June 2, 1939
8:47 a.m.

Operator: Good morning, Mr. Sproul.

HMJr: Hello.

Sproul: Hello, Allan.

HMJr: Thank you.

S: Go ahead.

Allan: Hello, Allan.

HMJr: Hello, Allan.

S: How are you?

Sproul: I'm all right. How are you?

HMJr: All right. I thought we got a pretty good press.

S: Yes, I think we did.

HMJr: Considering what a tough, mean guy I am.

S: What?

HMJr: Considering what a mean guy I am.

S: (Laughter) I'm just beginning to talk to some of the dealers and it depends on whether they had any rights or whether they had long bonds how they feel about it.

HMJr: I see.

S: If they had rights they think it was terrible, and if they had long bonds they think it was pretty good.

HMJr: I see. What does it look like a coupon today?

S: Well, it's five-eighths or three-quarters if the -- I think the weight on the side of three-quarters probably, but I'll.....

HMJr: No one is talking any interest adjustment, are they?

S: What?

HMJr: No one has talked about interest adjustment?

S: No. No -- no one.
No. The three-quarters will be all right, huh?

That's the way it looks now.

Well, I'm going to talk to Danny Bell to tell Home Owners' Loan that they might begin to sell some of that hundred million.

I think they might too.

Yeah. And I'm going to tell them -- suggest that anytime they can get a hundred and two net, let some go.

Yeah.

Huh?

I think it would be a good idea.

Don't you think so?

Yeah.

O.K. I'll be talking to you again.

All right, fine.

Good bye.
June 2, 1939
8:49 a.m.

HMJr: Hello.
Operator: Mr. Bell. Go ahead.

HMJr: Hello.
Daniel Bell: Good morning.

HMJr: Hello, Dan. We got a pretty good press on this note thing.
B: This morning?

HMJr: Yes.
B: I hadn't noticed anything. I didn't see anything in the Post. That's the only paper I've seen.

HMJr: Well......
B: It was all right, huh?

HMJr: You only read these farm papers like the Post.
B: Yeah, that's all I read. That's all I have time for in the morning.

HMJr: I talked to Allan Sproul and he said that the fellows who have got the rights think it's terrible and the fellows who have got the long bonds think it isn't so bad.

B: Do they?
HMJr: The reason I'm calling.......
B: You can't satisfy them both.

HMJr: No. The reason I'm calling you is to suggest that you call Home Owners' Loan.
B: Yeah.

HMJr: And say any time they can get a hundred and two net, they ought to begin to sell.
B: Well now, you want to do that while this thing is open.
HMJr: Oh, sure.

B: Well, that's -- that's O. K. Then we ought to write the
letter to the Federal Reserve Bank of New York like we did before and let them just start peddling them out.

HMJr: That's right.
B: And do you want to put a price on them?
HMJr: A hundred and two net.
B: A hundred and two net.
HMJr: Yeah.
B: Let's see. I don't know what they closed that last.....
HMJr: Two and one.
B: Huh?
HMJr: A hundred and two and one thirty-seconds, I think.
B: A hundred and two?
HMJr: But that was in the "Times" anyway -- "New York Times".
B: Yeah, I haven't got it here.
HMJr: Well, it was in the "Times" a hundred and two and one thirty-seconds.
B: Yeah, a hundred and two, one -- that's right. A hundred and two net we want to put in there then?
HMJr: A hundred and two net.
B: Yeah. All right. Well, we'll get the letter out today then.
HMJr: Yeah.
B: Because I'm sure they'll be -- now, do you want to do any-thing about the premium or just let it go for the time being?
HMJr: Premium?
B: Yeah -- I mean, you don't want the Postal Savings to enter into this now?
NMJr: No, no. I -- I think it can wait.

B: O. K.

NMJr: No, that -- I can't argue with them on that.

B: All right.

NMJr: Tell them a hundred and two net, but I'd also say I don't think I'd sell more than ten million dollars in any one day.

B: Yeah, we'll let the bank use its discretion, but you'd probably want them to call you.

NMJr: I'd tell Sproul not to sell more than ten million in a day.

B: Yeah.

NMJr: What?

B: That's right.

NMJr: And not to one dealer.

B: And not to one dealer.

NMJr: Yeah.

B: And if the situation changes he ought to give you a ring.

NMJr: Sure. He can call us any time.

B: Yeah. All right.

NMJr: Not more than ten million in one day and -- and not more than five to one dealer.

B: O. K. I'll tell him to spread it around a little.

NMJr: Yeah.

B: As much as he can, as a matter of fact, so that he -- all right I'll get his instructions right off.

NMJr: O. K.

B: Good bye.

NMJr: Good bye.
Allan
Sproul: Hello, Mr. Secretary.

HMJr: How are you?

S: All right. The market seems to have been sharpening
its pencil during the day and coming to a conclusion
which we more or less reached this morning in talking
over here that a three-quarter coupon on this five-
year issue would be giving -- they'd probably show a
premium of a point and a quarter anyway, and that would
be too much to expect on a five-year obligation. That
would be more nearly what you might expect on a fifteen-
year obligation, or even longer.

HMJr: Yeah.

S: So the price of rights is down at the close to 101 three,
five whereas it was 101 nine, eleven......

HMJr: Yeah.

S: ......at the close yesterday.

HMJr: Yeah.

S: And we've been discussing here, which I give you for your
consideration, the possibility of a three-quarter coupon
at par and a half, say.

HMJr: Well, what do you know about that? Well, how -- how can
they do that?

S: What?

HMJr: Well, they'd have to put up fifty cents, huh?

S: Yeah.

HMJr: Wouldn't that be kind of squeezing them a little?

S: Well, it would still leave a premium of up to a point --
up toward a point.

HMJr: And how is it now with the loss of interest and all that?

S: Well, the -- on the present market they seem to be expect-
ing a premium of a point or slightly above.

HMJr: Yeah. Well, of course, I love to hear it, but I -- I
think it would be kind of pressing them a little hard.
S: Well, I just wanted to......
HMJr: Well, I'll sleep on it.
S: .....give you the suggestion and......
HMJr: Yes, well, I'm -- I'm amazed.
S: But that's the way the market has begun to figure now as shown by these quotations. They're thinking of the possibility of a five-eighths coupon or a three-quarters coupon at a premium.
HMJr: Well, I don't want to go down to five-eighths. I think that's squeezing them too much.
S: Well, I think the other would be better too.
HMJr: Well, I'll sleep on it.
S: All right.
HMJr: How are those Home Owners' Loans going?
S: Well, we sold thirteen and a half million today.
HMJr: That's all right.
S: At rising prices. The first sale we made was at 102 two and the last sale we made was at 102 five.
HMJr: Wonderful!
S: And they closed at 102 three, five.
HMJr: I see.
S: So there was quite a good demand most of the day and eased off a little at the close. I think we may have satisfied the most urgent part of it for today, but I expect it will be back there tomorrow or Monday if......
HMJr: Well, it was good to have them there, wasn't it?
S: Yes.
HMJr: It gives us something.
S: Yeah.
HMJr: Well, thanks. You -- you -- you surprised me.
S: Well, I'll talk to you in the morning again.

HMJr: All right.

S: All right.

HMJr: Good bye.
June 2, 1939
3:12 p.m.

HMJr: Hello.
Robert Wagner: Yeah.

HMJr: Congratulations.
W: My God, you get the news fast, don't you?

HMJr: Well, the ticker had it here. We have news tickers.
W: Oh, God! They get it fast too.

HMJr: It came over at three o'clock.
W: Well, we had to put it over on the old man. I always hate to do that, but you can't.......

HMJr: Was he there, Bob?
W: Oh, yes. Oh, yes. Oh, he took it very nicely. He was perfectly disgusted, of course. I had a bunch of proxies in my pocket to show him that he didn't like.

HMJr: I......
W: But it's all right. He......

HMJr: How was the vote?
W: Five to four.

HMJr: Five to four. Brown was out of town.
W: Yeah.

HMJr: Well, that was good.
W: Yeah. Well, it -- it had to be done. I mean, you don't like -- I suppose he felt a little badly about it, but it was all right and I think we'll be all right in the full committee, Henry. I'm having a meeting on Tuesday.

HMJr: Oh, swell!
W: Yeah.

HMJr: Now, I'm ever so much obliged.
W: Yeah. What are you going to do for me now?
I tell you what -- son-of-a-gun! I tell you what......

Why don't you get your hooks off that slum clearance bill. Why should......

Now, listen.

Yeah.

I'm glad you raised that.

Yeah.

There's a letter from me in the Bureau of the Budget recommending that that thing be extended by eight hundred million dollars. Now, what have you got to say to that?

That is, you're for it?

Sure, I'm for it!

All right. Well then, -- then I'm going to stop talking, but you don't like the -- the -- giving the National Bank the power to invest?

That's all.

What?

That's the only thing.

Well, what'll I do about that? I.....

Well......

Of course, if it comes up that you're against it, it'll start a little trouble on the floor.

Against what?

Against the provision -- or are you -- are you all right on that now?

Well, I tell you, I'm a little bit embarrassed. This is the thing, I sent this letter in because I felt it should clear through the Budget to the President.

Yes.

Now, we're for it all except the part on the Comptroller's office. See?
W: Yes.

HMJr: And -- but I'm waiting to get a clearance through the Bureau of the Budget. But I'm -- I'm on record with them and have been over my name.

W: Yes.

HMJr: That -- that I want this thing extended.

W: Yeah, fine!

HMJr: Now what they do is they send my letter across the street as I understand it.

W: Oh, that was it?

HMJr: See?

W: Yeah. I see.

HMJr: And -- but I......

W: Well, what do you think of this giving the National Banks right to invest in these local......

HMJr: Well, of course, we -- the Comptroller -- we -- we think it's a mistake.

W: What's that?

HMJr: We think it's a mistake.

W: You do?

HMJr: Yeah.

W: Well, they're pretty safe bonds I should think.

HMJr: Well, they're safe as long as Congress votes the subsidy.

W: Yeah. Well, they're never going to refuse that. I mean, once -- once they authorize a contract to be made......

HMJr: Bob......

W: Yeah?

HMJr: I am heartily in favor of extending and giving another....

W: Yeah, I know that, but I mean......
HMJr: But on that bank thing, they don't -- as long as they've got the Government guaranty they don't need that.

W: Yeah.

HMJr: And.....

W: No, no, I'm speaking about the bonds which the local authorities issue.

HMJr: Oh! Let me -- could I do this at your convenience.....

W: What?

HMJr: Send Ed Foley to you?

W: Yeah.

HMJr: When would you like to see him?

W: Well, supposing I call him up next week, huh?

HMJr: Yeah. But I'm here and.....

W: The only reason I mentioned that -- I may have to take that feature without it because if it comes up that you're opposed to that provision, naturally it's going to give some people some concern about the thing.

HMJr: Yes.

W: And our Banking Committee didn't -- I didn't send that to Banking at all.

HMJr: I know.

W: Yeah. Well all right, Henry.

HMJr: Well, isn't that enough?

W: Yeah. That's all right -- swell -- swell.

HMJr: One good turn deserves another.

W: Yeah. I think I better -- I better talk to Ed about that -- this man that -- whose name I gave him and.....

HMJr: (Laughter) You want your pound of flesh!
W: No, that's -- I got that long ago.

HMJr: Oh, you got that?

W: Well, I haven't -- the appointment hasn't been made, but it was promised. When -- the moment a promise is made by you, I dismiss that.

HMJr: (Hearty laughter)

W: Then I -- I go to the next thing, you see. As a matter of fact, Henry, I'm the worst patronage Senator -- Senator that's -- of the United States.

HMJr: Say listen......

W: I get nothing.

HMJr: That's what you say.

W: Well, that's true.

HMJr: Oh, hell!

W: Well, you've been pretty nice to me, but I don't ask around except......

HMJr: Oh, you think you -- you think you've already got Flech?

W: No, I haven't, but I say I pick on you, because I know you and some of these other fellows I don't bother them at all.

HMJr: Well, you're a swell guy, Bob.

W: Yeah.

HMJr: And we're delighted. We got a good report on Flech.

W: Oh, have we?

HMJr: Yeah.

W: And when are you going to appoint him?

HMJr: Well.....

W: Tomorrow?

HMJr: We've been kind of waiting to make it worth your while, you know.

HMJr: Well, it hasn't gotten by the other Committee yet, has it?

W: What?

HMJr: It hasn't -- my bill isn't by the big committee yet, is it?

W: Well, I'll -- I'll make a bet on that.

HMJr: Oh, you will?

W: Yeah. I'll make a little bet on that.

HMJr: All right, Bob.

W: All right, Henry.

HMJr: Good bye.

W: Good bye.
Operator: Go ahead.

HMJr: Hello.

Cordell Hull: Hello, Henry.

HMJr: Good morning.

H: Are you over-working?

HMJr: No. Busy.

H: I've got here a bill by Senator Bone -- 1720, Senate Bill.

HMJr: Yeah.

H: That's -- that makes an embargo -- intended to make an embargo against all -- especially all supplies for building.

HMJr: Yeah.

H: The lumber and the shingle people are behind it.

HMJr: Yeah.

H: Principally. You may recall that from 1909 up to 1931 neither political party even seriously thought about putting a tariff on lumber or on shingles on account of the enormous burden it was to all the home owners -- especially the smaller ones.......

HMJr: Yeah.

H: ...... everywhere.

HMJr: Yeah.

H: In 1931 I sat down before the Senate and I tried to resist it. I wasn't able to do it. I saw this lumber crowd get in with the coal and the copper and the oil.

HMJr: Yeah.

H: None of those things were seriously thought of up to that time as subject to any kind of tariff.

HMJr: Yes, Cordell.

H: Now, this crowd over on the Pacific Coast. We just lumber over there practically, and some in the east over across
the Canadian border for our building people to build all
their houses.

Mr: Yeah.

M: And their shingles.

Mr: Yeah.

M: Now this bill is introduced by Bone.......

Mr: Yeah.

M: .......to -- to prohibit anything from being bought by your
Procurement, anybody presumably, except of American origin.

Mr: I see.

M: Now, the Commerce Department and the Housing people, and
the Agriculture Department are thoroughly disposed to
protest against this sort of freak, fantastic piece of
legislation.

Mr: Yeah.

M: Then I get the impression from your men in Procurement that
they -- they are not taking any interest in it either way
and just waiting to enforce whatever comes along. I'm just
wondering if you wouldn't want to join in with us in pro-
test on this sort of a thing.

Mr: Who -- who do you hear over at Procurement.......

M: How's that?

Mr: Who over at Procurement is taking any interest in it?

M: Why, nobody.

Mr: Oh!

M: Some of our fellows asked them and they said they weren't
taking any.

Mr: Well, I'll look into it at once.

M: I think, Henry, this is a good time to show up -- I'm ask-
ing our building corporation to show up the enormous amount
of increased cost to all of the home owners.

Mr: Right!
H: And it's just a few dozen of these big timber people --
mill people......

HMJr: Well......

H: ......getting -- getting the money.

HMJr: I -- thank you for bringing it to my attention and I'll
look into it at once.

H: Fine! They've got a notice out for a hearing now in a
very few days.

HMJr: Well, I'll -- I'll......

H: Next Wednesday.

HMJr: I'll start on it immediately.

H: Thank you so much.

HMJr: Righto!
June 2, 1939

My dear Mr. President:

Shortly after our Board was instituted, we submitted to you on December 19, 1938, a statement relating to the prospective national income for 1939 and recommending certain types of action with reference to fiscal policy. (A copy of the statement is attached for your convenience.)

Since that time we have had numerous meetings and have given intensive study to the problem of attaining a higher national income. We now feel that we have reached substantial agreement on many of the elements responsible for the low level of national income. Our studies have convinced us of the urgent need for action.

There is, we believe, no more important problem confronting the nation and we, therefore, would appreciate the opportunity of discussing with you the findings on which this conclusion rests.

Respectfully submitted,

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[Signature]

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1. The 1938 national income is estimated at $62 billion. For the calendar year 1939 it is estimated that the national income will be between $65 and $68 billion.

2. A national income of around $80 billion would provide:
   (a) substantial reduction of unemployment;
   (b) Federal revenues sufficient to balance the current level of cash expenditures on the basis of the existing tax structure.

3. An income of $90 billion or more is attainable through full utilization of our man power, plant and equipment, technology and natural resources, assuming the elimination of some important bottlenecks.

4. Also it is important for Federal fiscal policy to take into account:
   (a) changes in the volume of capital expenditures being undertaken by private enterprise and any hindrances or bottlenecks tending to restrict the expansion of private expenditures;
   (b) the fact that available supply of credit is so great that present and prospective Federal borrowing will not create a shortage of credit available at reasonable rates for private enterprise.
   (c) changes in the volume of the outstanding debt of States and local governments and changes in the volume and character of their expenditures and receipts.

In pursuit of the objective of attaining a higher national income we make the following recommendations with respect to fiscal policy for the next fiscal year:

1. If taxes are to be increased, those selected should be such as interfere least with additions to the aggregate income of the American people. These taxes, among others, are: estate taxes, gift taxes, lowering tax exemptions as personal income rises, higher income tax on middle brackets.
2. We advise against new taxes which operate to reduce substantially consumer purchasing power. These taxes, among others, are: processing taxes, sales taxes, taxes on payrolls, excise taxes.

3. The Board notes with approval the proposed changes in the budget presentation and recommends that the principles embodied in these changes be extended as rapidly as feasible. (See appended copy.)

4. (a) For the purpose of adding to the national income next year, and of preventing what promises to be a serious bottleneck within the next year or so, action should be taken to secure a large railroad equipment program.

(b) Recovery could be further stimulated by additional government activities financed through self-financing government corporations. These activities should be, in the main, such as will facilitate private investment and private expansion of private industry. A special report on such activities will be later submitted.

5. That a comprehensive survey be started with the view of immediately setting up machinery to obtain all necessary detailed information with respect to the current receipts and expenditures of State, local and municipal administrative bodies and to changes in the volume and make-up of their outstanding debt.

6. Arrangements should be made at once that would make possible engineering and legal planning of various public works which would be available for immediate prosecution when required to give increased flexibility in the timing of public expenditures and increased assurance of value and utility of the expenditure itself.

This program is much needed not only because of the character of current Federal, State and local public works and relief, but even more especially because of the extensive rearment program being undertaken. To make certain that the rearment program shall not be continued as a device to reduce unemployment or to stimulate business activity, it is essential to have such plans perfected as will permit a ready transfer of employment from rearment industries into needed productive public and private works projects as soon as peak activity in rearment is passed.
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H. Morgenthau, Jr. Chairman

M. S. Eccles

Frederic A. Delano

Harold D. Smith

The President,
The White House.

By hand

HDW:1rs
6/2/39
Treasury Department
Division of Monetary Research

Date: 6/3/39

To: Miss Chauncey

From: L. S.

Mr. White has the copy of attached which you sent around, and so far I have been unable to locate it. Thought you might want to substitute this one until I can send yours.
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5. That a comprehensive survey be started with the view of immediately setting up machinery to obtain all necessary detailed information with respect to the current receipts and expenditures of State, local and municipal administrative bodies and to changes in the volume and make-up of their outstanding debt.

6. Arrangements should be made at once that would make possible engineering and legal planning of various public works which would be available for immediate prosecution when required to give increased flexibility in the timing of public expenditures and increased assurance of value and utility of the expenditure itself.

