be acquired without additional borrowing. (We have a memorandum on this proposal.)

3. Embargo on the export of scrap iron as a defence measure.

4. Program outlined in my memorandum to you of March 31, 1939.

HDW:lrs
4/10/39

April 10, 1939

I got an O.K. from the President today to talk to
Calvert Magruder about the General Counselship position.

April 10, 1939
12:02 p.m.

HMJr: Hello.

Operator: Go ahead.

HMJr: Hello.

James Farley: How do you feel?

HMJr: Mentally, all right; physically, a little bit below par.

F: That's too bad.

HMJr: How are you?

F: Fine, thanks. I had a bad cold. I stayed up here, and I have to go to Albany to a dinner tomorrow night..

HMJr: Oh.

F: So I won't be down there until Wednesday. I'll be there Wednesday and Thursday.

HMJr: That'll.....

F: We got some replies and I'm going to get Bray to send them over to you.

HMJr: Yes.

F: So with -- as fast as we get them in we'll get them in your possession.

HMJr: How do they look?

F: Well, now to be truthful with you, Henry, I haven't even read them.

HMJr: I see.

F: To be honest with you, I told Mrs. Duffey to get them right down.....

HMJr: Right.

F:to Bray, so that we could get them over to you. You see?

HMJr: Good.

- 2 -

F: Now, I'm honest with you. I haven't read them; I told them to make copies for me.

HMJr: Right.

F: But I'll get them right over to you.

HMJr: Well, that's -- I'm going to see you when you're down here?

F: Yes, positively. You're all right, are you, outside of that?

HMJr: Oh, yes.

F: Has the boss arrived?

HMJr: He got in this morning.

F: I see.

HMJr: I'm having lunch with him.

F: Well that's fine. The state of the nation is apparently all right.

HMJr: So far.

F: By the way, Henry, it's rather an interesting thing -- despite supposedly falling off of business, which you and I have discussed, the doggone postal receipts keep coming up all over.

HMJr: Well, I'll be darned.

F: It's an amazing thing. Of course, you -- if you haven't got on your desk yet you will be getting from me those weekly reports, see?

HMJr: Uh-huh.

F: It's quite amazing. Now, last week they were up five per cent in the twelve large cities.

HMJr: Well, I'll be darned.

F: It's an amazing thing. Now, they've held up right along during this last month or six weeks -- during this rather bad period, if you want to put it that way.

HMJr: Yes, that is interesting.

F: It's an amazing thing, and it's rather general, Henry, too. It isn't sectional in character.

HMJr: Well, when you're down I'd like to see you.

F: Well, I'll be delighted to see you. Meanwhile, you hold the lines. I was delighted to see you out with the colored folks yesterday.

HMJr: (Laughter) Well, it was a great speech. There was a great show yesterday.

F: I imagined it was. Harold was right in his element, I suppose.

HMJr: Yeah. It really was a great show.

F: Yeah. I would imagine so. I saw the pictures of them.

HMJr: Yeah.

F: Well, I'll see you when I get back, Henry.

HMJr: O. K.

F: When I get down there.

HMJr: Good bye.

F: All right, Henry.

April 10, 1939
3:57 p.m.

HMJr: Hello.

Operator: Yes, sir.

HMJr: Well, on this Ronald Ransom thing, I'll be in a press conference at sharp four.

O: All right.

(Pause)

HMJr: Hello.

O: Governor Ransom. Go ahead.

HMJr: Hello.

Ronald Ransom: I'm sorry I missed you when I called you back.

HMJr: That's all right. Hello, Ronald, how are you?

R: Fine, thank you. I reported our conversation as near verbatim as I could to the Board this morning. Both Marriner and John McKee are out of town for the Easter holiday.

HMJr: Oh, yes.

R: They had a feeling that as we were having a regular Board meeting tomorrow morning, they would like me to make the report -- they thought at the time they would have a full Board meeting. I'm not sure about McKee -- I doubt if he's here -- Marriner will be here.

HMJr: Yeah.

R: And then we would like to call you back after I do that.

HMJr: All right.

R: Now, may I make one suggestion for your consideration?

HMJr: Please.

R: I would like very much to feel that I could bring the other five members of this Board together with you --

- 2 -

just the six of us -- in an entirely informal and friendly conference so that we can discuss out the questions of -- the question that will repeatedly come up as to matters which should be discussed between these two agencies so that we can, as nearly as possible, always avoid any possible misunderstanding in the future.

HMJr: Well, that suits me down to the ground.

R: You'd do that, wouldn't you?

HMJr: Oh, of course.

R: All right. Now.....

HMJr: Now when you say, the six others, you mean that's the whole Board.

R: I mean the whole Board, yes.

HMJr: Yeah. Why, of course.

R: All right. Now, when they get back, I'm going to propose that and I think we can get a procedure where this wouldn't occur again.

HMJr: Well, there's nothing that would please me more.

R: Thanks. All right.

HMJr: Good bye.

April 10, 1939.

The Honorable,
The Attorney General,
Washington, D. C.

My dear Mr. Attorney General:

I transmit herewith a letter, in the usual form, addressed by the Commissioner of Internal Revenue to Assistant Attorney General Morris, recommending that criminal proceedings be instituted against M. L. Annenberg for stated violations of the internal revenue laws. I of course concur in the Commissioner's recommendation, and in view of the grave character of the violations and in accordance with my conversations with you on the subject, I am taking the liberty to bring it to your personal attention. The Treasury Department is prepared to cooperate with the officers of the Department of Justice in any steps necessary to the success of the prosecution recommended, and its facilities will at all times be at your disposal to that end.

Sincerely,

Wendell H. Douglas, Jr.

Secretary of the Treasury.

ENG/mrf

Released by The [unclear]
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OFFICE OF
COMMISSIONER OF INTERNAL REVENUE
ADDRESS HEREIN TO
COMMISSIONER OF INTERNAL REVENUE
WASHINGTON, D. C.

TREASURY DEPARTMENT

WASHINGTON

April 10, 1939.

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MEMORANDUM FOR THE SECRETARY:

In re: Moses L. Annenberg.

There is attached a letter to the Department of Justice in which I am recommending that the above-named individual be prosecuted for attempted income tax evasion for the years 1933 to 1936, inclusive. The letter contains a detailed statement of the manner in which the attempted evasions were accomplished.

The principal items of evasion, as enumerated in attached letter, are as follows:

- (a) Profits of over \$200,000 a year from the sale of gambling paraphernalia, known as "wall sheets", were omitted and their receipt was concealed by a complicated series of manipulations. This item is discussed in detail under heading No. 1 in the attached letter.
- (b) Income from Canadian business received by Annenberg in a clandestine manner and totaling over \$30,000 a year was omitted. This item is discussed under heading No. 2 in the attached letter.
- (c) When Annenberg bought the stock of the General News Bureau his corporation paid \$750,000 for such stock. However, the item was entered on the books of the purchasing corporation at a cost of \$350,000 and the \$400,000 overstatement was received in currency by Annenberg. This item is discussed under heading No. 3 in the attached letter.
- (d) Personal and non-deductible expenses of Annenberg, such as the cost of settling a criminal prosecution against him and his son, the cost of a wedding party for his daughter, etc., were charged to expense accounts of various corporations controlled by him. Improper withdrawals were also made from such corporations by Annenberg for his personal use and charged to expenses. These items are discussed under heading No. 5 in the attached letter.
- (e) Under the guise of advances from one of his corporations to another, Annenberg received in excess of \$2,000,000 in a manner which ordinarily would conceal the fact that he in reality had received income of this amount. This item is discussed under headings No. 8 and No. 9 of the attached letter.

(f) To conceal the true ownership of the stock of his top holding corporation, The Cecelia Company, Annenberg caused one-sixth of the stock to be issued in the name of a confidential employee who denies that he ever owned any stock in that corporation and whose name was dropped from the list of stockholders when the name of the corporation was changed. One-sixth of the stock of this corporation was worth almost \$1,000,000, which will indicate the magnitude of the manipulation. This had the effect of cutting down Annenberg's surtaxes. In addition, if it can be shown in the Grand Jury investigation that the remaining stock standing in the names of Annenberg's children was really his, more than \$500,000 of surtaxes will be found to have been evaded on this item alone.

I am of the opinion that a criminal case has been made out for deliberate concealment of taxable income and planned evasion of surtaxes, and that the reference of the case to the Department of Justice at this time for the institution of criminal prosecution is fully warranted.


Commissioner.

TREASURY DEPARTMENT

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INTER OFFICE COMMUNICATION

CONFIDENTIAL

DATE April 10, 1939

TO Secretary Morgenthau
FROM Mr. Haas 
Subject: The Business Outlook.

The situation in brief

A marked slump in business sentiment has occurred during the past three weeks. Trade analysts blame it chiefly on the crisis in Europe, and cite as a contributing factor a relapse, or failure to carry through, of an Administration accord with business. The change in sentiment has been reflected in, and affected by, a severe drop in stock prices on the domestic markets to levels below the Munich lows. Stock markets abroad have also been affected, but have held relatively steady in comparison with New York, and foreign selling has not been an appreciable factor in the decline in our markets.

The European crisis so far has had little measurable effect on actual business activity, though it has apparently been a factor in preventing a seasonal improvement in new orders. Its chief effect has probably been on the buying policies of those who see in the stock market decline a forecast of a decline in business.

The current situation has been complicated by a somewhat vulnerable position of the automobile industry, combined with an unusually cold and rainy spring which has restricted sales of new cars. This has had repercussions on operations in the steel industry. Resulting downturns in automobile output and steel production have given the impression that business is getting worse, adding to the general unsettlement. In more recent weeks, however, a marked improvement in new car sales has made an important change in the automobile picture.

We think that much of the current pessimism over the business outlook is unjustified. There is little doubt, however, that the serious turn in European affairs initiated by Germany's violation of the Munich agreement has in some degree postponed the 1939 recovery. It has had a deflationary effect on commodity prices, and has set in motion various influences discouraging private business expansion.

The outcome of the European crisis is, of course, impossible to predict. Unless developments abroad become definitely more serious, however, our analysis of the situation shows little basis for expecting any serious business decline.

The present position of business

The spring improvement in business which many had expected has apparently been held back, and recovery has been postponed, by a tendency to withhold new orders and reduce commitments in various lines of industry, owing to developments arising from the serious turn in European affairs. Among these developments, the severe stock market decline has probably had most effect on buying policies.

In one respect the war scare came at an unfortunate time. In a period of rising business activity it might have caused merely a few weeks' interruption of the upward trend, as was the case last September. With production about in balance with demand, as in the present situation, it is likely to delay the regaining of momentum on the up-side and may result in some prolonging of the recent setback in industrial production. The FRE index stood at 98 in February, and apparently held at about that level during March.

Nevertheless, we believe that current fears of a business setback, as reflected in the severe stock market break, are exaggerated. The present position of business does not justify fears of a serious decline, barring the unpredictable possibility of more serious developments in Europe. The cautious inventory policy which most businessmen and most lines of industry have followed during the past six months serves as protection against a general liquidating movement and against a prolonged postponement of new buying. The absence of excessive speculation in stocks or commodities in recent months is likewise a favorable factor.

Our basic indices (See Chart 1) confirm the absence of serious maladjustments. Of particular significance is a strong upward trend in consumer buying (center graph) which, according to our estimates, continues to exceed the level of industrial production. This has apparently not, as yet, been fully translated into new orders, since these have not shown a seasonal spring upturn. Our estimates indicate that the level of basic demand has been reduced slightly in recent months, accompanying the setback in industrial production, but it remains at approximately the current level of production.