This program is much needed not only because of the character of current Federal, State and local public works and relief, but even more especially because of the extensive rearmament being undertaken. To make certain that the rearmament program shall not be continued as a device to reduce unemployment or to stimulate business activity, it is essential to have such plans perfected as will permit a ready transfer of employment from rearmament industries into needed productive public and private works projects as soon as peak activity in rearmament is passed.
1. It is the general opinion among Administration officials and technicians in Washington who are on, or are cooperating with the Fiscal and Monetary Advisory Board, that there is little if any prospect for marked recovery during the next two years.

2. Even with a moderate improvement in business the unemployment situation will still be acute. With no improvement in business the number of unemployed will increase because of the annual accretion to the labor supply of more than half million a year, and because of continued technological change.

3. Some of them also recognize the possibility of a downturn in business activity before the end of 1940.

4. The inability of our economy to reach and maintain the objective of an $80 billion national income is due to the existence of certain fundamental maladjustments which have been developing.

5. Some of the basic changes which are partly responsible for the lower level of business activity during the 30's are as follows:

(a) For the first prolonged period in our history private enterprise and local governments together have not spent or invested the funds which have become available currently for such spending or investment and which must be invested or spent if the national income is to be maintained or increased.

(b) Certain large industries have now reached a stage of growth relative to their potential markets which eliminates them in the foreseeable future as potential users of large amounts of investment funds. Though we expect a continued growth of most of these industries the rate of expansion and the absolute volume of new investment funds they will absorb will be less than it was in the 20's.

(c) Basic difficulties in certain important industries which for special reasons do not provide nearly so important an outlet for capital as they did in prior decades, e.g., railroads, agriculture, coal.
(d) The rate of population increase has been cut in half as compared with the 20's.

(e) The virtual cessation of foreign investment which in the 20's accounted for about one-half billion a year net.

(f) State and local bodies which in the 20's provided an outlet for investment funds of nearly a billion dollars a year have in recent years actually added to the current volume of funds available for investment through a net reduction in their outstanding debt.

(g) Sharply curtailed expenditure on non-profit private building, i.e., churches, universities, non-governmental schools, charitable institutions, clubs, etc. In some years in the 20's these accounted for as much as 700 million a year, whereas they now are less than 200 million.

(h) The slack created by the over-production of commercial buildings in the late 20's will not have been taken up for several years more.

(i) The Federal, State and local government tax structures now derive a greater proportion of total revenue from taxes that curtail consumption than was true in the 20's.

(j) The serious reduction of certain foreign markets for important export crops, e.g., cotton, wheat, tobacco and hog products, and the failure of foreign trade generally to revive to the level of the 20's. The curtailment of these markets is not due to temporary factors.

(k) The situation is aggravated by the fact that those who have or control the nation's funds for investment appraise the risk of investment as greater now than hitherto and are less willing to assume risks. The increasing uncertainty, both economic, political and social, which has characterized the past decade has made people more conservative in both expenditure on consumer goods
and in the investment of their savings. In addition, the tax burden has increased as compared with the 20's, thus reducing the net profits left to the investor or business entrepreneur and thereby in some instances reducing the incentive to undertake risks.

6. The United States is not unique with regard to the changed nature of the economy. The industrially advanced European countries have experienced the same contraction of outlets for their investment funds. Some of them have temporarily solved their problems by a new industry greater than all the new industries of the past period combined, i.e., armaments and complementary industries. In some of them the problem has been rendered less acute by the fact that their tax program has resulted in a diversion of a larger portion of potential savings back into consumption.

7. As a consequence of these basic changes we are faced with inevitability of a low national income unless either or both of the following happen:

(a) The development or appearance of sufficient investment outlets to absorb the funds available for investment at a high national income.

(b) An increased proportion of the national income is spent on consumers goods, thereby reducing the volume of idle funds and increasing the profitable outlets for investment.

8. Turning to the immediate situation there are numerous indications that the prospects for substantially increased national income in 1939 and 1940 are not good.

There are two elements in the picture which are favorable:

(a) Inventory reduction has been proceeding for some months and a cessation or reversal of this trend would be a temporary stimulus to production.

(b) Expenditure on consumers goods has been maintained despite the decline in business activity.
Elements in the situation which are either neutral or unfavorable:

(a) The upturn which began in 1938 reached its peak in December and since that time the level of business activity has been downward.

(b) No significant increase in the net contribution to buying power by the Federal Government under the existing program will occur this year and a reduction is anticipated in the fourth quarter.

(c) There is little basis for the expectation that our exports in 1939 and 1940 will exceed the 1938 level despite the increased armament programs abroad.

(d) Housing activities appear to have reached a plateau and there seems to be little prospect of a further marked increase of home construction.

(e) No substantial increase in railroad equipment buying can be anticipated in the balance of the year.

(f) There is little prospect of an expansion in public utility investment.

(g) Despite the increase in orders for armaments both domestic and from abroad, the heavy industries are still depressed.

(h) There is nothing in the prospects of the agricultural situation to justify the expectation that it will supply a stimulating influence on business activity.

(i) There will probably develop a strong tendency on the part of certain groups to forego the prospects of immediate profits by postponing any investments or plant expansion until after the election.
9. Even if there is a moderate increase in business activity next year the unemployment situation will remain acute.

In 1937, 35 million persons were employed in non-agricultural pursuits. Today less than 35 million are so employed. During 1940 we shall be doing well if we again reach the volume of employment of 1937, whereas the non-agricultural working population in 1940 will be about 2 million greater than in 1937.

In addition to this unemployment situation in non-agricultural lines, there is known to be a surplus labor supply on farms perhaps as large as 1.5 million working persons that need to shift from farming into industrial opportunities.

In view of the fact that there is no expectation for more than a moderate rise in national income for the next fifteen months, and in view of the further fact that a decline in business activity some time during the next fifteen months is a possibility, and, most important, in view of the conviction that sustained full recovery is impossible unless action is taken to correct basic maladjustments:

There is general agreement among the persons referred to above that a comprehensive program of action should be initiated at once, such action to be designed to accomplish two things:

1. Make all effort possible to eliminate the basic maladjustments which stand in the way of a sustained full recovery. Though the full effects of this program will not be felt for several years, it is vitally important that such a program be initiated at once for two reasons:

   (a) It will take time before such a program could be worked out and put into effect.

   (b) It is important to make clear to the public that this Administration recognizes the existence of basic maladjustments and will take steps to correct them, that it will push toward a further extension of New Deal principles and will adopt measures designed to insure sustained prosperity.
2. A program of immediate action designed to insure a substantially increased national income in 1940 and to protect us against the possibility of a sharp downturn in business during the next fifteen months.

Some of the measures which can be undertaken to correct basic maladjustments can be initiated with sufficient rapidity to raise the national income in 1940.

If to the increase in national income that would result from measures undertaken to correct basic maladjustments there be added the further increases to the national income which would result from measures specifically designed to increase in 1940 investment and expenditures, then a significant increase in the national income can be assured for next year.

There appears to be general agreement in the group mentioned above that Congress should not adjourn until an adequate program has been inaugurated. Or, if Congress is to adjourn, it should do so only with the distinct understanding that after a short recess it would reconvene prepared to deal with these major problems, some of which have been before us for a long time.

Sincerely,
[Signature]

[Signature]

January
1939
STATEMENT OF ELLSWORTH C. ALVORD

(Presented to the Ways and Means Committee of the House of Representatives at hearings on revenue proposals, June 2, 1939)

Mr. Chairman, Gentlemen:

I am Ellsworth C. Alvord, an attorney, of Washington, D. C., appearing as the Vice Chairman of the Committee on Federal Finance, of the Chamber of Commerce of the United States.

Introduction

It is always difficult to discuss a revision of our revenue laws in the absence of specific proposals. It is additionally difficult this morning, for we are fully appreciative that the limitations of time necessarily restrict your Committee and the Congress and prohibit extensive changes in existing law.

We are attempting a two-fold classification of our suggestions: (1) those which we think can be considered and enacted prior to June 30th of this year; and (2) those which we believe should be considered a part of a more far reaching and more permanent revision, to be considered, for example, during the adjournment of the present session and prepared for the consideration of the Congress during the next session. We hasten to assure you, however, that our suggested classification is tentative indeed.

We are very happy to endorse and approve (with two minor exceptions, of perhaps no immediate importance, which will be discussed briefly hereinafter) the objectives and the program of the Secretary of the Treasury in his opening statement to your Committee last Saturday. We commend his constructive approach to the fiscal problems confronting the Congress and the country. It merits the support of every citizen. Differences of opinion with respect to the application of the principles enunciated and urged by the Secretary of the Treasury are, of
course, to be expected. But there can be no serious differences upon the objec-
tives and principles he has advocated.

**Fiscal Objectives**

In the opening statement of these hearings, the Secretary of the Treas-
ury presented the following basic objectives of a fiscal program:

1. The maintenance of public finances in a sound and unassailable
   position;

2. The promotion of free enterprise and private investment;

3. The attainment of full business recovery;

4. A just distribution of tax burdens, and a more equitable distribu-
tion of national income.

To accomplish these ends, the Secretary recommended the following pro-
gram:

1. A definite approach to a balanced budget;

2. A Congressional Joint Committee on Fiscal Policy to coordinate ex-
penditure and revenue programs;

3. A non-partisan commission to examine the problems created by
   Federal-State tax conflicts;

4. Revision of the Federal tax laws to remove manifest inequities or
   other defects, including

   (a) provisions likely to hinder business expansion and
   investment,

   (b) provisions constituting "tax irritants", and

   (c) provisions raising questions of tax equity.

The Secretary correctly stated that the foregoing objectives are essen-
tial to the successful operation of our democracy; that full recovery and a sound
fiscal position are imperative for an adequate national defense; that fundamental
objective of sound finance is a balanced budget; and that changes in our fiscal
program must conform to this end. The Secretary might have added that they should
guide not only fiscal decisions but all activities of Government.

One of our reservations is directed toward the fourth objective in tax
policy, namely, "a more equitable distribution of national income". Our reserva-
tion is based upon the fact that we do not understand the statement. We merely
make the point at this time, not for purposes of debate, but solely to avoid mis-
understanding of our position.

The second reservation is directed toward coupling a reduction in indi-
vidual surtax rates (which seem, we believe, to be admittedly far too high, and
which must be reduced substantially if one of the most serious deterrents to pri-
vate investment and industry is to be removed) with the taxation of future issues
of Federal, State and municipal securities. We have advocated measures to reach
both objectives. But we cannot agree that they are so closely interrelated that
neither should be brought about unless both are, and that the former should await
the attainment of the latter.

Magnitude of the Problem

We are very far from the fulfillment of our objectives at the present
time. In the years since 1931, we have "bought time to think", perhaps, but we
have made little progress towards a permanent recovery.

(a) Maintenance of Sound Public Finances. — On June 30, 1940, we
shall have completed a ten-year period of continuous deficits, since the deficit
of 1931. The books of the Federal Government will show the following results of
operations over the period:

(1) Total expenditures of $72 billions, or $7 billions annually (in
the last two years, $9 billions annually);

(2) Total deficits of $31 billions, averaging $3 billions a year;
(3) Gross Federal debt which will approximate $45 billions, excluding
 guaranteed obligations of about $5 billions;

(4) Gross Governmental debt, including State and local debts, of about
 $3 billions;

(5) An increase in the per capita debt, Federal, State, and local, from
 $289 to $482, in the space of ten years;

(6) An annual interest burden on the Federal debt of more than a billion
 dollars.

Tables marked (1) and (2) indicate the receipts, expenditures, deficits
 and debt, by years, from 1931 to 1940.

(b) Promotion of Private Investment. — While public expenditures have
 more than doubled in the last decade, private investment has dwindled even more
 rapidly. In fact, new private investment seems almost to have disappeared.

At least two positive indications of this trend are at hand. Table (3)
 shows the decline in the volume of corporate security issues. Table (4) indicates
 the extent of the shift from private to public construction.

Professor Adolf A. Berle, in his recent testimony before the Temporary
 National Economic Committee, summarized the situation as follows:

"The flow into capital construction may be said to have
 found its norm at a level of somewhere between eight and ten
 billions of dollars during the decade from 1920 to 1930. Of
 this, at least six billions went through the public markets —
 that is, occurred by sale of stocks and bonds. The balance
 went into construction through the mortgage markets or through
 private placement. By 1931, the amounts going through
 the public markets had fallen to approximately half that amount;
 then withered to a mere fraction. At a maximum, since 1931,
 not more than two and one-half billions of true capital money
 has gone through the mechanisms of the public markets. The
 average is considerably less.

"The conclusion is obvious: American private markets
 are not funneling capital funds into capital construction at
 more than (roughly) one-third to one-half the rate they were
 doing in the 1920-1930 decade. This means that private activity
 in heavy industry is not being continuously generated in suf-
 ficient volume to keep those industries busy, or to keep the
 country continuously on an even economic keel."
To some extent, Government expenditure has taken up the slack in private financing. But it has been estimated, also in testimony before the Temporary National Economic Committee, that in the years 1930-1937, inclusive, there was an accumulated deficit of $17 billions in new purchasing power, despite the billions expended by the Federal Government. If, as Chairman Eccles recommends, the Government had attempted to make good this shortage of private investment, it would have required an additional Federal deficit of more than $2 billions in each of these eight years.

(c) **Attainment of Recovery.** — Our recovery goal may be stated as the sum of the following:

1. The maintenance of a democratic form of government;
2. Adequate provision for national defense;
3. Reduction of unemployment, at least to 1929 levels;
4. A balanced budget, including provision for orderly debt retirement;
5. A substantial increase in our national income — ($60 billions to $100 billions annually.

How close are we now to this goal?

There are now between 15 and 20 million persons receiving public assistance financed by Federal, State, or local funds. The cost of relief to the Federal Government alone this year approximates $2-3/4 billions.

Industrial production last month was only 92% of the 1923-5 average; factory payrolls only 85% of wages paid in the period 1923-5, more than fifteen years ago.

The national income has not approached $80 billions since 1929 — has not, in fact, in all the intervening years been within $10 billions of our minimum objective.

The indexes of business recovery, and the statistics of relief, given
in tables (5) and (6) tell their own story of our failure to achieve recovery. They will repay study.

A Permanent Fiscal Program

It seems clear that a full, healthy and permanent recovery requires a transition from government spending to private investment, a sound constructive fiscal program for the Federal, State, and local governments, a decrease in the demands for Federal assistance, a reduction in relief rolls with a corresponding increase in private payrolls, and a substantial increase in the national income.

These results can only be attained by the encouragement of private industry, private investment, and private employment.

In terms of a general fiscal program, this means:

(1) Adjustment of tax rates to the point of maximum business activity and hence maximum productivity;
(2) Removal of tax barriers to private enterprise and investment;
(3) Assurance of stability and certainty in the revenue system;
(4) Simplicity and ease of administration;
(5) An effective control of expenditures, so that they may be kept within the revenue yields of a reasonably permanent tax system enacted to carry out the foregoing program.

Control of Expenditures

We commend for the consideration of the Congress, the recommendation of the Secretary of the Treasury that Congressional procedure be devised for the consideration of revenues and expenditures together as two interrelated aspects of a single problem. Stability and certainty in our fiscal program cannot be maintained without effective legislative control over expenditures and coordination of receipts and expenditures.
We are confident that the Congress can readily devise legislative procedure to improve the existing control. For example, a special Budget Committee of the House might be created, to consist of the Speaker, the Majority and Minority Leaders, and the ranking members of the Committee on Ways and Means, Appropriations, and Rules. This Committee could consider the Budget as a whole — that is, the estimated revenues and the proposed expenditures — and report to the House its recommendation as to the total appropriations to be made. The Committee's report could be subjected to full debate and the House decide upon a total for all appropriations, thus placing an effective "ceiling" below which they must be kept. The Appropriations Committee would then adjust its various appropriation bills and keep them within the maximum thus fixed. No appropriation could exceed the "ceiling", unless specially approved by the Budget Committee. If the Budget Committee concluded that the appropriation was essential, despite the previously fixed aggregate total, it could approve a Special Rule permitting its consideration; otherwise the appropriation would not be considered.

A similar committee, suitable to Senate procedure, might be developed for the Senate, which, of course, could act independently of the House.

Such a plan would seem to be flexible enough to allow extraordinary and emergency expenditures but it would permit fixation of a definite and well considered limit to expenditures and to legislation authorizing expenditures.

General Tax Recommendations

Obviously, it is not feasible to complete a revision of the revenue system before the end of the present session. Nevertheless, progress can be made. A stable, permanent revenue system is sorely needed as a foundation for maximum business activity, the first requisite of maximum yield of a revenue system.
As the first step in such a program, and for immediate action by Congress, we recommend the following specific changes:

(1) A flat-rate normal corporation tax of 15%, with a specific credit of $2,000 to reduce the applicable rate on small incomes.

(2) Outright repeal of the 3-1/2% undistributed profits tax.

(3) A carryover of net business losses for three years.

(4) Simplification of the individual capital gain provisions, eliminating the unnecessary distinction between assets held 18 and 24 months and substituting a shorter holding period.

(5) The treatment of "long-term" capital gains and losses of corporations as ordinary gains and losses, thus more nearly according to corporations the treatment now accorded individuals.

(6) An annual declaration of capital stock value, beginning with the current year.

(7) Permission for affiliated groups to file consolidated returns.

(8) Elimination of double taxation by exempting all intercorporate dividends from tax, and excluding corporate dividends from individual normal tax.

(9) Remedying a few of the existing defects in the so-called technical or administrative provisions of the present law.

We believe that a long range program of tax revision should include the following:

(1) A reasonably permanent revenue system, based upon the principles above advocated — that is, a system the basic principles of which are to remain in force, for example, for a period of ten years;

(2) Simplification of the present law, which can be effected in large part by the elimination of unnecessarily complicated policies and refinements;

(3) The reduction of individual surtaxes to the point where they will
not discourage private investment and individual initiative;

(4) A substantial reduction in the tax upon capital gains;

(5) An effective earned income credit;

(6) A revision and simplification of the present estate tax laws, including a substantial reduction in the present confiscatory rates;

(7) A provision for the setting aside of adequate funds (through insurance or otherwise), free of estate tax, for the payment of the estate tax;

(8) The repeal of the capital stock-excess profits tax system, as soon as the revenue requirements permit;

(9) Removal of the inequities now existing in our excise tax system;

(10) A procedure for the collection of excise taxes corresponding to the existing procedure for the collection of income taxes.

Attached, as Appendix A, are a series of examples, showing the effect of existing surtaxes upon the investment of individuals.

Corporate Normal Tax

The normal tax on corporations should not and need not exceed 15%. It is agreed, of course, that some allowance from the maximum rate should be made for corporations having an income, for example, below $25,000. A specific credit of $2,000 for this purpose is preferred on the ground of simplicity. Such a credit would reduce the effective rate to 9% on incomes of $5,000; 12% on $10,000, and 13.8% on $25,000.
It is usually assumed that a rate above 10% will produce more revenue. With this assumption, we can not agree. The fundamental factor in an income tax is the amount of income subject to tax. There is a point of maximum productivity. Above that point, increases in the rate diminish business volume and the total profits subject to tax.

Prior to the undistributed profits tax of 1936, general corporate rate was 13-3/4% for the years 1932, 1933, 1934 and 1935. The present normal corporate tax is 16-1/2%, which in itself constituted a very substantial increase — attributable solely to the enactment of the undistributed profits tax. Adding other taxes, many corporations today are paying more than 50% of their net income in taxes. In our opinion, this is well above the point of maximum productivity. Attached is a table (Table 7), prepared from Registration Statements filed with the Securities and Exchange Commission, showing the total taxes paid and their relation to the net incomes of certain groups of corporations. It would seem that further proof is unnecessary.