New orders affected by war fears

New orders in recent weeks have failed to show a seasonal increase sufficient to indicate a nearby improvement in industrial activity. Our combined weekly index (See Chart 2) has tended downward during March owing to a marked decline in textile orders, which was accompanied by a disappointingly small improvement in steel orders. The trend of orders for products other than steel and textiles, on the other hand, has shown an uptrend similar to that in March last year.

It is possible that the effect of war scares in general on industrial buying has been somewhat exaggerated by business writers. As will be noted in Chart 2, our new orders index showed no apparent effect of the Munich crisis last September nor of the French-Italian crisis last January.

The current decline in textile orders, upon analysis, has apparently been due in considerable degree to uncertainty over the proposed Government subsidy on cotton exports, and the market undertone remains steady. The smallness of the rise in steel orders likewise has been due in part to influences other than the foreign crisis, notably to the failure of automobile steel buying to show a normal spring increase. On the other hand, trade writers mention that in recent weeks a decline in new orders and inquiries, and requests for deferment of deliveries have been noted in various industries.

Decline in sentiment rather than business

Our analysis of factors in the current situation leads to a belief that the present slump is one of sentiment rather than actual business. In recent interviews, I have found businessmen at a loss to explain the decline in the stock market, in view of trends in their own sales. It remains an open question whether this slump in sentiment will be translated into a further business setback, though it will undoubtedly tend to postpone the beginning of a renewed upturn.

An important contributing factor to the bearish sentiment has been the break of 30 points in the Dow-Jones industrial stock average in less than a month, carrying it below the Munich lows, and indicating to the many followers of the "Dow theory" that the major trend of the stock market is downward. We are impressed, however, by the relative steadiness of stock prices in London and Paris recently, in comparison with New York, and by the fact that foreign selling has not been a noticeable factor in our stock market decline, which suggest that our market may have been over-discounting war fears. (See Chart A attached.)

Secretary Morgenthau - 4

On the other hand, according to various business writers, domestic confidence has also been affected by a loss of faith in the permanence of the move toward a closer accord between Government and business, which early in March had been credited by the press with an important share in the revival of confidence then developing. Corporation officials recently interviewed place emphasis on this factor.

A decline in commodity prices accompanying the European crisis has carried some sensitive prices sharply lower. Spot price indices for farm products and industrial raw materials (See Chart 3) have turned downward, but the declines so far have not been extensive.

The automobile situation

The failure of steel orders to show a seasonal increase has been due principally to a lack of the usual spring buying from the automobile industry, where the outlook has been clouded by an accumulation of new car inventories in factory and dealer hands. Retail automobile sales during the first two-thirds of March were held back by unseasonably cold and rainy weather, leading to a fear in some quarters that a general curtailment of automobile production would be necessary, with its unfavorable repercussions on other industries. A decline in output during the week ending April 1 seemed to confirm these fears.

During the last ten-day period of March, however, new car sales turned sharply upward despite continued cold weather, according to confidential data just received from General Motors Corporation, 65,000 units being sold in that period versus 39,000 and 36,000 in the two preceding periods. This raises the total sales of the Corporation for March to 68 per cent over February, the third largest February-March increase since 1929, according to preliminary figures. The sales upturn places the automobile outlook in a definitely more favorable light.

Current business trend steady

The New York Times adjusted business index has remained generally steady over the past several weeks, with the week ended April 8 showing a gain of .9 point to 89.4. Substantial increases in the indices of electric power production and lumber production were largely responsible for the upturn, offsetting a sharp decline in the automobile production index.