The only way in which more revenue can be realized from corporations is by stimulating increased business activity. The possibilities are revealed by the following table, showing the rate of industrial production, the amount of corporate income subject to tax, and the revenue collected from corporations, by calendar years, from 1922 to date:
<table>
<thead>
<tr>
<th>Year</th>
<th>F.R. B. Index Industrial Production</th>
<th>Corporate Net Income</th>
<th>Rate of Corporate Tax</th>
<th>Revenue from Corporate tax</th>
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<tbody>
<tr>
<td>1922</td>
<td>85</td>
<td>6364</td>
<td>12-1/2</td>
<td>775.3</td>
</tr>
<tr>
<td>1923</td>
<td>101</td>
<td>8322</td>
<td>12-1/2</td>
<td>937.1</td>
</tr>
<tr>
<td>1924</td>
<td>95</td>
<td>7537</td>
<td>12-1/2</td>
<td>881.6</td>
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<td>1925</td>
<td>104</td>
<td>9584</td>
<td>13</td>
<td>1,170.3</td>
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<tr>
<td>1926</td>
<td>108</td>
<td>9673</td>
<td>13-1/2</td>
<td>1,229.8</td>
</tr>
<tr>
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<td>106</td>
<td>9882</td>
<td>13-1/2</td>
<td>1,130.7</td>
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<td>111</td>
<td>10618</td>
<td>12</td>
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<td>119</td>
<td>11654</td>
<td>12</td>
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<td>1930</td>
<td>96</td>
<td>6429</td>
<td>12</td>
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</tr>
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<td>91</td>
<td>3663</td>
<td>12</td>
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<td>1932</td>
<td>64</td>
<td>2153</td>
<td>13-3/4</td>
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<td>1933</td>
<td>76</td>
<td>2986</td>
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<td>79</td>
<td>4275</td>
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<td>588.4</td>
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<td>90</td>
<td>5149</td>
<td>13-3/4</td>
<td>707.9</td>
</tr>
<tr>
<td>1936</td>
<td>105</td>
<td>6732</td>
<td>(8-15 *)</td>
<td>1,111.0</td>
</tr>
<tr>
<td>1937</td>
<td>110</td>
<td>7160 E. (on undist. (tributed (profits)</td>
<td>1,160.0</td>
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</tr>
<tr>
<td>1938</td>
<td>86</td>
<td>4700E</td>
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<td>1939</td>
<td>Jan. 101</td>
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<td></td>
<td>Feb. 99</td>
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<td>Mar. 98</td>
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<td></td>
<td>Apr. 92 p.</td>
<td></td>
<td></td>
<td>1,005. Est.</td>
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<td>May 92 p.</td>
<td></td>
<td></td>
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<tr>
<td>Year</td>
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</table>

* Preliminary

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Regraded Unclassified
Given an industrial production index of about 105 and a corporate tax base of $7 billions, a 16% rate would produce over a billion dollars, approximately the amount which will be collected for the current calendar year at present rates. It appears from the table that this is only a moderate expansion of business volume over the present estimates of 100 for the index and $6200 millions for the corporate base.

In the recent publication "Taxation and Capital Investment" issued by The Brookings Institution, the author concludes:

"As has been pointed out earlier in this analysis, the means of securing fiscal stability is to be found in the expansion of total national production. Taxation revenues will pretty much take care of themselves if we can achieve full economic recovery."

We are thoroughly in accord with this analysis.

Undistributed Profits Tax

There is no legitimate excuse for retaining the 2-1/3% undistributed profits tax. The principle of a penalty tax on earnings was repudiated at the last session of Congress. The tax produces no substantial revenue. The computation of a dividend paid credit introduces complexities which are wholly out of proportion to the importance of the tax.

It has been asserted that the repeal of the 2-1/3% undistributed profits tax will encourage tax avoidance by wealthy stockholders, who will prefer to leave profits in corporations under their control rather than to pay high personal surtaxes thereon. Naturally, every effort should be made to prevent tax avoidance in this or any other form. The whole problem, however, of tax avoidance by corporate stockholders has been grossly exaggerated. The personal holding company provisions, enacted in 1934 and strengthened in 1936 and 1938, are adequate to take care of "incorporated pocketbooks." In the rare case of an operating company being used for tax avoidance, section 102,
imposing penalty taxes on the unreasonable accumulation of surplus, affords sufficient protection to the Government. This section can be enforced, as the National Grocery Company case (304 U. S. 282) demonstrates — despite representations to the contrary before this Committee last year when the Title IB tax on closely-held operating companies was proposed. It will be recalled also that section 102 was purposely strengthened last year to make it more easily enforceable, by putting the burden of proof on the taxpayer to show the absence of a purpose to avoid surtax.

Net Loss Carryover

We urge that the privilege of carrying forward net operating losses be restored to the Revenue Act immediately.

The selection of a single year as the taxable period is admittedly arbitrary, and results in great hardship to industries and particular companies in which years of profit and loss alternate. If such companies are taxed in years of profit, without allowance for prior years' losses, their tax burden is wholly out of proportion to the income actually earned over the period as a whole. As compared with businesses having a stable income from year to year, moreover, they are at a severe competitive disadvantage. There are attached a series of computations (Appendix B) illustrating the effective rates of taxation upon corporations sustaining losses during one or more years of a five-year period.

The Revenue Act, from 1921 to 1933, recognized this hardship and permitted a net loss carryover. The privilege was abolished in the National Industrial Recovery Act in 1933, solely by reason of the urgent necessity of protecting the revenues at that time. It has never been disputed that such a provision is an essential feature of an equitable tax system.

The determination of the carryover period is necessarily arbitrary. The British income tax permits losses to be carried forward for six years. A
shorter period may be desirable for revenue purposes. In view of the abnormal conditions of the last ten years, and the wide fluctuation of business activity, incomes and values we have experienced, a carryover of at least three years should be allowed.

**Capital Gains and Losses**

The capital gain and loss provisions applicable to individuals, as revised by the 1938 Act, distinguish between assets held less than 18 months, taxable in full; assets held 18 to 24 months, taxable at a maximum flat rate of 20%; and assets held more than 24 months, taxable at a maximum flat rate of 15%. The "intermediate" period of holding, 18 to 24 months, appeared as a compromise provision, for which no real necessity existed. As a practical matter, it greatly complicates the structure of the section, and for purposes of simplification, it should be eliminated.

The dividing line between "short-term assets" and "long-term assets" is intended to separate speculative from investment transactions. Since assets bought for speculative purposes are rarely held longer than six months, a substantially shorter holding period than the 18 months now prescribed should be considered.

Corporate capital gains were ignored in the 1938 revision of the section. Such gains continue to be taxed in full regardless of the period of holding; while corporate capital losses are deductible only to the extent of gains plus $2,000. There is an obvious injustice in this situation which should be corrected. We recommend that "long-term" losses be allowed as a deduction, without limitation.

**Capital Stock and Excess-Profits Taxes**

While it is undoubtedly desirable to repeal these taxes, we believe that it is necessary to retain them, as a temporary proposition, for revenue purposes. The most serious objection to them is that they do not impose a tax.
on true excess profits. The iniquitous feature of the present law is that it requires a corporation to declare a value for its capital stock which will serve as a basis for the computation of profits for the next thirty years. Since no corporation can estimate its profits beyond the current year with any degree of certainty, the declaration of a proper value is sheer guesswork, and no proper basis is established for determining excess profits.

Accordingly, we recommend that the capital stock tax be revised to permit an annual declaration of value, beginning with the current year, with adequate precaution, if necessary, against any immediate reduction in its yield.

Consolidated Returns

The requirement of separate returns for a group of affiliated corporations is indefensible. Such a requirement leads to the statement of non-existent profits and losses on intercompany transactions and distorts the presentation of earnings of particular units. Accountants, the Stock Exchange and the Securities and Exchange Commission uniformly require or permit consolidated returns to reflect the financial position of the affiliated group. The Treasury Department has consistently supported the use of consolidated returns.

A mandatory requirement for consolidated returns is impracticable owing to constitutional and administrative difficulties. An elective provision similar to the one in force prior to 1934 is therefore recommended.

Double Taxation of Dividends

Prior to 1936, corporate dividends were excluded from the individual normal tax, since the corporation had already paid the tax upon the earnings out of which the dividend was paid to its stockholders. In the 1936 Act, dividends were subjected to the individual normal tax, but only because the undistributed profits tax, as originally drafted in the House, did not require the corporation to pay a tax on income which it distributed. With the restoration of a corporate normal tax, the imposition of a second normal tax upon the stock-
holders cannot be supported.

Intercompany distributions offer an even more severe instance of double or multiple taxation of corporate earnings. Such distributions are subject to taxation in the hands of the originating corporation, again to the extent of 15%, thereof in the hands of the receiving corporation, and finally when distributed to its stockholders.

On the other hand, bond interest, as distinguished from dividends, is allowed as a deduction to a corporation in computing net income and is taxed only once, as income to the bondholder. This situation has led the 20th Century Fund to conclude in a recent study that borrowed money is more attractive than venture capital, both to corporations and investors, with the result that a heavy permanent debt structure may be created which becomes unmanageable in times of depression.

We recommend that the exemption of dividends from normal tax be restored and that the intercorporate dividend tax be repealed.
Administrative and Technical Recommendations

In addition to the foregoing major recommendations, we believe that consideration of the following amendments of a technical nature should not be delayed, and should be acted upon at the present session:

(1) Correction of the Effect of the Hendl er Decision. — In United States v. Hendler, 303 U.S. 564 (1938), the Supreme Court held that the assumption and payment of bonded indebtedness by the transferee in a 112(b) (4) reorganization constituted "other property" taxable to the transferor under section 112(d). This decision was contrary to the long-established Bureau rule that the assumption of a liability was not "property" of the character referred to in 112(d), since it was not capable of distribution to stockholders. It also seems contrary to the policy and interest of Congress to accord similar treatment to reorganizations effected by consolidations or mergers, by acquisition of control, or by acquisition of assets. The Hendler decision has created great confusion in the reorganization field, not only because of uncertainty as to the scope of the Hendler rule for the future, but also because it affects countless prior reorganizations, opening the way to claims by the Government for increased taxes and claims by taxpayers to stepped-up bases with respect to transactions long since closed. In addition, under the definition of a "reorganization" in section 112(g)(1)(B) of the 1934 and subsequent Acts, there is a serious question whether reorganizations carried out after that date involving the assumption of liabilities were not taxable transactions in their entirety. A general retroactive amendment confirming the Bureau rule seems to be the only satisfactory method of avoiding these complexities, both for the Government and the taxpayer.

(2) Correction of the Effect of the Rosenfield Decision. — R.S. 3186 provides for an automatic lien of the Federal Government for unpaid tax liabilities. The lien is not valid against a purchaser for value unless notice thereof
is filed in accordance with the law of the State in which the property subject to
C.C.R. 3204), the Federal Court in Michigan enforced such a lien upon negotiable
securities in the hands of a firm of Detroit stockbrokers, who had purchased the
stock without actual notice of the lien. The lien had been properly recorded
under Michigan law and the decision obviously conforms to the strict terms of the
statute. Nevertheless, the fears and uncertainties of purchasers and security
dealers created by the decision are apparent, since it is virtually impossible in
the course of normal dealings in securities to determine whether there may be
liens filed against securities presented for delivery. It is recommended that
the Federal statute be amended to conform to the Uniform Stock Transfer Act, by
providing that no lien shall attach to negotiable securities unless notice of
the lien is stated on the certificate, or actual notice can be proved.

(3) Correction of the Effect of the Koshland and Gowran Cases. — From
1921 to 1936, the Revenue Act provided that all stock dividends were tax-free.
The Treasury Regulations required, where a stock dividend was declared, that the
basis of the original shares be apportioned between those shares and the dividend
stock for computing gain or loss on the sale thereof. In Koshland v. Helvering,
298 U.S. 441 (1936), the Supreme Court held that a dividend of common stock on
preferred stock was a taxable distribution. The Court further held, contrary to
the Regulations, that where a stockholder had received such a dividend, and had
sold the preferred stock, no part of its cost could be allocated to the dividend
stock in determining gain or loss. In Helvering v. Gowran, 302 U.S. 238 (1937),
the converse situation was presented, where the dividend stock had been sold, and
the Court held that the cost of such stock to the taxpayer was "zero". These
decisions overturning the Regulations may adversely affect either the Government
or the taxpayer, depending on which stock the taxpayer may have parted with, a
wholly fortuitous circumstance. It is suggested that the proper remedy is a
statutory ratification of the Department's regulation with respect to a taxpayer who still has one of the stocks and in disposing of the other computed gain or loss in accordance with that regulation.

(4) Inventory Amendment. — Section 22(d) of the 1938 Act recognized, for the first time, the "last-in, first-out" method of valuing inventories, but severely limited its area of application. In accordance with the instructions of the Senate and House Conferences on last year's Bill, further study has been given to the amendment by the Treasury Department with a view to action at this session. It is understood that the Department is ready to present an appropriate redraft of the amendment, which should be incorporated in the Bill.

(5) Purchase of Bonds at a Discount. — There is no specific provision in the Act with respect to the tax treatment of purchase or cancellation of indebtedness, but the Regulations provide that the purchase or cancellation of indebtedness at less than par results in taxable income to the extent of the indebtedness discharged, except where the taxpayer is insolvent after the cancellation. This regulation, in our opinion, is unsound. The purchase of indebtedness at less than par produces no real gain or income. Moreover, the regulation works extreme hardship on corporations in distressed financial circumstances, which are unable to reduce unhealthy debt structures because of the amount of taxable gain which would be realized in the transaction. A partial relaxation of the strict Treasury rule was afforded by the Chandler Act at the last session of Congress, which contained a specific provision that no taxable income shall be realized by virtue of indebtedness cancelled or reduced in a proceeding under that Act. The sound principle thus expressed, however, is too limited in application, since it does not apply to the purchase of indebtedness generally, or to reduction of indebtedness effected without the aid of a Federal bankruptcy court.

A general principle that the purchase of bonds at a discount does not result in
tangible income should be written into the Revenue Act.

(6) Revision of Section 820. -- This complex and technical provision, relating to the correction of errors barred by the statute of limitations, requires revision in several important particulars. For present purposes, however, it is sufficient to call attention to one obvious deficiency. The section authorizes an adjustment against the taxpayer, if a determination establishes the proper year for a deduction or credit erroneously allowed by the Commissioner in a barred year. It does not, however, permit an adjustment in favor of the taxpayer if a deduction or credit has been erroneously disallowed by the Commissioner in a barred year, and a determination is later obtained establishing that fact. Correction of the section in this respect will not afford relief to the taxpayer who has failed to claim a bad debt deduction in the proper year, and seeks to correct the error after the statute of limitations has run; the deduction must have been claimed and improperly denied to get relief. But the amendment does cover an important type of case which the Subcommittee recommended should be covered, and which is necessary to dispense "even-handed justice" between the taxpayer and the Commissioner.

(7) Foreign Tax Credit. -- Section 131, allowing a credit for taxes paid to foreign countries, was designed to encourage and protect American citizens engaged in foreign trade or having investments abroad. A recent limitation on the credit, however, had deprived it of much of its effectiveness. This restriction arises from the change in the definition of "net income" made by the 1936 and 1938 Acts. For United States tax purposes, the term "net income" now includes partly-tax-exempt interest and intercorporate dividends, credits against net income being employed to remove these items, wholly or partially, from tax. For purposes of the foreign tax credit, however, the phrase "entire net income", used in computing the limit on the credit, includes both partly-tax-exempt interest
and intercorporate dividends, with the result of distorting the application of the formula and unjustly reducing the amount of the credit. We hope an amendment to correct this error will be promptly adopted.

(8) Pension Trusts. — The pension trust amendment adopted in section 165 of the 1938 Act, together with the stringent new regulations adopted, threatens the creation and continued existence of many pension, bonus and profit-sharing trusts for employees. The amendment denies tax-exemption to these trusts, if there is any possibility, however slight, that funds may revert to the employer prior to the satisfaction of all liabilities — both fixed and contingent — to employees under the trust. The only exception is the possibility of recovery of amounts through erroneous actuarial computation. Since this requirement can be met only by a virtually irrevocable trust, which is usually undesirable, if not impossible, from a business standpoint, the effect will be to curtail seriously the number of these trusts, to the detriment of employees.

The 1938 amendment unquestionably went too far. The original law worked well, and no convincing reason was advanced for changing it. The amendment was based on the assumption that tax avoidance might occur through the use of revocable trusts. No actual cases were presented in support of this assertion. It is our recommendation that Congress, at this session, should return to the original law. If that is impossible, at least an amendment should be adopted to correct the present situation, preferably by limiting the requirement of irrevocability to that portion of the trust fund which is necessary to satisfy liabilities which have become fixed and certain, as contrasted with liabilities which are merely contingent.

(9) Deficiency Dividends. — A credit was provided in the Revenue Act of 1938, permitting personal holding companies subject to the penalty excises of Title IA to declare dividends to offset deficiencies determined by the Commissioner or the courts. All business corporations, with respect to 1936 and 1937
incomes, are liable to the heavy penalty surtaxes of the 1936 Act for failure to
distribute income, if deficiencies are hereafter discovered. In the absence of
a similar credit, a corporation which in good faith distributed all the income
shown on its return for 1936 and 1937 may suddenly be confronted with an unex-
pected increase in its taxable income for these years and become subject to a
heavy undistributed profits tax. We recommend provision for such a credit in
the pending revision of the Act.

(10) Capital Gains of Personal Holding Companies. — A very large
amount of capital assets which have appreciated in value remain "frozen" in
personal holding companies. Under the 1938 Act, complete liquidations could be
affected at capital gain rates (sec. 115(c)) and, under certain circumstances
(sec. 112(b)(7)), without any immediate tax, upon the stockholders. However,
many of these companies could not, and can not now, be completely liquidated.
A partial liquidation is prohibited, for it involves full taxation of the cap-
ital gains. Sale of the assets is out of the question, since the gain would be
taxable first as corporate income and then either as an ordinary dividend at full
normal tax and surtax to the stockholders or as undistributed income of the hold-
ing company at the 65-75% rate.

The personal holding company surtax was intended as a rough equaliza-
tion of the taxes which would have been payable by the stockholders if the in-
come had been realized by them directly. In the case of capital gains, however,
the section goes far beyond this objective, since the stockholders would be en-
titled to the flat 15% rate if they disposed of the assets directly instead of
through the corporation.

One solution would be the exclusion of capital gains from the defini-
tion of "undistributed net income" of personal holding companies. Another
possibility is the extension of section 112(b)(7), which would permit the dis-
tribution of the appreciated assets with the tax postponed until subsequent sale
by the stockholders. Other suggestions deserving consideration are to permit
the partial liquidation of such companies at capital gain rates, or with a carry-
over basis and the tax postponed until the gain is actually realized by the stock-
holder, or to allow the corporation to sell its capital assets, paying the cor-
porate rate thereon and thereafter to distribute the gain tax-free to its stock-
holders.

(11) Surtaxes upon Income from Personal Services Extending over a
Period of Years. -- A very severe hardship under the existing law, which can be
adequately and simply remedied at the present time, exists with respect to the
taxation of income for personal services rendered over a period of years and paid
for after completion. For example, inventors, authors, engineers, scientists,
lawyers, and others frequently work for years, and receive their compensation
upon the successful completion of their services -- usually all in one year.
Consequently, their entire income, being accumulated and received in one year,
is subject to the highest surtaxes. If this income had been received as their
services were rendered, it would have been subjected to the lower rates of tax;
and the aggregate taxes paid would have been substantially less than the amount
payable under the present law. It would seem that the person who invests his
time and services over a period of years should be in the same position as one
who invests his funds in assets which appreciate over a period of years. We
recommend that income from personal services extending over a period of more
than two years should be taxed at the capital gain rates. A reasonably simple
device to prevent evasion will afford effective protection.

Conclusion

We approve the program to revise our existing revenue laws, as exten-
sively as time permits, in accordance with the principles advocated by the Secre-
tary of the Treasury. We urge the Congress to consider seriously other necessary changes, with a view to their enactment during the next session of Congress.

We always stand ready to assist the Congress and the Administration in its consideration of revenue legislation.
### Table (1)

**Federal Debt and Expenditures, 1931-1940**

<table>
<thead>
<tr>
<th>Fiscal Year</th>
<th>Total Receipts</th>
<th>Total Expenditures</th>
<th>Gross Deficits</th>
</tr>
</thead>
<tbody>
<tr>
<td>1931</td>
<td>$3,189,638,632</td>
<td>$4,091,597,712</td>
<td>$901,959,088</td>
</tr>
<tr>
<td>1932</td>
<td>$2,005,725,437</td>
<td>$5,153,644,895</td>
<td>$3,147,919,455</td>
</tr>
<tr>
<td>1933</td>
<td>$2,079,696,742</td>
<td>$5,142,953,627</td>
<td>$3,063,256,885</td>
</tr>
<tr>
<td>1934</td>
<td>$3,115,554,050</td>
<td>$7,105,050,085</td>
<td>$3,989,496,035</td>
</tr>
<tr>
<td>1935</td>
<td>$3,900,467,202</td>
<td>$7,375,825,166</td>
<td>$3,575,357,964</td>
</tr>
<tr>
<td>1936</td>
<td>$4,115,956,615</td>
<td>$8,879,798,258</td>
<td>$4,763,941,643</td>
</tr>
<tr>
<td>1937</td>
<td>$5,293,840,237</td>
<td>$8,105,158,548</td>
<td>$2,811,318,311</td>
</tr>
<tr>
<td>1938</td>
<td>$6,241,661,227</td>
<td>$7,691,287,108</td>
<td>$1,449,625,861</td>
</tr>
<tr>
<td>1939<strong>a</strong></td>
<td>$5,520,070,000</td>
<td>$9,592,329,000</td>
<td>$4,072,359,000</td>
</tr>
<tr>
<td>1940<strong>a</strong></td>
<td>$5,669,320,000</td>
<td>$9,095,663,200</td>
<td>$3,426,343,200</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$41,031,930,142</strong></td>
<td><strong>$72,233,307,599</strong></td>
<td><strong>$31,201,377,462</strong></td>
</tr>
</tbody>
</table>

*Source: Annual Report of the Secretary of the Treasury, 1937.*

*Estimated, President's Budget Message, January 3, 1939.*
Table (2)
Federal, State, and Local Debt, 1931-1940
(Millions of Dollars)

<table>
<thead>
<tr>
<th>June 30</th>
<th>Gross Federal Debt</th>
<th>Gross Debt, Including State and Local</th>
<th>Per Capita</th>
</tr>
</thead>
<tbody>
<tr>
<td>1931</td>
<td>$16,801</td>
<td>$35,861</td>
<td>$288.94</td>
</tr>
<tr>
<td>1932</td>
<td>19,467</td>
<td>38,817</td>
<td>310.60</td>
</tr>
<tr>
<td>1933</td>
<td>22,539</td>
<td>42,066</td>
<td>334.39</td>
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<tr>
<td>1934</td>
<td>27,053</td>
<td>45,876</td>
<td>362.29</td>
</tr>
<tr>
<td>1935</td>
<td>28,701</td>
<td>47,673</td>
<td>373.84</td>
</tr>
<tr>
<td>1936</td>
<td>33,779</td>
<td>52,757</td>
<td>410.78</td>
</tr>
<tr>
<td>1937</td>
<td>36,425</td>
<td>55,579</td>
<td>429.99</td>
</tr>
<tr>
<td>1938</td>
<td>37,165</td>
<td>56,165 Est.</td>
<td>432.04</td>
</tr>
<tr>
<td>1939a</td>
<td>41,132</td>
<td>60,165 Est.</td>
<td>459.98</td>
</tr>
<tr>
<td>1940a</td>
<td>44,458</td>
<td>63,458 Est.</td>
<td>482.20</td>
</tr>
</tbody>
</table>

Source: Annual Report of the Secretary of the Treasury, 1937.
a — Estimated, President’s Budget Message, January 3, 1939.
Table (3)

New Capital Issues in the United States (Government Obligations and Refundings Excluded)

(Millions of Dollars)

<table>
<thead>
<tr>
<th>Year</th>
<th>Total Corporate</th>
<th>Domestic Corporate</th>
<th>Foreign Corporate</th>
</tr>
</thead>
<tbody>
<tr>
<td>1919</td>
<td>2,303.3</td>
<td>2,246.4</td>
<td>56.9</td>
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<tr>
<td>1920</td>
<td>2,710.0</td>
<td>2,563.4</td>
<td>146.6</td>
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<tr>
<td>1921</td>
<td>1,823.0</td>
<td>1,700.7</td>
<td>122.3</td>
</tr>
<tr>
<td>1922</td>
<td>2,335.7</td>
<td>2,211.5</td>
<td>124.2</td>
</tr>
<tr>
<td>1923</td>
<td>2,702.5</td>
<td>2,635.4</td>
<td>67.1</td>
</tr>
<tr>
<td>1924</td>
<td>3,322.3</td>
<td>3,027.1</td>
<td>295.2</td>
</tr>
<tr>
<td>1925</td>
<td>4,100.7</td>
<td>3,604.5</td>
<td>496.2</td>
</tr>
<tr>
<td>1926</td>
<td>4,357.0</td>
<td>3,754.0</td>
<td>603.0</td>
</tr>
<tr>
<td>1927</td>
<td>5,391.0</td>
<td>4,656.8</td>
<td>734.2</td>
</tr>
<tr>
<td>1928</td>
<td>6,079.6</td>
<td>5,346.1</td>
<td>733.5</td>
</tr>
<tr>
<td>1929</td>
<td>8,639.4</td>
<td>8,022.0</td>
<td>637.4</td>
</tr>
<tr>
<td>1930</td>
<td>4,944.4</td>
<td>4,484.7</td>
<td>459.7</td>
</tr>
<tr>
<td>1931</td>
<td>1,763.5</td>
<td>1,550.7</td>
<td>212.8</td>
</tr>
<tr>
<td>1932</td>
<td>325.4</td>
<td>325.4</td>
<td></td>
</tr>
<tr>
<td>1933</td>
<td>160.7</td>
<td>160.6</td>
<td>1</td>
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<tr>
<td>1934</td>
<td>178.3</td>
<td>178.3</td>
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</tr>
<tr>
<td>1935</td>
<td>403.6</td>
<td>403.6</td>
<td></td>
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<tr>
<td>1936</td>
<td>1,216.9</td>
<td>1,195.9</td>
<td>23.0</td>
</tr>
<tr>
<td>1937</td>
<td>1,158.5</td>
<td>1,158.5</td>
<td></td>
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</table>

Source: Commercial and Financial Chronicle.
<table>
<thead>
<tr>
<th>Year</th>
<th>Total Construction</th>
<th>Public Construction</th>
<th>Private Construction</th>
<th>Percent of public to total</th>
</tr>
</thead>
<tbody>
<tr>
<td>1920</td>
<td>8,563</td>
<td>2,044</td>
<td>6,519</td>
<td>23.9</td>
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<tr>
<td>1921</td>
<td>8,062</td>
<td>2,325</td>
<td>5,737</td>
<td>28.8</td>
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<tr>
<td>1922</td>
<td>9,346</td>
<td>2,358</td>
<td>6,988</td>
<td>25.2</td>
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<tr>
<td>1923</td>
<td>10,920</td>
<td>2,228</td>
<td>8,692</td>
<td>20.4</td>
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<tr>
<td>1924</td>
<td>12,049</td>
<td>2,555</td>
<td>9,494</td>
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<tr>
<td>1925</td>
<td>13,063</td>
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<td>10,244</td>
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<td>1926</td>
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<td>10,917</td>
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<tr>
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<td>13,944</td>
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<td>10,755</td>
<td>22.9</td>
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<td>1928</td>
<td>13,710</td>
<td>3,330</td>
<td>10,380</td>
<td>24.3</td>
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<td>13,488</td>
<td>3,309</td>
<td>10,179</td>
<td>24.5</td>
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<tr>
<td>1930</td>
<td>11,814</td>
<td>3,733</td>
<td>8,081</td>
<td>31.6</td>
</tr>
<tr>
<td>1931</td>
<td>8,689</td>
<td>3,484</td>
<td>5,205</td>
<td>39.4</td>
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<td>1932</td>
<td>5,445</td>
<td>2,539</td>
<td>2,906</td>
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<td>1933</td>
<td>4,044</td>
<td>1,918</td>
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<td>1934</td>
<td>4,860</td>
<td>2,474</td>
<td>2,386</td>
<td>50.9</td>
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<td>1935</td>
<td>5,578</td>
<td>2,548</td>
<td>3,030</td>
<td>45.7</td>
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<tr>
<td>1936</td>
<td>7,731</td>
<td>3,406</td>
<td>4,295</td>
<td>45.2</td>
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<td>1937</td>
<td>8,440</td>
<td>3,329</td>
<td>5,111</td>
<td>39.4</td>
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<tr>
<td>1938</td>
<td>8,396</td>
<td>3,711</td>
<td>4,685</td>
<td>44.2</td>
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</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>1925</td>
<td>104</td>
<td>101</td>
<td>69.9</td>
</tr>
<tr>
<td>1926</td>
<td>108</td>
<td>104</td>
<td>72.8</td>
</tr>
<tr>
<td>1927</td>
<td>106</td>
<td>102</td>
<td>73.4</td>
</tr>
<tr>
<td>1928</td>
<td>111</td>
<td>102</td>
<td>75.8</td>
</tr>
<tr>
<td>1929</td>
<td>119</td>
<td>109</td>
<td>79.8</td>
</tr>
<tr>
<td>1930</td>
<td>96</td>
<td>89</td>
<td>73.6</td>
</tr>
<tr>
<td>1931</td>
<td>81</td>
<td>67</td>
<td>62.6</td>
</tr>
<tr>
<td>1932</td>
<td>64</td>
<td>46</td>
<td>49.6</td>
</tr>
<tr>
<td>1933</td>
<td>76</td>
<td>49</td>
<td>47.9</td>
</tr>
<tr>
<td>1934</td>
<td>79</td>
<td>63</td>
<td>52.4</td>
</tr>
<tr>
<td>1935</td>
<td>90</td>
<td>71</td>
<td>55.1</td>
</tr>
<tr>
<td>1936</td>
<td>105</td>
<td>82</td>
<td>62.6</td>
</tr>
<tr>
<td>1937</td>
<td>110</td>
<td>98</td>
<td>69.3</td>
</tr>
<tr>
<td>1938</td>
<td>86</td>
<td>78</td>
<td>64.0 Est.</td>
</tr>
<tr>
<td>1939</td>
<td>Jan. 101</td>
<td>83</td>
<td>---</td>
</tr>
<tr>
<td></td>
<td>Feb. 99</td>
<td>85</td>
<td>---</td>
</tr>
<tr>
<td></td>
<td>Mar. 93</td>
<td>87</td>
<td>---</td>
</tr>
<tr>
<td></td>
<td>Apr. 92 p.</td>
<td>85 p.</td>
<td>---</td>
</tr>
</tbody>
</table>

p — preliminary
Table (6)

Federal Relief Costs (1)
(Figures in millions)

<table>
<thead>
<tr>
<th>Year</th>
<th>Cost (in millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1934</td>
<td>1,856</td>
</tr>
<tr>
<td>1935</td>
<td>2,361</td>
</tr>
<tr>
<td>1936</td>
<td>2,342</td>
</tr>
<tr>
<td>1937</td>
<td>2,467</td>
</tr>
<tr>
<td>1938</td>
<td>1,953</td>
</tr>
<tr>
<td>1939</td>
<td>2,741</td>
</tr>
</tbody>
</table>


(1) Includes direct relief, work relief (W.P.A. and C.W.A.), and Civilian Conservation Corps.

Number of Persons and Households Receiving Public Assistance Financed From Federal, State, or Local Funds

<table>
<thead>
<tr>
<th>Year</th>
<th>Households</th>
<th>Persons</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dec. 1933</td>
<td>7,000,000</td>
<td>24,800,000</td>
</tr>
<tr>
<td># 1934</td>
<td>6,547,000</td>
<td>23,475,000</td>
</tr>
<tr>
<td># 1935</td>
<td>5,886,000</td>
<td>19,851,000</td>
</tr>
<tr>
<td># 1936</td>
<td>5,968,000</td>
<td>18,872,000</td>
</tr>
<tr>
<td># 1937</td>
<td>5,390,000</td>
<td>15,605,000</td>
</tr>
</tbody>
</table>

### Table (7)

**Corporation Taxes - 1937**

<table>
<thead>
<tr>
<th>Industry</th>
<th>Number of Principal Companies and subsidiaries</th>
<th>Principal Companies</th>
<th>Taxes (1) Exclusive of sales, excises, etc.</th>
<th>Net Income after Taxes</th>
<th>% of Taxes to net Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>Steel Producers</td>
<td>10</td>
<td>316</td>
<td>$149,215,305</td>
<td>$199,742,515</td>
<td>74.7</td>
</tr>
<tr>
<td>Meat Packers</td>
<td>4</td>
<td>157</td>
<td>21,495,637</td>
<td>19,324,716</td>
<td>111.2</td>
</tr>
<tr>
<td>Chain Variety Stores</td>
<td>10</td>
<td>30</td>
<td>29,804,997</td>
<td>64,516,968</td>
<td>46.2</td>
</tr>
<tr>
<td>Automobile Mfrs.</td>
<td>10</td>
<td>129</td>
<td>152,866,266</td>
<td>251,435,246</td>
<td>60.8</td>
</tr>
<tr>
<td>Tire and Rubber Mfrs.</td>
<td>16</td>
<td>219</td>
<td>43,934,999</td>
<td>27,178,443</td>
<td>161.7</td>
</tr>
<tr>
<td>Agricultural Implement Mfrs.</td>
<td>10</td>
<td>56</td>
<td>39,410,325</td>
<td>65,918,418</td>
<td>59.8</td>
</tr>
<tr>
<td>Cigarette Mfrs.</td>
<td>6</td>
<td>15</td>
<td>24,786,185</td>
<td>83,357,761</td>
<td>29.7</td>
</tr>
<tr>
<td>Sugar Refiners</td>
<td>14</td>
<td>53</td>
<td>15,745,628</td>
<td>19,720,972</td>
<td>79.8</td>
</tr>
<tr>
<td>Mail Order Houses</td>
<td>6</td>
<td>33</td>
<td>25,327,215</td>
<td>53,479,005</td>
<td>47.4</td>
</tr>
<tr>
<td>Oil Refiners</td>
<td>19</td>
<td>567</td>
<td>223,581,402</td>
<td>522,722,343</td>
<td>42.8</td>
</tr>
<tr>
<td>Office Equipment Mfrs.</td>
<td>10</td>
<td>92</td>
<td>14,963,822</td>
<td>34,728,285</td>
<td>43.1</td>
</tr>
<tr>
<td>Cement Mfrs.</td>
<td>8</td>
<td>21</td>
<td>2,888,433</td>
<td>6,571,240</td>
<td>44.0</td>
</tr>
<tr>
<td>Department Stores</td>
<td>27</td>
<td>232</td>
<td>30,758,286</td>
<td>28,940,073</td>
<td>106.3</td>
</tr>
<tr>
<td>Container Mfrs.</td>
<td>10</td>
<td>43</td>
<td>18,631,304</td>
<td>44,161,686</td>
<td>42.2</td>
</tr>
<tr>
<td>Chain Groceries</td>
<td>13</td>
<td>52</td>
<td>15,338,924</td>
<td>9,439,804</td>
<td>162.5</td>
</tr>
<tr>
<td>Chemical and Fertilizer Mfrs.</td>
<td>21</td>
<td>217</td>
<td>55,138,294</td>
<td>193,517,916</td>
<td>28.5</td>
</tr>
</tbody>
</table>

**TOTALS** 194 2,238 $863,886,933 $1,634,755,391 53.2

**Source:** Compiled from published reports sponsored by the Securities and Exchange Commission.

(1) Above figures on taxes exclude all excises, sales taxes and other imposts which may be regarded as "consumers' taxes", with the possible exception of minor amounts, if any, of such taxes which may not have been excluded from the data issued by the Securities and Exchange Commission. It is understood, however, that certain other taxes which might properly have been included in the total borne by the registrants were ignored.
Appendix A

Examples Showing the Effect of High Surtax Rates on Individual Incomes Under the Revenue Act of 1938

(Amounts of incomes here referred to are "surtax net income" after allowance for exemptions, etc. Amounts of tax are combined normal and surtax rates.)

I. (a) A man with $50,000 of net income (taxable at from 4% to 31%) will have a tax to pay of $9,700 (an average rate of 19.4%). He will have left, after tax, a net amount of $40,300.

(b) An additional $1000 of income will be taxable at 35%, so that the tax will take $350 of that amount, leaving him net, after tax, $4650, or 65% of such additional income.

II. (a) A man with $100,000 of net income (taxable at from 4% to 59%) will have a tax to pay of $34,000 (an average rate of 34%). He will have left, after tax, a net amount of $66,000.

(b) An additional $1000 of income will be taxable at 62%, so that the tax will take $620 of that amount, leaving him net, after tax, $3380, or 33% of such additional income.

III. (a) A man with $150,000 of net income (taxable at from 4% to 65%) will have a tax to pay of $65,000 (an average rate of 43-1/3%). He will have left, after tax, a net amount of $85,000.

(b) An additional $1000 of income will be taxable at 64% so that the tax will take $640 of that amount, leaving him net, after tax, $360 or 36% of such additional income.