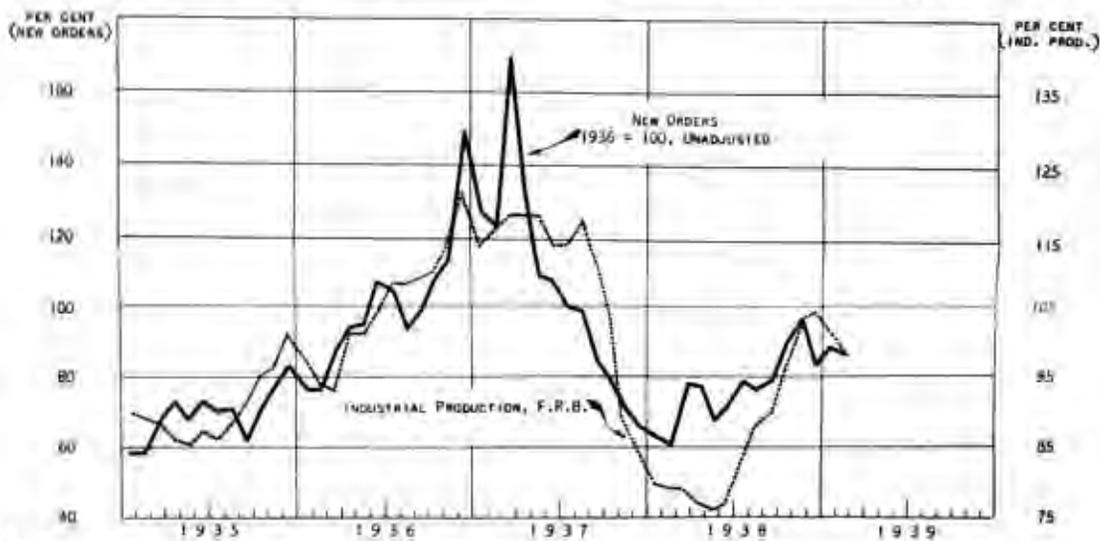
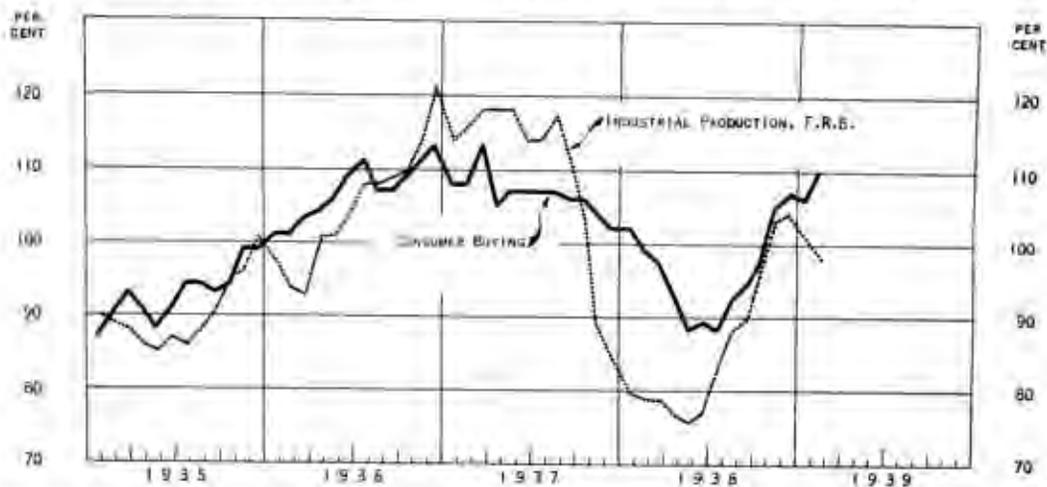
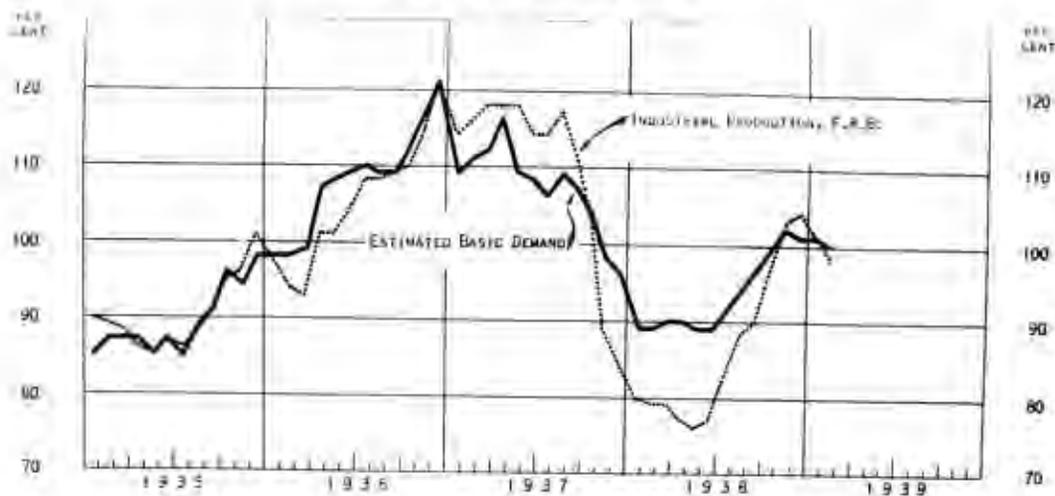
In Chart 4 the New York Times index (dotted line), in comparison with our weekly index of new orders, shows business activity to be in a relatively firm position on the basis of past relationships, unless new orders decline further.

A marked improvement in residential contract awards during March (See Chart 5) suggests that the construction industry will offer continued support to business activity this spring.

In Great Britain, the trend of business activity has levelled out during March, according to the weekly index of the Financial Times of London, following its steep February upturn. (See Chart 6.)

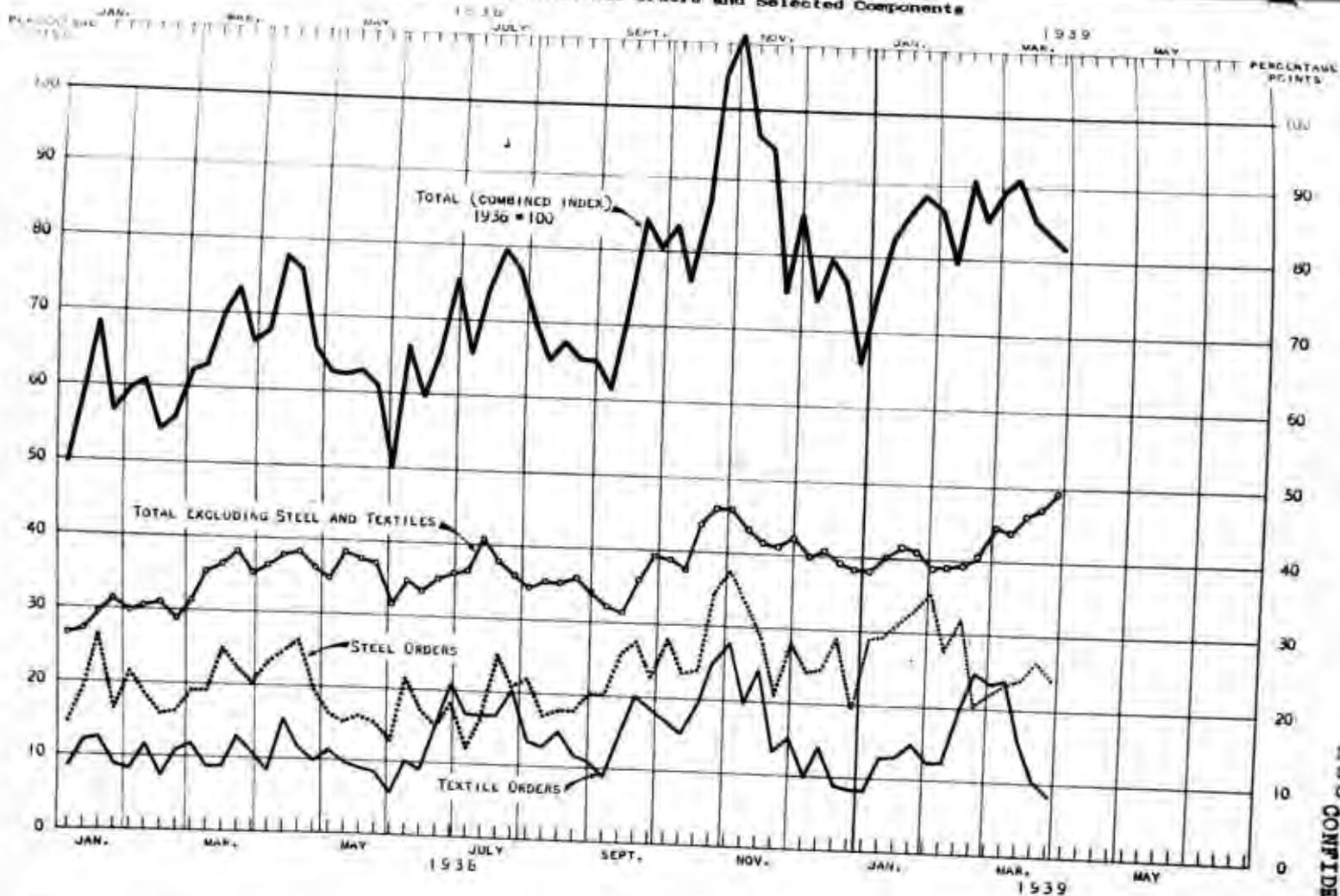
INDICES OF BASIC BUSINESS TRENDS COMPARED
WITH INDUSTRIAL PRODUCTION

1923 = 100, SEASONALLY ADJUSTED*



* EXCEPT NEW ORDERS

INDEX OF ORDERS
 Combined Index of New Orders and Selected Components



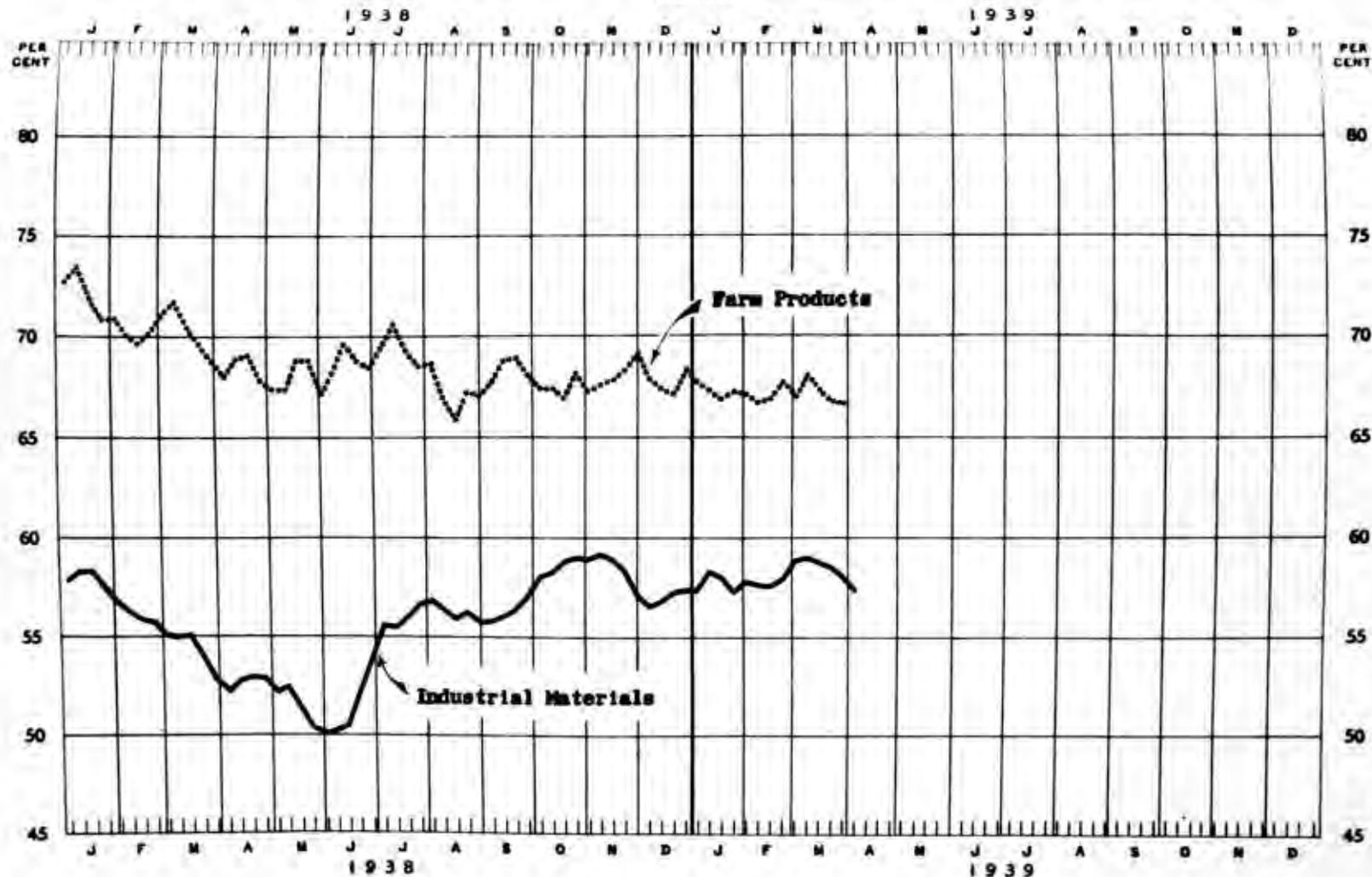
200 Chart 2
 CONFIDENTIAL