(c) Considering the $150,000 net income by $50,000 blocks, the result is as follows: 

Regraded Unclassified
Regraded Unclassified

<table>
<thead>
<tr>
<th>Net Income</th>
<th>Average %</th>
<th>Tax Amount</th>
<th>%</th>
<th>Remaining</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>First $50,000 I(a)</td>
<td>19.4%</td>
<td>$9,700</td>
<td>80.6%</td>
<td>$40,300</td>
<td></td>
</tr>
<tr>
<td>Second $50,000</td>
<td>48.6%</td>
<td>24,300</td>
<td>51.4%</td>
<td>25,700</td>
<td></td>
</tr>
<tr>
<td>$100,000 II(a)</td>
<td>34.0%</td>
<td>34,000</td>
<td>66.0%</td>
<td>66,000</td>
<td></td>
</tr>
<tr>
<td>Third 50,000</td>
<td>62.0%</td>
<td>31,000</td>
<td>38.0%</td>
<td>19,000</td>
<td></td>
</tr>
<tr>
<td>$150,000 III(a)</td>
<td>43.1/3%</td>
<td>65,000</td>
<td>56-2/3%</td>
<td>85,000</td>
<td></td>
</tr>
</tbody>
</table>

IV. Considering 4% as the rate of interest which a reasonably safe industrial might yield, 6% as the rate for a bond or loan which carried a reasonable business risk, and higher rates of 8%, 10%, 15% and 20% as the possible yields which might be expected as greater elements of risk might be involved; then we find the net yields, after the federal income tax (but without considering state income or other taxes), if these represented additional income to A who already had $50,000 of net income, to B who already had $100,000 of net income, and to C who already had $150,000 of net income would be as follows:
### Table

<table>
<thead>
<tr>
<th>Income Rate</th>
<th>Net Yield To A after 35% tax</th>
<th>Net Yield To B after 62% tax</th>
<th>Net Yield To C after 64% tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>4%</td>
<td>2.60%</td>
<td>1.52%</td>
<td>1.44%</td>
</tr>
<tr>
<td>6%</td>
<td>3.90%</td>
<td>2.28%</td>
<td>2.16%</td>
</tr>
<tr>
<td>8%</td>
<td>5.20%</td>
<td>3.04%</td>
<td>2.88%</td>
</tr>
<tr>
<td>10%</td>
<td>6.50%</td>
<td>3.80%</td>
<td>3.60%</td>
</tr>
<tr>
<td>15%</td>
<td>9.75%</td>
<td>5.70%</td>
<td>5.40%</td>
</tr>
<tr>
<td>20%</td>
<td>13.00%</td>
<td>7.50%</td>
<td>7.20%</td>
</tr>
</tbody>
</table>

Possibly A might feel that the net yields which he could hope for would be sufficient to justify such investments if conditions were reasonably satisfactory. B and C could hardly be expected to make investments which involved such business risks as would normally call for 6%, 8% or 10% returns to make them attractive investments when B and C would only have 2%, 3% or 4% net left to themselves from such investments.

V. (a) If A, a man who already has $50,000 of net income, is contemplating investment of $100,000 in a business which he hopes will yield 10% a year, he finds that the $10,000 he hopes to receive will be subject to $3,660 tax so the net yield to him from his $100,000 investment will be $6,340, or slightly more than 6%. He may feel that this is sufficient to justify the investment.

(b) If B, a man who already has $100,000 of net income, is contemplating investment of $100,000 in a business which he also hopes will yield 10% a year, he finds that the $10,000 he hopes to receive will be subject to $6,200 tax, so the net yield to him will be only $3,800 or less than 4%. He
can hardly feel that such a net return is sufficient to justify him in making the investment.

VI. The high surtaxes work out to place excessive penalties on variations in income from year to year.

(a) A man with $50,000 a year net income pays $9,700. For 2 years on $100,000 of income thus received his tax would be $19,400, leaving to him a net amount, for the 2 years, of $80,600.

(b) A man with $20,000 net income in one year, on which he has to pay $2,050 tax, and $80,000 net income in the next year, on which his tax would be $22,600; would also have $100,000 net income for the two years, but his taxes thereon would be $34,660, leaving him a net amount, for the two years, of $75,340. Because of the irregularity of his income, he has to pay 27% more tax than if his income had been received in equal amounts in each of the two years.

(c) If a man had $50,000 loss in one year and $150,000 of income in the next, he also would have a net income of $100,000 for the two years, but his tax would be $65,000, leaving him net only $35,000. His tax will be over 3 times the amount of tax payable on $100,000 realized in equal amounts each year.
The Effect of Net Losses Upon Business Investment

Any man considering a new investment will be faced with many possible conditions which may develop. He must consider possibilities of success and possibilities of failure; possibilities of losses in some years and gains in others. He must balance the probability of a final result with gains to out-weigh losses.

The man who would make a substantial business investment is probably a man who already has a substantial amount of other income. In measuring the advantages to him of making the investment, he will take into account the net result of the new venture to him, applying to it the rates which would be applied to it on top of his other income. Manifestly, unless this will yield to him a return in addition to his other income which is sufficient to cover the risk, he would be better off to be contented with his present income and not make the new investment, or possibly to make the investment in some conservative low-yield security.

In trying to determine the net result of the business the investor should take into account the possibility, or even probability, of having one, two or three years' losses before the new business could get on its feet and really start its earnings. Even after it has reached a point where it can show earnings in good years, he must still consider the possibility of some years of loss falling in any extended period of years. Of course, if he can feel well assured of the absence of serious risk in the investment and the reasonable expectation of steady income from it, he can make his investment with little regard to possibility of loss. Only rarely, however, will this condition exist with regard to any new enterprise.

A man may consider the results of the investment if he engages in it
individually (or through a partnership) so there will be no corporation tax to pay but only the individual income tax. In that case he can figure the additional tax he would have to pay on income from the enterprise received in addition to his other income, and may count on being able to apply losses on the enterprise in years of loss against his other income, with reduction of the amount of tax he would otherwise have to pay.

If, however, he makes an investment through a corporation, then the net amount remaining to him will be what is left after paying the corporate tax in any years in which the corporation has a gain (with no corporate tax to pay in years of corporate loss) and after paying his individual income tax on any net profits the corporation distributes to him.

We have set up certain rather typical examples of how this situation would work out as to tax and net gain from investments. First, as to a man with $100,000 of other income, so that any taxes he would have to pay on additional income would be at a rate of at least 62%; and second, for a man who had such income that the average rate of tax he would have to pay on additional income would be 31%. (This latter computation cannot be related to specific amounts of income as the 31% falls at a point where the gradations between rates are quite rapid. However, we are justified in making the computation on an assumption that a man might happen to have this exact rate to pay on additional income, or that he might be one of a number of men who were participating in the investment so that he would have an average rate of 31% to pay.)

For convenience of computation, we have assumed earnings of $100,000 a year in years of profit, with possibility that there might be a year or years in which there would be losses of $100,000. (Computation could, of course, be made as to fluctuating amounts of income in various years and fluctuating amounts of possible loss, but the computations are at best so complicated that the simple
case seems sufficient to illustrate the tendencies involved.)

For simplicity also we are assuming that the investor has a steady income from other sources which does not fluctuate from year to year. Perhaps the real tendency would be for his other income to be higher in the years when the new enterprise had income for distribution, and be lower in years when the new enterprise was sustaining loss, with the effect, as hereinbefore noted, that this would serve still further to increase the average rates of tax which he would have to pay.

On these assumptions we have set up various examples which in each case show the results for a five-year period:

(A) If the enterprise had steady earnings of $100,000 a year, with no years of losses;

(B) If the enterprise had earnings of $100,000 a year for four years of the five-year period and had one year of loss of $100,000;

(C) If the enterprise had three years of earnings of $100,000 a year, and two years of loss of $100,000 a year;

(D) If the enterprise had two years of profits of $100,000 a year and three years of loss of $100,000 a year each.

Some of these may seem rather extreme figures, but they are by no means beyond the possibilities with which an investor may be faced with regard to a new business.

The computations show how this would work out —

I(a) — For an individual conducting the business directly.

I(b) — For an individual who had the business conducted by a corporation under existing provisions where taxable income of each year was computed without deduction for losses of another year.

I(c) — For an individual who conducted the business through a corporation if the net income of one year was computed after allowance for deduction of losses of other years.
As a final computation we have figured what would be the average net
return under the various conditions which would remain to the investor after pay-
ing the income taxes involved -

(1) On the assumption that a $1,000,000 investment
was required to yield the estimated earnings
(so that in years of profit the business would
be earning 10% on its invested capital); and

(2) On the assumption that a $500,000 investment was
was required to yield the estimated earnings
(so that in years of profit the business would
be earning 20% on its invested capital).

First, these are presented on the assumption that the individual has
other income of $100,000, so that on any income from this enterprise he would be
taxed at 62%.

As to computation I(a) if the business were conducted individually,
it is assumed that the losses in any years of loss would have the result of off-
setting $34,000 of tax which the individual would otherwise have to pay on his
$100,000 of other income.

On computations I(b) and I(c) it is assumed that even though the cor-
poration might have to pay tax on the full amount of income which it earned in
years of profit, it would not be penalized for failure to distribute earnings
to the extent that it was necessary to apply such earnings to offset the losses
of other years.
Such computations, briefly summarized, show as follows:

<table>
<thead>
<tr>
<th></th>
<th>A</th>
<th>B</th>
<th>C</th>
<th>D</th>
</tr>
</thead>
<tbody>
<tr>
<td>5 years</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>I(a) Business conducted by individual having other income of $100,000.</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Business earnings $100,000 per year except for losses as indicated.</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net earnings</td>
<td>$500,000</td>
<td>$300,000</td>
<td>$100,000</td>
<td>$-100,000</td>
</tr>
<tr>
<td>Net tax</td>
<td>$310,000</td>
<td>$214,000</td>
<td>$118,000</td>
<td>$22,000</td>
</tr>
<tr>
<td>Net gain</td>
<td>$190,000</td>
<td>$86,000</td>
<td>$-18,000</td>
<td>$-122,000</td>
</tr>
<tr>
<td>Average net gain per year</td>
<td>$38,000</td>
<td>$17,200</td>
<td>$3,600</td>
<td>$24,400</td>
</tr>
<tr>
<td>Percentage of earnings remaining to represent net gain to investor</td>
<td>38%</td>
<td>28.57%</td>
<td>-18%</td>
<td></td>
</tr>
<tr>
<td>Average annual net return on capital:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(1) On $1,000,000 investment</td>
<td>3.8%</td>
<td>1.72%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(2) On $500,000 investment</td>
<td>7.6%</td>
<td>3.44%</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

There is here, of course, no inducement for investment if two years' losses or three years' losses are a probability, as in Columns C and D. Even an assumption of one year's loss in five would certainly leave no inducement for investment of $1,000,000 in such an enterprise. There is practically no inducement for the results in Column B to be obtained on a $500,000 investment.

If the business could reasonably be expected to make 20% a year on a $500,000 investment, with no years of losses, as in Column A, the possible 7.6% return on the investment might be sufficient to offset the probability of loss. There would hardly be sufficient inducement if it was necessary to make a $1,000,000 investment to obtain these results.
If, however, such a business is to be conducted by a corporation, under the existing law which denies right to apply losses of one year as deductions from profits of other years, and all earnings in excess of taxes and losses are to be promptly distributed to a stockholder (or to stockholders) taxable thereon at 62%, such computations briefly summarized above as follows:

<table>
<thead>
<tr>
<th>A</th>
<th>B</th>
<th>C</th>
<th>D</th>
</tr>
</thead>
<tbody>
<tr>
<td>No losses</td>
<td>1 year</td>
<td>2 years</td>
<td>3 years</td>
</tr>
<tr>
<td>Corporation earnings $100,000 per year except for losses as indicated.</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>$100,000</td>
<td>$200,000</td>
<td>$300,000</td>
<td></td>
</tr>
<tr>
<td>Net earnings distributed to stockholder taxable @ 62%.</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>$500,000</td>
<td>$300,000</td>
<td>$100,000</td>
<td>$100,000</td>
</tr>
<tr>
<td>Total tax (corporation and individual)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>341,350</td>
<td>211,060</td>
<td>80,810</td>
<td>33,000</td>
</tr>
<tr>
<td>Net gain</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>$158,650</td>
<td>$88,920</td>
<td>$19,190</td>
<td>$133,000</td>
</tr>
<tr>
<td>Average net gain per year</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>$31,730</td>
<td>$17,784</td>
<td>$3,838</td>
<td>$26,600</td>
</tr>
<tr>
<td>Percentage of earnings remaining to represent net gain to investor</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>31.73%</td>
<td>29.64%</td>
<td>19.19%</td>
<td>-</td>
</tr>
<tr>
<td>Average annual net return on capital:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(1) On $1,000,000 investment</td>
<td>3.173%</td>
<td>1.778%</td>
<td>3.383%</td>
</tr>
<tr>
<td>(2) On $500,000 investment</td>
<td>6.346%</td>
<td>3.557%</td>
<td>7.676%</td>
</tr>
</tbody>
</table>

This gives some variation from the results under Example III(a) where the business is conducted by the individual. In Column C (2 years losses), the tax would take substantially all the net earnings under I(b) but would not actually exceed the net earnings as it would under I(a).

Probably the only basis which would make such an investment reasonable under these conditions would be the assumption that the corporation could each year earn 20% on its invested capital, with no years of loss.
If, in computing taxes, losses of one year could be deducted from profits of other years, a somewhat better result would be shown, but at least the element of loss due to taxes would be minimized. Making this computation under the conditions of Example I (b), the results would be as follows:

<table>
<thead>
<tr>
<th>I (c)</th>
<th>5 years</th>
<th>A</th>
<th>B</th>
<th>C</th>
<th>D</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>No losses</td>
<td>1 year</td>
<td>2 years</td>
<td>3 years</td>
<td></td>
</tr>
<tr>
<td>Corporation earnings</td>
<td>$100,000 per year</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Losses deducted in computing tax on profits</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net earnings distributed to stockholder taxable @ 62%</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Corporation earnings</td>
<td>$100,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total tax (corporation and individual)</td>
<td>$31,730</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net gain</td>
<td>$68,270</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Average net gain per year</td>
<td>$20,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Percentage of earnings remaining to represent net gain to investor</td>
<td>31.73%</td>
<td>31.73%</td>
<td>31.73%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Average annual net return on capital</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(1) On $1,000,000 investment</td>
<td>3.173%</td>
<td>1.903%</td>
<td>.635%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(2) On $500,000 investment</td>
<td>6.346%</td>
<td>3.807%</td>
<td>1.269%</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

The results in the first Column A (no losses) remain the same as in Example I (b) but the possible return under Columns B and C, while not an inducement in itself, is substantially better than in I (b). If the Column D situation should exist, the investor does not have to stand taxes to the Government in addition to a net loss of the business.
The foregoing Examples I (a), I (b) and I (c) are all on the basis of results to a stockholder (or stockholders) taxable at 62%.

We may assume an individual (or individuals) taxable @ 31%, without attempting to say exactly where in the tax scale that average result would come. Also we may assume that if the business were individually conducted any losses would result in a tax saving to the individual of 15% of the loss. On that basis, with conditions otherwise the same as in Examples I (a), I (b) and I (c), we may make the respective computations of II (a), II (b) and II (c).

<table>
<thead>
<tr>
<th>II (a)</th>
<th>5 years</th>
<th>A</th>
<th>B</th>
<th>C</th>
<th>D</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>No losses</td>
<td>1 year</td>
<td>2 years</td>
<td>3 years</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>loss</td>
<td>losses</td>
<td>losses</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>$100,000</td>
<td>$200,000</td>
<td>$300,000</td>
</tr>
</tbody>
</table>

As in Example I (a) except that individual is taxable @ 31% and losses give tax saving of 15%.

Net earnings: $500,000 $300,000 $100,000 $100,000

Net tax: 155,000 109,000 65,000 17,000

Net gain: $345,000 $191,000 $37,000 $117,000

Average net gain per year: $69,000 $38,200 $7,400 $23,400

Percentage of earnings remaining to represent net gain to investor... 69% 63.67% 37% -

Average annual net return on capital:

1. On $100,000 investment...... 6.9% 3.82% .74% -

2. On $500,000 investment...... 13.8% 7.64% 1.48% -
II (b): 5 years

<table>
<thead>
<tr>
<th></th>
<th>A</th>
<th>B</th>
<th>C</th>
<th>D</th>
</tr>
</thead>
<tbody>
<tr>
<td>No losses</td>
<td>$500,000</td>
<td>$300,000</td>
<td>$100,000</td>
<td>-$100,000</td>
</tr>
<tr>
<td>1 year loss</td>
<td>$211,925</td>
<td>138,540</td>
<td>65,155</td>
<td>33,000</td>
</tr>
<tr>
<td>2 years losses</td>
<td>$288,075</td>
<td>$161,460</td>
<td>$34,845</td>
<td>-$133,000</td>
</tr>
<tr>
<td>3 years losses</td>
<td>$57,615</td>
<td>$32,392</td>
<td>$6,969</td>
<td>$26,600</td>
</tr>
</tbody>
</table>

As in Example I (b) except that stockholder is taxable @ 31%.

Net earnings: $500,000
Total tax: $211,925
Net gain: $288,075
Average net gain per year: $57,615

Percentage of earnings remaining to represent net gain to investor: 57.61%

Average annual net return on capital:

(1) On $1,000,000 investment: 5.762%
(2) On $500,000 investment: 11.523%

II (c)

As in Example I (c) except that stockholder is taxable @ 31%.

Net earnings: $500,000
Total tax: $211,925
Net gain: $288,075
Percentage of earnings remaining to represent net gain to investor: 57.61%

Average annual net return on capital:

(1) On $1,000,000 investment: 5.762%
(2) On $500,000 investment: 11.523%
Only a brief review of these is necessary to show how much more of an inducement for investment is offered to the man taxable at 31% than is offered to the man taxable at 62%.

Admittedly, the computations here made deal with certain special situations which are adopted as assumptions for these computations. The results, however, are generally representative of the tendencies which exist in the present law, as will appear from even more extended computations of this kind which can be made.

While it is not perhaps the ordinary contemplation that a single investor will make the complete investment of $500,000 or $1,000,000 for financing an enterprise of this kind, computations made in this way will show the same tendencies as would face an investor if he were contemplating putting in only a part of the total amount, with the balance to be supplied by others.
TO

Secretary Morgenthau

FROM

Mr. Haas

Subject: Financing Needs of Small Businesses

Summary

1. The difficulty of financing small business concerns has been a cause for intermittent complaint for many years. It is probably somewhat more difficult for such concerns to finance themselves now than it was ten years ago, but somewhat easier than four or five years ago.

2. The statistical data with respect to the availability of credit to small businesses lead to the conclusion that there exists on the part of solvent borrowers an unsatisfied demand for credit, the total amount of which is smaller than supposed, however, and the would-be borrowers of which are poor credit risks by reason of their small equity in their businesses.

3. The difficulties encountered are somewhat different for different types of concerns -- the problems of small or medium-size corporations with fairly widely dispersed bodies of stockholders differing particularly from the problems of small unincorporated enterprises or closely held corporations. The difficulties also vary with different types of capital requirements -- the problems connected with obtaining proprietors' capital and other permanent capital differing considerably from those encountered in obtaining working capital.

4. Proprietors' capital for unincorporated enterprises or small, closely held corporations is generally furnished entirely by the managers and their personal acquaintances, while that for small or medium-size corporations with fairly widely dispersed bodies of stockholders must often be raised in part by the sale of securities to persons not intimately acquainted with the enterprises. The supply and availability of capital for the first type of enterprise has been somewhat restricted by the attrition of personal resources and the timidity of capital brought about by the depression, but presents no fundamental problem aggravated by or likely to be alleviated by the action of the Federal Government.
5. The problem of the small or medium-size corporation in endeavoring to raise capital by the public offering of securities has been much more acute in recent years. This difficulty has been occasioned principally because the Securities Act and the operations of the Securities and Exchange Commission are primarily attuned to larger-scale enterprises and, consequently, are burdensome to those just large enough to fall under the Act or be affected by it indirectly.

6. The amount of capital needed by the small business man can be greatly reduced by relying to as large an extent as possible upon the use of facilities owned by others, as, for example, by renting machinery and equipment. When this is impracticable, the purchase of equipment on the instalment plan provides a readily available means of financing, but the rate of interest charged on the deferred payments is very high.

7. Business loans from the Reconstruction Finance Corporation and from the Federal Reserve banks have been relatively unimportant as sources of either working capital or new plant and equipment for the small business man.

8. Commercial banks have for many years furnished a larger portion of the capital of business concerns in general and of small business concerns in particular than would be sanctioned by the classical theory of commercial banking. One of the manifestations of the timidity of capital engendered by the depression has been a resurgence of the classical doctrine among commercial bankers and a consequent restriction in the amount of bank credit allowed business. The rates charged for bank accommodation to the small business man are substantially higher than those charged larger concerns.