Office of the Secretary of the Treasury
 Division of Research and Statistics

1 - 85 - A

Regraded Unclassified

PRICES OF INDUSTRIAL MATERIALS AND FARM PRODUCTS
1926 = 100



SOURCE: BUREAU OF LABOR STATISTICS

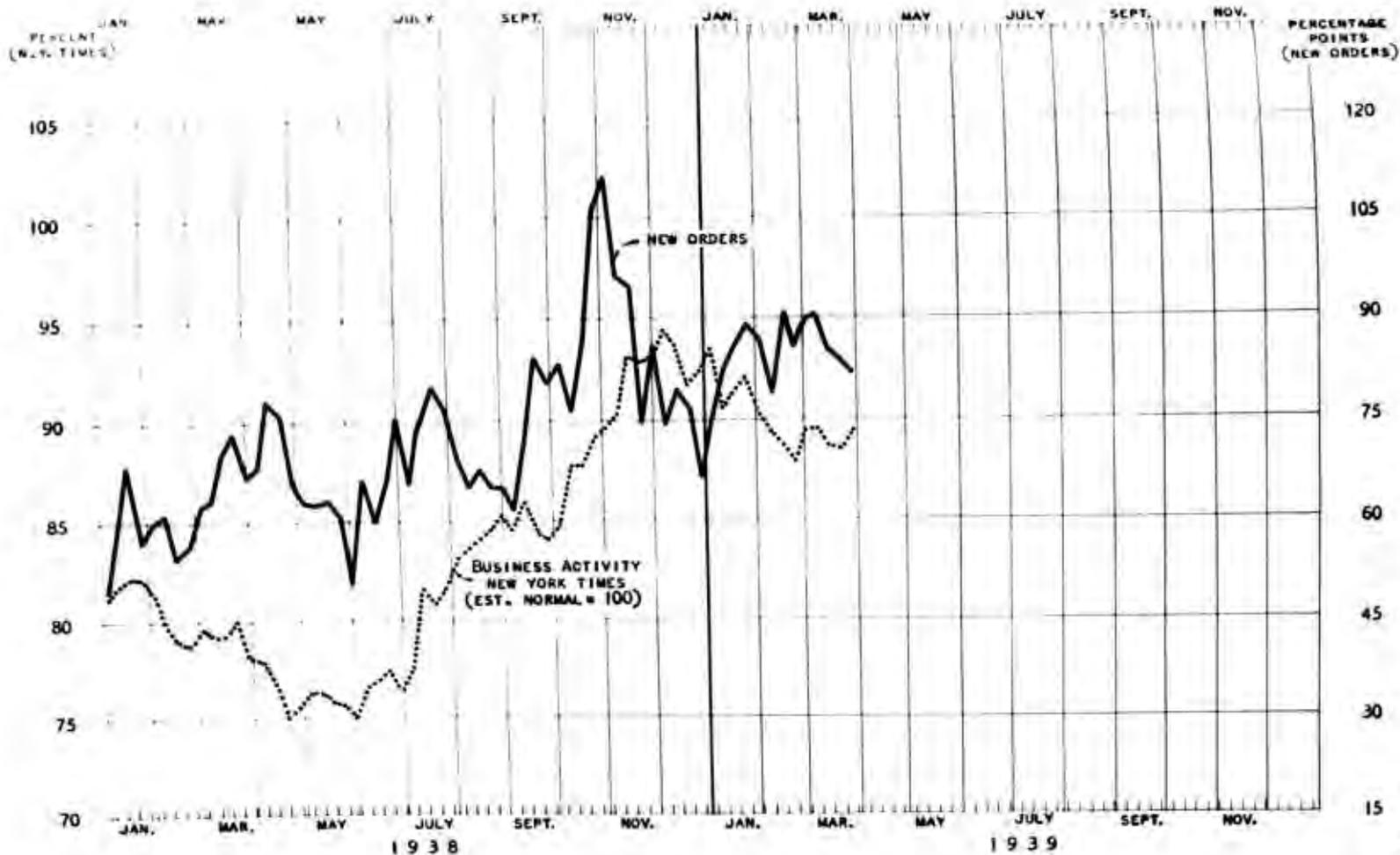
Office of the Secretary of the Treasury
Division of Research and Statistics

201 CONFIDENTIAL
Chart 3

P - 171 - A

Regraded Unclassified

WEEKLY NEW ORDERS AND BUSINESS ACTIVITY



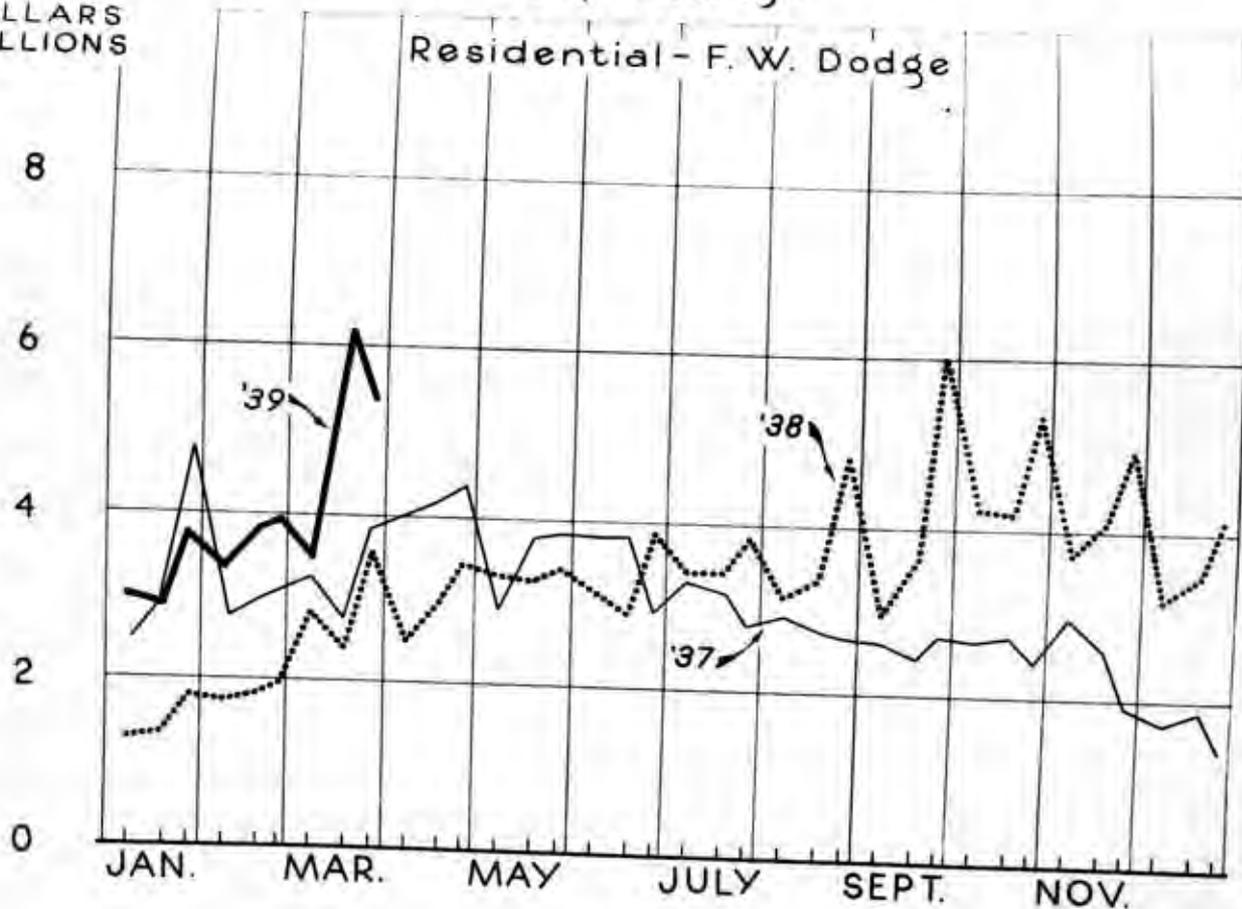
Office of the Secretary of the Treasury
Division of Research and Statistics

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Chart 4
CONFIDENTIAL

RESIDENTIAL CONTRACTS AWARDED Daily Average

DOLLARS
MILLIONS



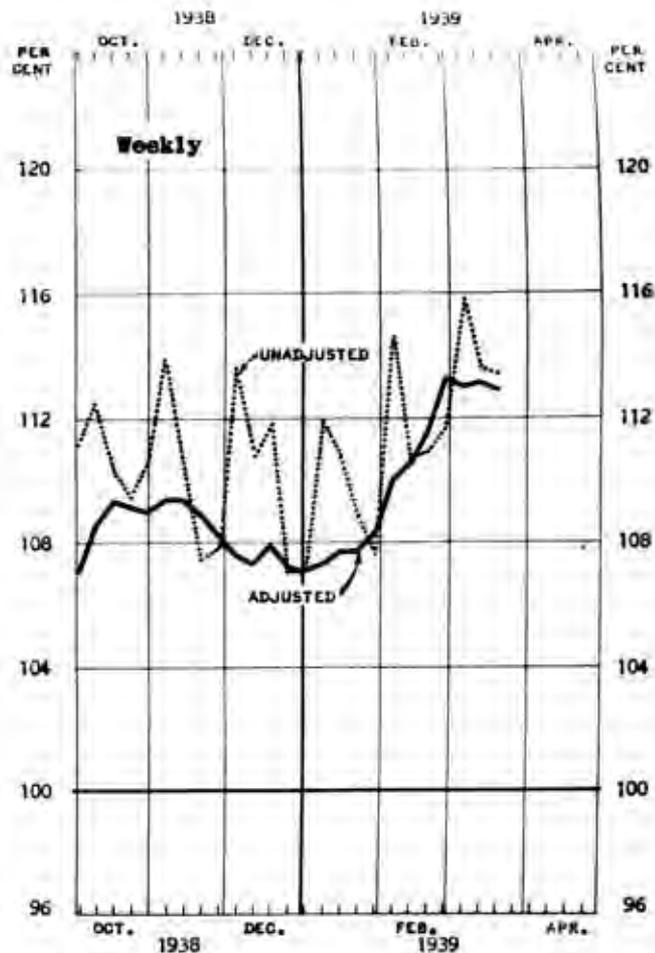
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Chart 5