9. The sale of receivables to a finance company or a factor is a financing medium which has been growing rapidly in importance in recent years, and the stigma once attached to it has now been largely removed. The rate charged is very high, however.
Small business concerns in the United States today are doubtless experiencing considerable difficulty in financing what they believe to be their legitimate needs. This difficulty is by no means recent, nor is it confined to the United States. Complaint against the inadequacy of the financing media open to small business concerns has been intermittent in this country for many years, and is probably somewhat less vigorous at the present time than five years back, when legislation was enacted authorizing the Reconstruction Finance Corporation and the Federal reserve banks to make direct loans to industry. In England, the McMillan Report, presented in 1931, makes the same complaint with respect to British conditions.

The difficulties which give rise to the complaints just referred to are in part inherent in any system of individual enterprise—in the absence of which the problem itself would not exist—and are in part the result of economic or political institutions not inseparable from the system of private enterprise as such. The difficulties are probably more acute than ten years ago, but less acute than five years ago.

The present study is necessarily very constricted in scope, and can hope to deal with the present problem only in a very broad way. The problem is by no means a homogeneous one, since both small businesses themselves and the type of financing which they require vary widely. A "small" business concern means radically different things to different persons. To the banker in a small town, a small business may be one employing only a half dozen persons or less, while to the investment banker in Wall Street, a concern with 300 persons on its payroll may be too small to be worth his consideration. Both the small town and the Wall Street banker may be right, each within his own field, for the important thing is that concerns of the type visualized by each may encounter difficulties in financing themselves which are properly attributable
to their "smallness." Although we shall find that these difficulties are of a somewhat different character, our view should be sufficiently comprehensive to include both.

In addition to the difference between the types of "small" concerns requiring financing, there is an important difference between the types of financing which any given concern may require. Its need may be for working capital of a self-liquidating character, as, for example, the need of a retail dry goods merchant for funds to finance the purchase of his peak inventory for the Christmas trade; or, on the other hand, the need may be for capital to remain permanently in the business, as, for example, the need of a small manufacturing concern for funds to erect an addition to its plant. It is traditional to say that these needs are different in kind and ought to be financed from totally different sources. The need for working capital, it is said, may properly be met by loans from commercial banks, while the need for permanent additions to fixed plant can only be met satisfactorily by additional proprietors' capital.

In practice, however, this distinction—based upon the classical theory of commercial banking—has never been widely observed, and the classification, based upon the character of the concern, is much more fundamental than that based upon the character of the capital requirement. We shall find, however, as one of our principal conclusions, that one of the major causes of the increased difficulty of small businessmen in securing as much accommodation as formerly is a resurgence of the classical doctrine among practical bankers.

Before turning to an analysis of the various sources of capital and credit available to small businesses, however, it may be advisable to consider the available evidence with respect to the unsatisfied credit and capital needs of small business.
I. Unavailability of Credit and Capital

On at least a half dozen occasions during the last 7 years, government agencies and private organizations have made extensive detailed investigations of the availability of credit and capital to businessmen, both large and small. All the studies that have been made available to us appear to lead to the same general conclusions, however, when allowance is made for the difference in scope and technique employed in the various studies:

1. There appears to exist a genuine unsatisfied demand for credit on the part of solvent borrowers, many of whom could make economically sound use of working capital. This demand for credit is mainly for permanent credit or capital, however -- a variety not provided satisfactorily by commercial banks.

2. The total amount of this unsatisfied demand for credit is considerably smaller than is popularly believed but may be large enough to be a significant factor, among many others, in retarding business recovery.

3. A large proportion of the would-be borrowers are persons whose equity in the business they control is so small that any bank or individual who lends them substantial amounts is assuming a major part of the risk of the business, rather than the normal risk of a creditor.

Unsatisfied demand for credit.

Although the studies made by the various private and Government agencies were made at different times and varied in scope to a considerable extent, they were all published in sufficient enough detail to permit direct conclusions with respect to the unsatisfied demand for credit in different parts of the country. In each study an important number of reporting concerns indicated that they had been refused credit accommodations by banks or had experienced some kind of credit restrictions during the period covered. The percentage of firms experiencing credit difficulties varied with the character of the sample however -- the percentage was very low when the survey included both large and small concerns (9% and 14%) --
National Industrial Conference Board, 1/ 1938 and 1932, respectively); the percentage was very much larger when the survey was confined to relatively small concerns (32% — Bureau of the Census, 2/ 1933).

The Bureau of the Census survey was made for the Business Advisory Council of the Department of Commerce. It covered 1933 and appears to have been framed with the following question in mind: "Have small manufacturers been handicapped by the lack of adequate credit?" The statistical facts were as follows:

6,156 small manufacturing firms submitted replies.

4,387 of these firms were would-be borrowers of capital.

1,964 or 45% of these would-be borrowers reported difficulty in obtaining credit. This difficulty extended to all size classes of firms, to all geographical districts, and to all industry classifications. 620 of these firms had a net worth-to-debt ratio of 2 to 1 or better. 393 of them, moreover, were rated "high" or "good" by Dun & Bradstreet, the mercantile credit agency.

Statistically, therefore, the Census report would appear to portray an important lack of credit facilities. The report understates the situation, moreover, because a substantial number of firms experiencing no actual credit difficulties during the year reported that no sources of long-term credit were available to them. Nor was this surprising, for 20% of such firms reporting on their credit sources, listed commercial banks as their previous source of long-term credit.

The replies submitted to the National Industrial Conference Board provided less conclusive statistical data than the foregoing because the sample included very large as well as small and medium-sized business concerns. The Conference Board's 1938 findings with respect to the small business were conclusive, however:


"Concerns classed as small and very small, or those with capital of $500,000 or less, accounted for more than 80 percent of the credit refusals and restrictions. . . . For all practical purposes, therefore, the problem of bank credit availability is a problem that concerns small enterprises. Refusals and restrictions reported by large manufacturing concerns are almost negligible."

Amount of Bank Credit Desired.

Very limited data with respect to the total amount of credit desired by would-be borrowers and denied them by their ordinary sources of credit accommodation have been compiled and the figures that have been tabulated have been subject to numerous qualifications. The data available point to a general conclusion, however — the total amount of the unsatisfied demand for credit is relatively small.

The Census Bureau tabulated estimated credit requirements of small manufacturers for meeting maturing obligations between 1934 and 1936. The Bureau estimated that, on the basis of its small sample, nearly 14,000 firms experienced difficulty in securing credit in 1934 and that these concerns required $562 millions to meet maturing obligations in that year. The Bureau pointed out, however, that this estimated aggregate requirement did not represent an additional demand for bank credit. Additional bank credit would have been needed only to the extent that maturing obligations to creditors other than banks were not renewed and could not be retired out of income without financial embarrassment. In other words, the Bureau called for estimated requirements for meeting maturing obligations and not for estimates of additional bank credit needed for that purpose.

The Bureau attempted to obtain information on annual requirements for working capital, in addition to the foregoing data. The replies were so unreliable, however, owing largely to the lack of a standard definition of the term "working capital" that they were never tabulated.

Charles O. Hardy and Jacob Viner analyzed reports of refusals of loan applications by commercial banks in the Fourth and Seventh Federal Reserve Districts 3/ and 4/.

Report on the availability of Bank Credit submitted to the Secretary of the Treasury: Fourth Federal Reserve District by Charles O. Hardy; Seventh Federal Reserve District by Charles O. Hardy and Jacob Viner.
submitted reports of their findings to the Treasury Department. When they investigated 1,913 cases of loan refusals in the Seventh District in which definite amounts were stated, they found that the total amount involved was only $17 millions or less than $9,000 per case. They investigated the effect of the interest rate on the willingness to borrow and found that in the aggregate some 1,500 borrowers would wish to borrow only $43 millions at a specified interest rate of 4 percent, and that most of the borrowing would be for refunding purposes.

More recent data with respect to the relatively small amount of capital and credit needed by small business men have been provided by the Securities and Exchange Commission in a survey of the Detroit area. 7/ Forty-eight companies reported immediate need for either additional working or equity capital or both. Thirty-seven of the companies had been refused bank credit within the past few years. Their total requirements amount to less than $1½ millions, or less than $40,000 per case.

The foregoing data corroborate each other and the conclusion with respect to the unsatisfied demand for credit is clear: The amount of the unsatisfied demand is considerably smaller than is popularly believed, but may be large enough to be a significant factor, among many others, in retarding business recovery.

Poor Financial Condition of Borrowers.

The problem of bank credit available to borrowers cannot be judged solely on the basis of over-all statistical figures on the number of credit refusals and restrictions. Serious attention must be given to the financial condition of the borrowers, particularly when they are small businesses.

The extreme liquidation of the 1929-33 period caused many small concerns to enter the period of revival with unbalanced financial structures and frequently with inadequate equity capital. The principal need of the small concern was for funds for relatively long periods - intermediate credit, long-term credit, and particularly equity capital. In numerous cases additional equity capital

7/ Testimony of William B. Whitehead before Temporary National Economic Committee.
was essential if a reasonable balance in the financial structure was to be attained; but risk capital in small amounts was generally unavailable. The small concern did not have access to the capital markets and the individual small-town capitalist seemed to have disappeared, or his capital had.

The weak financial condition of the small businessmen therefore, was a basic reason for the rejection of a large number of their applications for bank credit. The Census Bureau data indicate that nearly one-quarter of the concerns reporting credit difficulty had a ratio of current assets to current liabilities of less than one to one. Likewise, one-quarter of the concerns reporting credit difficulty (not necessarily the same firms) had a net worth to debt ratio of less than one to one. From a traditional banking point of view, therefore, the financial ratios of these concerns would be sufficient in most cases to prevent them from obtaining bank accommodation.

Hardy and Viner arrived at the same conclusion by analyzing the reasons given by banks. They noted that the most frequent reasons given for refusal of loans were "inadequate working capital" and "inadequate net worth", each of these reasons appearing in connection with more than one-third of the refusals.
II. Sources of Credit and Capital

The preceding section has been concerned with the available indications of the unsatisfied demands of small businesses for credit and capital. In the present section, the various sources of credit and capital will be analyzed in an effort to determine the importance of each source and its suitability under present-day conditions. For the purposes of this section, we have divided small business concerns into three categories, namely:

(1) Small mercantile firms, either unincorporated or, if incorporated, obtaining all of their proprietors' capital from those actively engaged in the business and their relatives or personal acquaintances.

(2) Small manufacturing concerns similarly situated.

(3) Incorporated enterprises, irrespective of the character of their business, which are too small to obtain ready access to the organized capital markets, but the stock of which is nevertheless distributed more widely than among those actively engaged in the business and their relatives and personal acquaintances.

Although, for purposes of convenience, the following discussion is arranged by classes of financing media, we have endeavored to make clear in all cases the extent to which these media are available to the different types of enterprises just enumerated.

1. Proprietors' Capital

Proprietors' capital, for the first two classes of enterprises just described comes exclusively from the personal resources of the business man and his partners and from his or their friends and relatives. The amount of capital which will be forthcoming is, therefore, dependent upon the resources of these persons and their confidence in the success of the enterprise. Both of these factors were doubtless greatly reduced, on the average, by the ravages of the depression. Both are so fundamental, however,
that there is no remedy available for these ravages, except the healing processes of time, since neither the Government nor any private individual can reasonably be expected either to supply a man with his whole stake, if neither this man nor his friends can supply a cushion; nor restore his or their confidence in his ability to make profits, if he and his close associates shrink from risking their own capital. Fortunately for the capitalistic system, these healing processes are proceeding at a fairly rapid pace; and, as the dark days of the depression recede into the background, small accumulations of capital are reinforced by the profits of good years and the will to reinvest them in venturesome enterprise returns.

The situation with respect to proprietors' capital for small unincorporated or closely held mercantile or manufacturing enterprises, while not amenable to any action which might be taken by the Federal Government, is thus, in our opinion, gradually improving and likely to improve further with the progress of business recovery. While not susceptible of accurate measurement, the quantitative importance of this factor is doubtless much greater for the first two types of "small" enterprise than that of all the more widely discussed sources of capital combined.

For small concerns of the third class—corporations with stock distributed more widely than among those actively engaged in the business and their immediate acquaintances—the outlook is much less clear. These corporations are unable to raise their proprietors’ capital entirely from those intimately acquainted with the enterprise or its managers, but are, nevertheless, too small to have their securities actively traded upon any organized market. These enterprises in the past have raised that portion of their proprietors' capital not furnished by their principal stockholders and their immediate friends by the sale of securities through local investment bankers. These securities, in large part, are "peddled" by the investment bankers without a firm initial underwriting commitment. After their primary distribution, they generally have only such market as is provided by the investment banking firm originally sponsoring the issue. This market, at best, is likely to be inactive, and bid and ask quotations may be completely nominal or at a prohibitive spread.

Most such flotations are strictly intrastate in character or are too small to require registration with the Securities and Exchange Commission. (Securities offered for
sale exclusively to residents of the same State as that in which the issuer is incorporated and doing business, or of less than $100,000 gross proceeds, whether offered in interstate or intrastate commerce, are, in general, exempt from registration with the Securities and Exchange Commission.) There are, consequently, no official statistics with respect to either the amount of such flotations at the present time or their average cost to the issuing concern, and statistics of either type, even if available, would be restricted in their significance until continued for a sufficiently long time to provide a base period for purposes of comparison.

It is the general opinion, however, of persons acquainted with the situation, both in the Securities and Exchange Commission and in private investment banking circles, that the volume of such offerings during the current business recovery has been much below that during the previous decade, and is much lower than that which would be warranted upon the basis of past experience by the present level of business activity. It is also probable that the cost of such flotations is somewhat higher now than in the Twenties.

No reliable data exist as to the cost of the smaller flotations in either period, but a tabulation of the expenses of flotation of certain securities registered under the Securities Exchange Act of 1933 during 1937 (the latest available) provides some significant information. For 33 cases of common stock, where the size of the individual issues amounted to less than $250,000, the average cost of issuance (including both commission and discount, and other expenses to the corporation) was 22.4 percent. In nine cases of preferred stock, each amounting to less than $250,000, the total expenses of flotation averaged 17.3 percent. These average costs are very much higher than were encountered in the case of much larger issues, as may be seen by the fact that two issues of preferred stock for more than $25 millions each had average costs of only 3.0 percent. With the type of unregistered issue discussed above, the average cost of issuance is probably about 25 percent of gross proceeds, and in some cases of legitimate concerns may easily run as high as one-third of proceeds.

The most important cause for the low volume of small security flotations at the present time, as compared with the previous decade, is probably the timidity of capital engendered by the depression. This timidity, which is least in the case of investment is well known securities with a broad market,
and greater in the case of investment in closely held enterprises with which the investors are personally familiar, is greatest in the case of investment in those medium-size enterprises, too large for intimate personal contacts between the management and investors, yet not large enough to provide any real market for their securities.

Securities of this class have real possibilities from the standpoint of the investor and are much more likely to bring extremely high returns or even great wealth to their fortunate holders than are actively traded listed securities. On the other hand, they harbor great risks and, often irrevocable ones, since at the inception of hard times, when the quotations of active securities go down, those for this type of security are likely to disappear altogether, leaving the holders with pieces of paper, perhaps of great potential value but absolutely unrealizable for a protracted period. The extent to which the investors of today, who have passed through the greatest depression in security values ever known, have seen this happen to their own and their friends' funds has made them extremely chary of investing in any security without an active market. This, again is a wound which time alone can heal. As the memories of depression experiences become more distant, and are replaced in the forefront of investors' attention by hopes for new bonanzas, investors may be expected again to direct more of their funds into this type of security.

But, it may be asked, "Is not the cost of floating such issues, which has just been estimated on the average at around 25 percent of the gross proceeds, exorbitant?" It is no doubt high, and it would be well if it were lower; but it always has been high and it is likely to remain so in any economic system based upon the free election by the individual capitalist of the channel in which he will place his funds. Moreover, it is not a price which has proved prohibitive in the past, nor is it likely to prove so in the future.

The funds under consideration, it will be remembered, are proprietors' capital—that is, stock—which will remain in the business permanently. The real effect of a 25 percent cost of obtaining new money is that the concern must earn one-third more than the rate of return expected by the investor in order to meet such expectation. Assuming, for example, that the investor expects 9 percent to be earned upon his money and will require probable earnings of this amount upon his investment before purchasing the stock, the corporation must earn 12 percent. This differential may seem high and doubtless is, but—assuming that the corporation is able to finance in this manner at all—it is not insuperable.
To a much lesser extent, the difficulty of raising capital for medium-small corporations through the sale of stock at the present time may be ascribed to the Securities Act of 1933 and the regulations of the Securities and Exchange Commission. The cost of complying with these regulations and particularly the cost of registration, where this is required, is high and does not vary proportionately with the size of the issue. It consequently tends to be a much greater burden on small flotations than upon large ones. As previously pointed out, registration with the Securities and Exchange Commission is required, in general, only for issues of $100,000 or more offered in interstate commerce. This lower limit, however, by no means excludes all of the offerings of "small" corporations of the type now under consideration, although most of such issues are exempt from registration, being either below the specified amount or offered in intrastate commerce only, or both. The Securities Act has probably made more difficult, however, the distribution of even these securities, since it has created a presumption in the investors' minds that registration with the Securities and Exchange Commission is a necessary protection and that issues lacking it might well be avoided. This presumption creates a sales resistance to unregistered securities which probably increases appreciably their cost of issuance.

This difficulty seems to be occasioned principally because the Securities Act and the operations of the Securities and Exchange Commission thereunder are attuned primarily to the larger corporations, and, consequently, are relatively more onerous in their impact upon the smaller-size enterprises. Analysis, however, should not be confused with solution, and the scope of the present report has obviously excluded any investigation of how the objectives of the Securities Act might be realized with respect to small corporations at a cost no more relatively onerous to them than to the larger corporations.

2. Use of the Facilities of Others

This source of capital is so important and obvious that it is often overlooked altogether. It is indeed impossible to assign to it a quantitative importance relative to other sources, since it would, in the case of any but a highly integrated supercorporation, swamp all others in its significance, and so ruin the symmetry of the discussion.
Reference to it is none the less essential, however, if the problem of financing a small business is to be seen in its proper perspective.

No business, however large, can hope to be a completely integrated unit in its industry. Most corporations, even the biggest ones, purchase their raw materials in a form where they have already undergone considerable processing and sell them, in turn, to others who will process or handle them yet further before they reach the ultimate consumer. Even large corporations, to put it in a word, tend to specialize their activities more or less, and by this specialization reduce the amount of capital which they require, relying instead upon the facilities of others to furnish them with services or raw materials in partially processed form, or to take their own product off their hands before it is ripe for the final consumer.

When any concern lacks the capital which it might desire for the full exfoliation of the ambitions of its owners it will tend, if well advised, to concentrate the capital which it does possess upon the particular stage of manufacture or merchandising in which its managers consider themselves most skilled. In this way, any person with a good idea and a relatively small amount of capital can make a much larger amount of capital in the possession of others the handmaiden of his own, bringing his materials ready for his own stage in the whole process of manufacture or merchandising, and taking away his product. It may be said without exaggeration that the most important thing for such a man to do is to keep his head and remember that it is all right for somebody else to make a profit too.

A remarkable example of the importance of this principle is found in the history of the automobile industry. The early automobile manufacturers who found a popular acceptance of their product were swamped with orders at prices which promised extremely attractive profits, but had very little capital upon which to operate. The concerns so favored met their problem by reserving to themselves, as far as possible, only the very profitable key functions of assembly, and letting out orders to already established foundries and machine shops for practically all of their required parts.

In this way, the infant automobile industry with a negligible direct capital investment was able to call to its aid an important segment of the already existing capital resources.
of the community. This process was so successful that the automobile industry proper was able to grow almost entirely from reinvested earnings, and no appreciable amount of outside capital was ever required. The suppliers of parts and the dealers (who bought the cars from the manufacturers for cash, financing them at their local banks), on the other hand, also made a lot of money; but the arrangement was mutually profitable, and was the only one by which so large an amount of the capital of the community could have been directed to the purposes of the infant industry.

Few small business men can hope to duplicate the success of the early automobile manufacturers, but most of them do endeavor to apply, more or less consciously, the principle which enabled these manufacturers to make the amount of capital in their own hands go as far as possible. A small merchant can greatly reduce his required capital investment by occupying rented rather than owned quarters; and he is foolish, if he is a good merchant in his line but suffers from lack of capital for his current operations, if he does not do so if he has the opportunity. In many cases, small merchants may further reduce their required capital investment by having their deliveries made by companies which specialize in this business. The small manufacturer may not only confine his operations to a restricted portion of the whole manufacturing process and operate in rented rather than owned quarters, but he may also in certain lines operate with rented equipment.

It is interesting to note in the latter connection that the United Shoe Machinery Company has for many years rented rather than sold its machinery, thus greatly reducing the amount of capital required to enter the shoe manufacturing business. This arrangement over a period of years has proved so satisfactory to both the United Shoe Machinery Company and the users of its products, that other companies, as, for example, the International Business Machines Corporation and the Food Machinery Corporation, have adopted in part the same plan of operation.

3. Sources of Funds for Investment in Plant and Equipment Other Than Proprietors' Capital

The funds considered under this head are all represented in the capital structure of the concern by some form of debt instrument, and include all such funds except those borrowed for "working capital" purposes. All funds borrowed from the
Reconstruction Finance Corporation or the Federal Reserve banks, however, and all loans from commercial banks, irrespective of purpose, are treated separately in the next two subsections for purposes of convenience.

The sources of funds for investment in plant and equipment discussed in this subsection are of much less importance quantitatively than those discussed in the preceding two subsections, and it is well that this is so, since, if unwisely used, they are often a source of embarrassment rather than strength to the enterprises relying upon them. In general, a small enterprise should rely upon proprietors' capital for its plant and equipment, depending as much as is necessary upon the facilities of others to round out its own deficiencies. In many particular cases, however, this advice will be found to be impracticable. This is principally because the store — in the case of a mercantile enterprise — or the plant or equipment — in the case of a manufacturing enterprise — which it needs for its business is so particular or specialized that it cannot be rented upon reasonable terms, and the small concern is left with no alternative other than to acquire it on its own account, if need be with borrowed funds.

Real estate mortgages probably constitute the most important single source of funds falling in this category. Such loans, when obtainable at all by the small business man, may be secured at rates varying from 5 percent to 8 percent or more, depending upon the community, the general credit standing of the business, the type of property which it has to offer, and the amount which it wants to borrow on it. Unfortunately, it can be laid down as a general rule that the lower rates are available only on unspecialized property which might readily be converted by the mortgagee to other purposes in the event of foreclosure. In the case of properties of a highly specialized character, the rates are likely to be very unfavorable, or loans not obtainable on any terms.

Bond issues secured by a blanket lien upon the entire property of the concern, which are so common a financing medium for larger concerns, are obviously impracticable for the small business man, so that about the only important source of financing of the type here under discussion available to him, other than real estate mortgages, is the purchase
of equipment on the installment plan. This is often done by many small concerns and is sometimes the best means of acquiring such equipment available to them. The rate of interest upon an annual basis which is either explicit or implicit in this means of financing is very great, however. It is well known that the true interest rates in many cases are half again as much, or twice as much, as the apparent rate, and it is not uncommon for the true rates to run from 12 to 15 percent and even higher. It is obvious that no business concern able to finance such purchases from its own cash resources or by bank accommodation will submit to such terms voluntarily, and the fact that large business firms generally purchase their equipment for cash while small concerns often purchase theirs on the installment plan, is one of the important elements in the advantage which large concerns enjoy as compared with small in financing their business.

4. Loans from the Reconstruction Finance Corporation and from the Federal Reserve Banks

By two separate statutes, each approved on the same date—June 15, 1934—the Reconstruction Finance Corporation and the Federal reserve banks were authorized to make direct loans to industry or to participate with banks or other financial institutions in making such loans. Both statutes provided that all such loans should be adequately secured, should be made only to established industrial or commercial businesses, and should be made only when such businesses are unable to obtain financial assistance upon a reasonable basis from the usual (i.e., private) sources.

The statute with respect to loans by the Reconstruction Finance Corporation, as it was originally passed, stated specifically that such loans were to be made "for the purpose of maintaining and increasing the employment of labor" and that they must mature not later than January 31, 1945. The maximum amount of such loans that could be outstanding at any one time was limited to $300 millions and new loans could not be made after January 31, 1937. This latter time restriction was extended to June 30, 1939 by an amendment approved in January, 1937. Loans made by the RFC did not necessarily have to be for working capital purposes.
On April 13, 1938, the Reconstruction Finance Corporation Act was liberalized by removing: (1) the clause that such loans were to be made "for the purpose of maintaining and increasing the employment of labor", (2) the restriction on the maturity of such loans, and (3) the restriction on the amount that could be outstanding at any one time.

The statute with respect to loans by the Federal reserve banks made no mention of increasing or maintaining the employment of labor, but specified that all loans made in pursuance thereof should be for working capital purposes and should have a maturity of not over five years. No limitation was set by the statute upon the period during which such loans might continue to be made by the Federal reserve banks, and the total amount of such loans authorized to be outstanding at any one time was equal to the combined surplus of the Federal reserve banks on July 1, 1934 ($138 millions) plus $139 millions which the Secretary of the Treasury was instructed to pay over to the Federal reserve banks as needed for this purpose from the increment resulting from the reduction in the weight of the gold dollar.

Over 90 percent of the disbursements made by the Reconstruction Finance Corporation have been on account of direct loans and less than 10 percent on account of participations. About three-quarters of the disbursements of the Federal reserve banks have been for direct loans and about one-quarter on account of participations. The amounts actually disbursed by the Reconstruction Finance Corporation and by the Federal reserve banks, respectively, for all such loans and participations, have been as follows:

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<th>Federal Reserve</th>
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<td>Finance</td>
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<td>Corporation</td>
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(In millions of dollars)

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<th>Year</th>
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<td>36</td>
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<td>1937</td>
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<td>1939*</td>
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<td>Total</td>
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* Figures for the Reconstruction Finance Corporation through March 31, 1939; for the Federal reserve banks through April 26, 1939.
It is interesting to compare the volume of business of the Reconstruction Finance Corporation before and after the temporary cessation of lending to business enterprises beginning in October 1937, when the President instructed the Corporation to take no more new applications. On March 1, 1938, lending was again resumed at the request of the President, because of the sharp decline in business and employment which was taking place. In the year 1937, the Reconstruction Finance Corporation disbursed $23 millions to business enterprises; but in the year 1938, such advances were more than twice as large, aggregating $53 millions. This was a larger amount than had been loaned in any previous year, but it is not clear whether the large increase over 1937 was due to a greater need for loans, or to the fact that the statute respecting such loans had been liberalized in April 1938. During the first quarter of 1939, disbursements on account of these loans fell off relatively, aggregating only $10 millions.

The amount of loans and participations made by the Reconstruction Finance Corporation outstanding on March 31, 1939, was $114 millions; and the amount of loans and participations by the Federal reserve banks outstanding on April 26, 1939, was $26 millions, with an additional $12 millions of commitments outstanding.

Applications received for action by the Industrial Advisory Committees of the Federal reserve banks aggregated 3,594 millions on approximately 9,300 applications through April 26, 1939. Approval was given to about 2,700 applications, accounting for $179 millions. Thus, rejections by the Committees amounted to 6,600 applications, aggregating $215 millions. Since 71 percent of the applications by number, were rejected, while the dollar amount of rejections represented 55 percent, it is clear that the tendency was for smaller loans to be rejected, as compared with larger loans.

It is interesting to consider the reasons for the rejections, although the available information is by no means as decisive as might be desired. Fifteen hundred of the rejections, aggregating $62 millions, were rejected because they were considered ineligible, that is, either the applications were not from "established" business enterprises or the purpose of the loans was not to increase working capital. The pose of the loans was not to increase working capital. The remain ing 5,100 rejections, accounting for $153 millions, were turned down because of the unsatisfactory character of the applicant, as respects his business prospects, his financial condition, his managerial ability, or the suitability of the proposed collateral.
In spite of the fact, however, that the Advisory Committee approved applications aggregating $179 millions, only $59 millions has thus far been advanced.

Unfortunately, we do not have complete information concerning rejections by the Reconstruction Finance Corporation in connection with its loans to business enterprises. We have been told informally, however, that in the last three years, approximately 22,000 applications for these loans were received in the field, and that only 5,000 of them were approved in the field and forwarded to Washington. Of these forwarded applications, 4,000 were subsequently approved. These figures would indicate that rejections have been very heavy, but we have no information as to the causes. We do have some evidence, however, that the rejections were decided upon reasonable grounds. The Department of Commerce checked 330 cases of rejections, and in almost every case concluded that the unfavorable decision of the Reconstruction Finance Corporation was justified. This information, however, has come to us on an informal basis, and we have not had access to the Commerce report. Hence, we are unable to state whether the sample involved in the Commerce survey was representative of the "run of the mine".

While there is a widespread impression that these loans are made principally to "small" concerns, this is not true, if this term is used at all strictly. While no data are available with respect to the size of the businesses which have received loans, only 20 percent of the total amount of such loans authorized by the Reconstruction Finance Corporation up through September 30, 1938, was for loans of $50,000 or less, and only 35 percent was for loans of $100,000 or less. A corresponding study of the size of loans made by or participated in by the Federal reserve banks up through December 29, 1937, indicates that only about 36 percent of the total amount of such loans or participations was for amounts of $100,000 or less.

The rate of interest charged by the Reconstruction Finance Corporation on both direct loans and on participations was 6 percent until May 15, 1935, after which date the rate was reduced to 5 percent on all new loans and participations, and the benefit of the lower rate was extended to all old loans and participations not in default. This was further reduced by the Reconstruction Finance Corporation to 4 percent per annum for a period of three years effective April 1, 1939.
The rates charged by the Federal reserve banks have varied both between different Federal reserve districts and between individual credit risks, and have been consistently higher on direct loans than on participations. On April 30, 1939, the published rates for new direct advances varied from 3-1/2 to 6 percent, while the corresponding range for participations was from 2-1/2 to 6 percent.

5. Loans from Commercial Banks

According to the classical theory of commercial banking, loans by commercial banks should be self-liquidating — that is, they should be made only for such purposes as will yield a gross return at least equal to the amount of the loan before the latter matures. The traditional example of such a transaction is a loan made to a merchant or manufacturer to finance a seasonal peak in his inventory, the loan being liquidated in ordinary course as the inventory is reduced after the peak season. An inevitable corollary of this theory is that every business, small or otherwise, ought to have enough permanent capital to finance itself during the slack periods. This is what is called, in the parlance of the trade, an annual "clean-up" of loans.

If this theory were rigorously applied, the possible contribution of loans by commercial banks to the available funds of any business, either small or large, would be very limited. In practice, however, the theory has never been rigorously applied, principally because the total available demand for such loans has for many years been insufficient to absorb the available supply of bank credit. Changes in business methods during the past several generations, moreover, have tended to shrink the demand for such loans relative to the available amount of credit. One of the most important of these changes is the reduction in inventories of all sorts which has been made possible by the improvement in the speed and certainty of transportation. There was consequently a marked tendency for many years prior to the depression for banks to compromise more and more with their desire to confine their loans to those of a self-liquidating character. This compromise usually took the form of making loans for "working capital", that is, for the purpose of carrying inventories and accounts receivable, but sometimes extended even to loans for the acquisition of fixed plant and equipment.
It is important to note, however, that loans for "working capital" are just as nonliquid as loans for the acquisition of plant and equipment, if the working capital so financed is needed during the seasonal slack period of the business. The only way in which such loans can ever really be liquidated (except from reinvested profits or other new capital) is by a final wind-up of the business or a drastic limitation in the scope of its operations, in either of which cases the bank is liable to suffer substantial losses.

On the eve of the great depression on December 31, 1929, the total loans of all member banks were $26.2 billions, of which only $12.1 billions were in the categories generally considered "commercial" loans, and probably only a small proportion of these were really self-liquidating. By June 30, 1933, the total loans of all member banks had been reduced to $12.9 billions, of which $5.5 billions were in the so-called commercial categories. This liquidation in bank loans continued for a considerable period into the recovery, the low point being November 1, 1935, at which time the total loans of all member banks were $11.8 billions, of which $5.6 billions were in the commercial categories.

As of December 31, 1938, the last date for which figures are available, total loans aggregated $13.2 billions, of which $6.9 billions were commercial loans. Total loans of all member banks on December 31, 1938 were thus about 50 percent below their level at the inception of the depression, but 12 percent above the post-depression low, while the corresponding figures on those loans included in the categories generally considered commercial were 57 percent and 12 percent, respectively.

As appears from the figures quoted above, there has been only a small expansion in commercial loans since the fall of 1935. Furthermore, this expansion has lagged far behind the recovery in other fields. This point is clearly seen when it is noted that, although the total amount of commercial loans on December 31, 1938 amounted to only about 57 percent of that on December 31, 1929, the physical volume of production in December 1935, as indicated by the index number of the Federal Reserve Board, was approximately the same as that in December 1929.

During the same period (December 31, 1929 to December 31, 1938) in which the total loans of all member banks decreased from $26.2 billions to $13.2 billions, their total investments increased from $9.8 billions to $18.9 billions. A large
portion of this change in the relative importance of loans and investments is probably permanent, and it is unlikely that we shall see for a long time a volume of bank loans, commercial or otherwise, as high in proportion to the monetary volume of business activity, as existed during the Twenties. The liquidation of loans, extending into the fall of 1935, was probably accelerated, however, and the subsequent expansion has been held in check, by a determined effort on the part of bankers to put into effect the classical theory of banking so long honored in the breach. This endeavor of commercial bankers has doubtless made it much harder for firms of all sizes to secure the type of accommodation to which they have become accustomed, and the impact is particularly hard upon the smaller concerns which have fewer alternative sources of borrowing at a reasonable rate. It is probably safe, however, to put down this resurgence of classical doctrine among commercial bankers as merely another manifestation of the timidity of capital following a great depression, which, like the other manifestations of the same phenomenon, is being undermined by the return of prosperity.

It is, of course, impossible to determine with any precision whether the small business man has received his share of such expansion of bank loans as has taken place. From surface indications, it might appear that he has not, since the expansion in both total loans and in the "commercial" portion of them has been much greater in New York and Chicago than in the country banks. New York banks, of course, make many loans to small business men; but, as the proportion of their loans going to the larger concerns is doubtless greater than among either reserve city or country banks, the geographical distribution of the increase in loans would seem to indicate that a less than normal proportion are going to small business concerns. An offsetting indication, however, is that the really large corporations still show very few bank loans on their published statements. It is a fair inference that the recent expansion of bank loans has reached well down among middle-size corporations, and borrowing at the bank is doubtless a more practicable source of funds for the small business man now that it was four or five years ago.

In February 1939, the latest date for which figures are available, the average rate charged on customers' loans by banks in New York City was 2.24 percent; by banks in 8 other Northern and Eastern cities, 3.33 percent; and by banks in 27 Southern and Western cities, 4.09 percent.
These rates are the averages for customers’ loans only and exclude open market paper which bears a much lower rate.

The rates charged the small business man for bank accommodation are, of course, much higher than the average figures for all customers just quoted. While there are no data on interest rates charged by banks grouped by size classes either of loans or of the business firms receiving them, an indirect approach to the subject is available which yields satisfactory results.

The difference in the average rate of interest charged customers by the larger and the smaller banks reflects in large part the difference in rates charged to large and small businesses, since, as has been noted, the smaller banks do a larger proportion of their business with the smaller concerns. It is this difference which accounts for a large portion of the spread in the average rates charged customers of banks in New York City, in Northern and Eastern, and in Southern and Western cities, respectively, which have already been cited. The average rates so charged tend to increase continuously as we pass from the larger to the smaller banks until we reach the bottom class of nonmember banks.

It should be noted finally that "small" business concerns of the type falling into the third category set up at the beginning of this section—namely, corporations too small to obtain ready access to the organized capital markets, but with the ownership of their stock more widely distributed than among those actively engaged in the business—are much more fortunately situated with respect to obtaining bank credit at a reasonable rate than are the really small concerns in the first and second categories. Their advantage in this respect offsets in part their disadvantage in obtaining proprietors' capital.

6. The Sale of Receivables

A further means of financing working capital requirements available to a small business concern is the sale of receivables to a finance company or a factor. This method of financing working capital requirements has grown very considerably in relative importance since the beginning of the depression and the two largest concerns in the field—the Commercial Investment Trust and the Commercial Credit Company—are among the best known financial firms in the country.
Receivables may be sold either with or without notification to the debtor, and either with or without recourse in case the receivables should prove bad. While it is not always the case, it is generally true that receivables sold without notification to the debtor are sold with recourse—that is the borrowing concern continues to bear the credit risk, the finance company merely advancing money prior to final collection. Accounts sold with notification, however, are generally also sold without recourse—the purchaser of the account assuming the credit risk. The latter type of business is called "factoring", in contrast to the former which is the normal method of operation of a finance company proper.

Factoring was formerly confined largely to the textile industry but is now invading other fields. Because of the greater risks which a factor runs, he generally takes over the whole function of credit investigation, approving all sales in advance, and usually also handles all bookkeeping for receivables. The relation of a factor to his clients is generally considered a more personal one than that of an ordinary finance company to its customers, the client often relying on the factor for marketing or other advice. It is difficult, however, to lay down any general rule with respect to the difference between the functions of finance companies proper and of factors, since the contracts of the finance companies often include a measure of "credit insurance" and the two functions tend to merge into each other. It should be noted that each of the two largest finance companies have factoring subsidiaries.

Neither a finance company nor a factor will ordinarily advance the full amount of an account receivable. In either case, advances usually range from 70 to 90 percent of the gross amount—the withheld portion serving as a cushion for merchandise returns and bad debts. After collection of the face amount of receivables, the finance company or factor returns the withheld amount to its customer, minus, of course, the charges incurred.

The sale of receivables used to be considered a sign of weakness and was resorted to only by marginal concerns. Since the beginning of the depression, however, the practice has become more popular—a popularity perhaps engendered by widespread necessity. As might be expected, its major disadvantage is the rate, which varies with the particular class of business and the amount of credit risk involved.
The means of financing discussed in this subsection is open to all three classes of small business concerns previously described but is availed of principally by concerns unable to secure bank credit. It is, therefore, more a recourse of the small concerns falling in the first two categories than of the medium size corporations in the third category.
June 3, 1939

FOR THE SECRETARY'S FILES:

Chairman Eccles today read to the Secretary the draft of the statement to be made by the Chairman before the Senate Banking and Currency Committee on the Mead Bill to insure loans to business. Mr. Bell and Mr. Duffield were present.

Mr. Eccles' proposed statement started by criticizing the Mead Bill as inadequate. He also criticized the insurance mechanism, the restriction on loans to bank directors, and the requirement for discounting of the loans by the Federal Reserve banks. On this latter point, he suggested that the loans merely be made eligible for the usual discount privilege rather than being subject to section 10(b) of the Federal Reserve Act.