INDICES OF UNITED KINGDOM BUSINESS ACTIVITY. LONDON TIMES



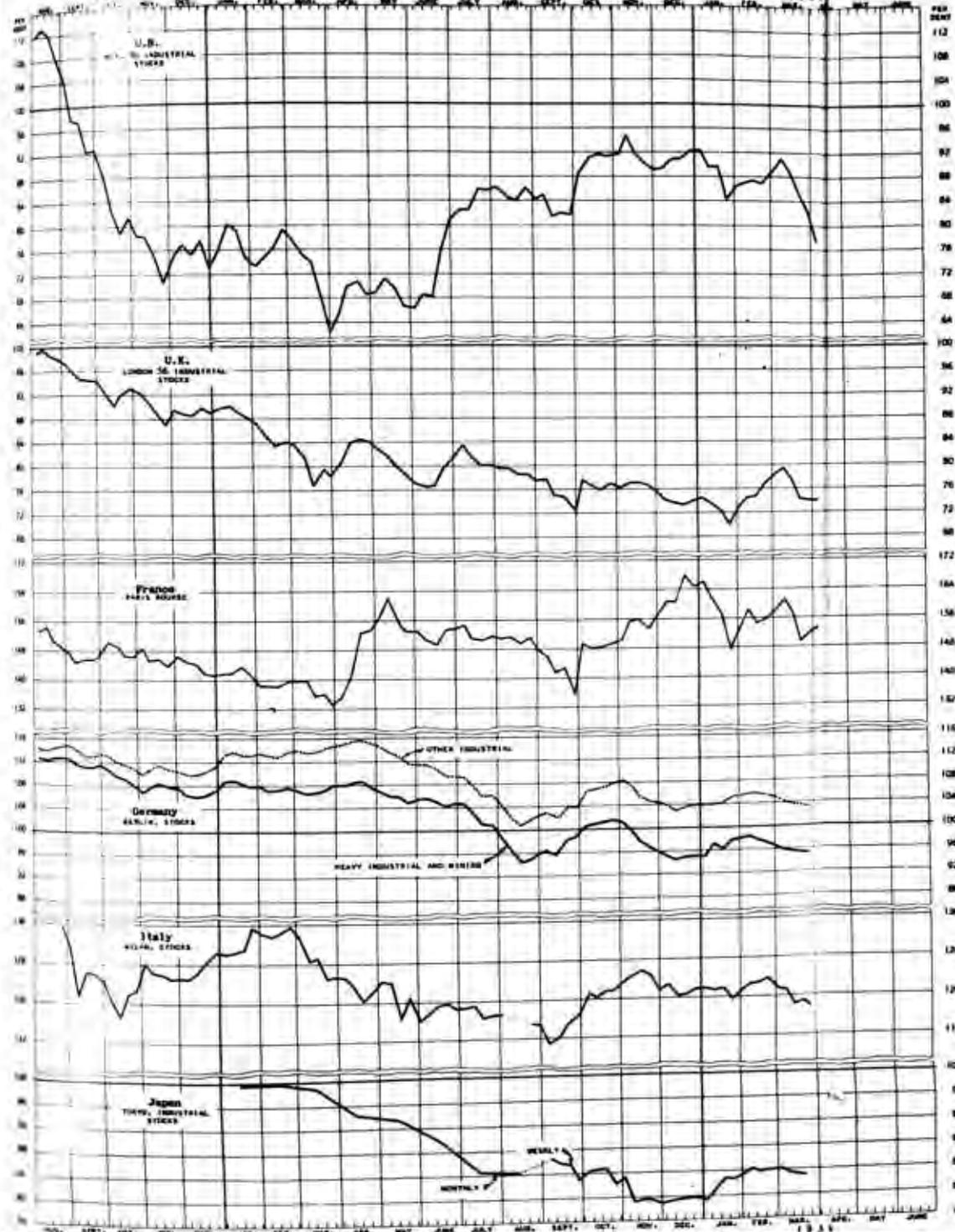
Office of the Secretary of the Treasury
Division of Research and Statistics

204 Chart 6

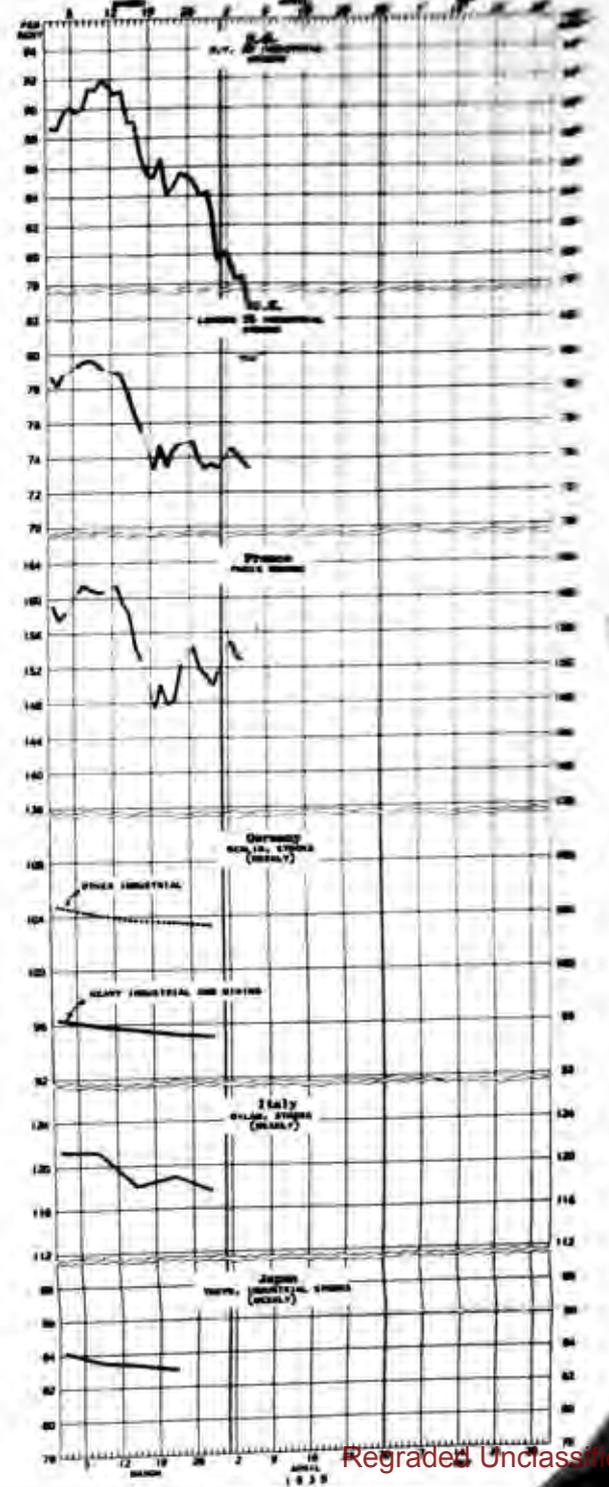
C - 261

INDICES OF FOREIGN AND DOMESTIC SECURITY PRICES
August 1928 = 100

Weekly
1928



Monthly
1928



COMMODITY PRICE INDEXES IN U.S. AND U.K.