Secretary Morgenthau interrupted the reading of Mr. Eccles' statement to remark, in connection with some of the other proposals for Government financing of business, that the President had told him that in Germany the positions as Government directors of private corporations were considered the best plums. The President had said that party members usually were given these positions and were getting fat on them. If the Government director raised any objection to any plan of the corporation he was given another block of stock and consequently these positions were lucrative, the President had remarked.

Chairman Eccles then continued reading his statement and outlined his proposed supplement to the Mead Bill under which the Federal Reserve System would set up a lending and insuring corporation with capital supplied out of the $139,000,000 of the gold profits now earmarked for industrial loans made by the Federal Reserve banks. The plan is as outlined in the attached statement.

Secretary Morgenthau recalled that one of the things he had done to encourage small business loans was to work out with the Federal Reserve banks the arrangement under which the $139,000,000 of gold profits was available to them for the making of such loans.
The Secretary remarked that Mr. Eccles' new proposal would seem to do away with that section of the existing law under which the Reserve banks would repay to the Treasury any money advanced for industrial loans at the rate of two per cent per year if earned. Mr. Eccles replied that his plan would change this feature, but that upon liquidation of the new lending-insuring corporation all of its assets would return to the Treasury. The Secretary remarked that he still liked the two per cent liquidating feature and Mr. Duffield suggested that it might be grafted on to the rest of the Eccles plan so that the lending-insuring corporation would repay to the Treasury two per cent of its capital each year if earned. Mr. Eccles objected to this lien on the earnings.

Mr. Bell raised the question of fixing a life for the corporation and Chairman Eccles replied that he preferred to have the corporation subject to termination at any time. Mr. Bell suggested that it continue indefinitely unless it had a definite terminating date. Secretary Morgenthau observed that it was a very healthy thing to have to go before Congress every two years to justify such activities.

Secretary Morgenthau asked Mr. Eccles how he was going to answer the question of why the Reserve System should do this lending rather than the RFC. Mr. Eccles replied that his honest opinion was that the Reserve System could do a better job. He said he thought he would tell the Committee that the Reserve System had to exist anyway and could do this work with no additional cost to the Government.

During the course of the discussion, Mr. Eccles expressed disapproval of the Berle and Jerome Frank plans of direct Government financing of business.
BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Statement for the Press

For Immediate Release

June 5, 1939

Statement of Chairman Eccles before the Senate Committee
on Banking and Currency with reference to S. 2343.
In commenting on Senator Mead's bill (S. 2343) I thought that I could be of most service to the Committee if I began by briefly stating the problem which it is designed to meet. As I see it, there is a definite gap in our financial mechanism in respect to facilities it offers for meeting two classes of needs: (1) the short and intermediate credit needs of small businesses whose paper in present circumstances is at the borderline of bankable assets, and (2) long-time credit and capital needs of small and medium-sized existing or prospective enterprises.

In the first category belong chiefly enterprises which would be doing better if business activity were more fully restored, but which with business at its present level represent a degree of risk that banks quite rightly hesitate to undertake unassisted. They are not enterprises that have been mismanaged or ill-advised, but merely those whose business, either because it is new or because it is peculiarly affected by general business conditions or for some other similar reason, are not at this time able to secure credit from the banks. With the existing volume of unused funds, banks are eager to make all the loans they can, but their responsibilities to depositors make many of them hesitate about extending credit to concerns in this category. There no doubt exists a substantial number of cases of this kind.

The second kind of borrowers for whom additional facilities should be provided are those needing funds for periods extending for ten years or more. Ability of enterprises, and particularly of smaller ones, to obtain credit or equity or loan capital has greatly diminished in recent years. This has been due in part to the general trend toward bigger
incorporated business units which has resulted in increasing opportunity for investors throughout the country to acquire equities in nationally known enterprises, which compete with local concerns for the local investors' money. It has been due also to the prohibition of security affiliates of banks, the increase in the cost of issuing securities, the prohibition of underwriting by banks, and the almost complete elimination of local underwriters of any kind. In the 1920's small and medium-sized concerns were able to raise long term capital locally, though at a pretty high cost, while now in many instances they are unable to raise it at all, except at costs that are entirely too high.

Banks meet a part of this need, but there are some demands of a character that banks do not feel justified in supplying, either because there is too much risk involved, or because the term is too long, or in case of bigger enterprises because in some areas there are no banks with sufficient resources to meet the requirements.

It seems to me that it is to fill this two-fold need for short and intermediate term credit for borderline enterprises and for long-time credit and capital for small and medium-sized concerns that additional facilities are required.

The Mead bill proposes to meet these needs by offering through the Reconstruction Finance Corporation insurance on certain terms for 90 per cent of any loan up to $1,000,000 made by an insured bank. I am in favor of accomplishing the purpose for which the bill is designed, but I have serious doubts whether the results of the measure would not be very
disappointing. There are practical considerations which lead me to the belief that there would not be any substantial increase in bank loans as a result of the adoption of this legislation.

One weakness of the bill, in my opinion, is in the provisions regarding the distribution of losses, which differ from those contained in other insurance plans set up by Congress. Under the bill, insurance may be granted against a loss which an insured bank may sustain in excess of 10 per cent of the principal amount of the loan. Thus, for example, if a loss of $10,000 were suffered on an insured loan of $100,000, the insured bank would have to bear the entire loss and the Reconstruction Finance Corporation none. Since a bank would derive no benefit from the insurance until after it had suffered a loss equal to 10 per cent of the loan, I seriously question whether the bill in its present form would give any substantial inducement to banks to make loans which they would not make without the insurance, or which they could not make under the present plan of RFC commitments.

I have heard it suggested in connection with this bill that the banks would be eager to extend loans which could be insured under the bill because, inasmuch as their loss is limited to 10 per cent on any one loan and they may charge an interest rate of 4 per cent, the interest received on the loan by the end of two and one-half years will be 10 per cent of the amount of the loan and will thus have eliminated the possibility of any loss of principal. This reasoning ignores the fact that the interest derived by banks from their loans is the gross return
and not the net return on the investment. The two are greatly different. The cost to a bank of making and servicing a loan is substantial and in the case of a loan on an installment basis it is increased. Even during the period of the 1920's the net returns to banks on their loans and investments were only around 1-1/2 per cent per annum and at present they are averaging less than 1 per cent. It is obvious, therefore, that a bank would have to receive interest on a loan for ten years or more before it could be sure that any loss on a loan insured under this bill would be eliminated, and then it would have earned nothing on its money.

In the second place, the rate of interest proposed in the bill for insured loans is set at 4 per cent per annum, less than the insurance premium, which is lower than banks normally charge on loans of this character and even on better loans than contemplated by this bill. Banks would hesitate to charge their established customers a higher rate of interest than they charge on the special loans made under the proposed bill or to reduce the rate of interest which they customarily charge.

Consequently, the banks would probably not be induced to make any considerable volume of insured loans on the basis provided in the bill.

It is possible that, even if the banks did avail themselves of the opportunity to insure business loans, there would be loans, some of which they would have made in any case even though there were no way to insure them.

It is also to be noted that the bill contains no limit on the aggregate amount of insurance, so that the Government, through the agency
of the Reconstruction Finance Corporation, would be subjected to an un-
limited contingent liability. This does not seem to me to be good public
policy, particularly since this liability would be incurred without
assurance that the fundamental purpose of the bill, to stimulate a sub-
stantial volume of loans to business, would be realized.

I also wish to suggest to the Committee that the provisions
of section 5 of the bill, authorizing the rediscount and purchase and
sale by Federal Reserve banks of insured loans, be eliminated, because
in so far as they relate to member banks these provisions are not necessary,
since Federal Reserve credit can now be obtained by member banks on any
satisfactory asset, and in so far as they relate to nonmember banks, they
are not desirable, because nonmember banks, not being subject to Federal
Reserve rules or regulations, should not be given the same borrowing
privileges as those extended to member banks. These banks should depend
upon their city correspondents where they carry their balances. Further-
more, section 5 would give to this type of loan a discount privilege that
is not enjoyed by obligations insured under the National Housing Act or by
other sound assets.

Turning now to the fundamental problem of the inadequacy of our
facilities for supplying certain kinds of capital and credit needs, I
should like briefly to review the experience of the Federal Reserve banks
under section 13(b), which was intended to meet these needs.
It will be recalled that the Federal Reserve banks were required in 1933 to subscribe for stock in the Federal Deposit Insurance Corporation in an amount equal to one-half of their surplus ($139,299,557). The Act of June 19, 1934, provided for loans to industry both by the Federal Reserve banks and by the Reconstruction Finance Corporation and the Secretary of the Treasury was authorized to pay to the Federal Reserve banks the amount of their Federal Deposit Insurance Corporation stock in order to assist them in making industrial loans. The Secretary entered into an agreement with the Federal Reserve banks providing for the payment to them of, roughly, one-half of the amount of the industrial loans which they made. Under the law, the Federal Reserve banks are required to pay to the Treasury annually 2 per cent, if earned, on the amount received from the Treasury.

Under this law, the Federal Reserve banks up to May 24, 1939, have executed commitments to financing institutions and directly to business enterprises amounting to $64,000,000 and have made advances of approximately $58,000,000, indicating that they have made a substantial volume of loans to business and industry. However, I believe that the authority which has been given to the Federal Reserve banks in this respect has not been sufficiently comprehensive. Many loans which might otherwise have been made have had to be declined because of restrictions in the law, such as the requirement that industrial loans be made only for "working capital" purposes and only to "established" businesses and for periods of
not more than five years. I believe that the experience of the Re-
construction Finance Corporation in this respect has been similar, though
the law under which the RFC makes these loans was materially liberalized
last year. It is apparent, in any case, that the problem still exists
and has not been adequately met.

Realizing this, some of us, as long as two years ago, began to
study the situation, in an effort to develop a practical plan for stimu-
larating business loans, without involving expenditures by the Government
or in any way affecting the budget. Briefly stated the plan is as follows:

The creation of an Industrial Loan Corporation as an integral
part of the Federal Reserve System, using the Federal Reserve banks and
branches as its field agents. It is my belief that this would be a most
efficient and economical method since the Federal Reserve banks have
offices already established in 35 cities (12 Federal Reserve banks and 24
branches) widely distributed in the various trade areas throughout the
country, and are well qualified for such service because of their knowledge
of business and economic conditions in their respective districts and their
close contacts with local banking institutions. With this organization
already in existence it would be possible to commence actual operations
with a minimum of delay, and these operations could be expanded or con-
tracted from time to time in accordance with changes in conditions. The
experience gained by the Board of Governors and the Federal Reserve banks
and the personnel of the System in connection with industrial loan
operations during the past five years would be of great aid to them in
performing this service.
The Corporation, whose board of directors might be composed of the members of the Board of Governors of the Federal Reserve System, would be authorized to provide funds for commercial and industrial enterprises through the acquisition of the obligations of such enterprises or by the purchase of preferred stock or by making commitments to do so. The amount of funds that could be supplied to any one business enterprise would be limited to $1,000,000, these advances to be made on a sound but liberal basis for a long period. Advances could be made directly by the Corporation or in cooperation with insured banks.

Out of its capital funds, which would be procured in the manner hereafter explained, the Corporation would be authorized to set aside up to $25,000,000 as an insurance fund for the purpose of granting insurance covering loans to small business enterprises. The insurance provided would differ from that proposed in the bill and would be similar to that under Title I of the National Housing Act. The insurance fund of $25,000,000 would be a revolving fund which would make possible outstanding loans of $250,000,000. This would be sufficient to meet the needs for a considerable period and would involve a fixed amount of contingent liability with no possibility of losses exceeding the $25,000,000 to be furnished by the Corporation. The insurance premium, in my judgment, should not exceed 1/2 of 1 per cent per annum on the face amount of any loan covered by the insurance and the maximum rate of interest on any such loan should not exceed 5 per cent on the outstanding balance. An insured loan would not exceed $25,000 in amount and should be amortized so as to be paid off within ten years.
In proposing this insurance plan my object is to meet in a liberal and practical way the needs of small business enterprises. This proposal, with its limitation of $25,000 on insured loans, in no way competes with or duplicates the proposal in the bill under consideration which provides for insurance of loans up to $1,000,000. Under this proposal the Corporation would set up an insurance reserve amounting to 10 per cent of the total insured loans, adding to this reserve the insurance premiums, and would meet out of this total reserve all losses incurred by any one lender provided they did not exceed 10 per cent of his entire insured loans. In other words, even a 100 per cent loss on a given loan would be covered by the insurance so long as the aggregate losses incurred by a lender were no larger than one-tenth of the total of his insured loans. This is unlike the insurance plan set up under the Mead bill under which the lender would stand all of a 10 per cent loss on each individual loan before the insurance would become applicable to the remaining 90 per cent.

As already indicated, the proposal would involve no additional appropriation of public funds and no increase in the budget. The capital of the proposed corporation would be derived from the return to the Federal Reserve banks by the Secretary of the Treasury of the amount subscribed by these banks in 1933 to the stock of the Federal Deposit Insurance Corporation.

The Secretary would use for the purpose that part of the increment resulting from the reduction in the weight of the gold dollar, which has been employed or is now set aside for participation in industrial advances.
The Treasury has already paid to the Federal Reserve banks under the authority in existing law about $27,500,000, and the plan would contemplate that the remainder of the amount of $139,299,557 which the Secretary now has authority to pay (or approximately $112,000,000) would be paid over to the Federal Reserve banks and by them to the Corporation. Of this amount $100,000,000 would be the capital of the Corporation, with $25,000,000 set aside for the insurance fund, and the remainder would be its paid-in surplus. The existing provisions of section 13(b) of the Federal Reserve Act authorizing industrial loans by the Federal Reserve banks would be repealed, and outstanding loans and commitments of the Federal Reserve banks under that section would be transferred to the Corporation at their book value as a part of its capital assets.

In order to obtain additional funds if needed, the Corporation would be authorized to issue debentures equal to five times its capital. While it is proposed that these debentures be guaranteed by the United States, the contingent liability which would be assumed by the Government by reason of such guarantee would be definitely limited to $500,000,000, with a cushion of $100,000,000, which is already in existence and may be expected fully to cover all the losses that can be reasonably expected to occur. It is also proposed that the debentures would have the usual tax exemption possessed by obligations of similar Government corporations, unless a policy should be established to the contrary.
It would be contemplated that so far as possible the Corporation would utilize officers and employees of the Board of Governors of the Federal Reserve System and of the Federal Reserve banks, but it would also have authority to employ additional employees if this should prove to be necessary.

Net earnings of the Corporation would be retained in surplus after making necessary provisions for such losses as the Corporation would have to risk if it is successful in accomplishing its purposes.

Upon liquidation of the Corporation, all of its capital and surplus would become the property of the United States.

The above is a brief statement of the proposal, but I would be very glad to give any further details or assistance in connection with the matter if desired by the Committee. It is my view that this proposal would go far in meeting the problem of providing additional facilities for obtaining credit and capital for such business concerns as have a legitimate need that is not supplied by existing facilities.

In making this proposal my only object is to offer what seems to me to be a practical plan for meeting the problem, to the solution of which the Mead bill is addressed. I suggest that the plan, if it is favorably received by the Committee, be incorporated into that bill. I have no interest in asking for more power in this field for the Federal Reserve System, but have suggested that its facilities be used simply because this seemed to me to be a most efficient and economical way to achieve the desired result. If the substance of the plan appeals to the
Committee but if it should wish to entrust its execution to another agency, I shall be satisfied.

If after consideration Congress should feel that it does not desire to enact a proposal of this kind, it would be my recommendation that section 13(b) of the Federal Reserve Act be repealed, because it does not operate satisfactorily in meeting the situation, and that provision be made for the orderly liquidation of outstanding loans and commitments and for the return to the Treasury of the amounts which it has paid to the Federal Reserve banks after deduction of their actual operating losses.

Finally, I feel that I should add that I do not believe that this or any other similar plan, however desirable as an improvement in the existing mechanism for facilitating the flow of funds for small business, will in itself bring about a substantial business improvement.
June 3, 1939

My dear Mr. President:

In compliance with Miss Le Land’s request over the telephone, I am sending you herewith the statement by E. G. Alvord, presented to the Ways and Means Committee on June 2nd.

Yours sincerely,

The President,
The White House.
June 5, 1920

My dear Mr. President:

In compliance with Miss Le Hard's request over the telephone, I am sending you herewith the statement by S. G. Alvord, presented to the Ways and Means Committee on June 2nd.

Yours sincerely,

The President,
The White House.
June 3, 1930

My dear Mr. President:

In compliance with Miss Le Mand’s request over the telephone, I am sending you herewith the statement by E. C. Alvord, presented to the Ways and Means Committee on June 2nd.

Yours sincerely,

The President,
The White House.
STATEMENT OF ELLSWORTH C. ALVORD

(Presented to the Ways and Means Committee of the House of Representatives at hearings on revenue proposals, June 2, 1939)

Mr. Chairman, Gentlemen:

I am Ellsworth C. Alvord, an attorney, of Washington, D. C., appearing as the Vice Chairman of the Committee on Federal Finance, of the Chamber of Commerce of the United States.

Introduction

It is always difficult to discuss a revision of our revenue laws in the absence of specific proposals. It is additionally difficult this morning, for we are fully appreciative that the limitations of time necessarily restrict your Committee and the Congress and prohibit extensive changes in existing law.

We are attempting a two-fold classification of our suggestions: (1) those which we think can be considered and enacted prior to June 30th of this year; and (2) those which we believe should be considered a part of a more far reaching and more permanent revision, to be considered, for example, during the adjournment of the present session and prepared for the consideration of the Congress during the next session. We hasten to assure you, however, that our suggested classification is tentative indeed.

We are very happy to endorse and approve (with two minor exceptions, of perhaps no immediate importance, which will be discussed briefly hereinafter) the objectives and the program of the Secretary of the Treasury in his opening statement to your Committee last Saturday. We commend his constructive approach to the fiscal problems confronting the Congress and the country. It merits the support of every citizen. Differences of opinion with respect to the application of the principles enunciated and urged by the Secretary of the Treasury are, of
course, to be expected. But there can be no serious differences upon the objectives and principles he has advocated.

**Fiscal Objectives**

In the opening statement of these hearings, the Secretary of the Treasury presented the following basic objectives of a fiscal program:

1. The maintenance of public finances in a sound and unassailable position;
2. The promotion of free enterprise and private investment;
3. The attainment of full business recovery;
4. A just distribution of tax burdens, and a more equitable distribution of national income.

To accomplish these ends, the Secretary recommended the following program:

1. A definite approach to a balanced budget;
2. A Congressional Joint Committee on Fiscal Policy to coordinate expenditure and revenue programs;
3. A non-partisan commission to examine the problems created by Federal-State tax conflicts;
4. Revision of the Federal tax laws to remove manifest inequities or other defects, including
   a. provisions likely to hinder business expansion and investment,
   b. provisions constituting "tax irritants", and
   c. provisions raising questions of tax equity.

The Secretary correctly stated that the foregoing objectives are essential to the successful operation of our democracy; that full recovery and a sound fiscal position are imperative for an adequate national defense; that fundamental
objective of sound finance is a balanced budget; and that changes in our fiscal program must conform to this end. The Secretary might have added that they should guide not only fiscal decisions but all activities of Government.

One of our reservations is directed toward the fourth objective in tax policy, namely, "a more equitable distribution of national income". Our reservation is based upon the fact that we do not understand the statement. We merely make the point at this time, not for purposes of debate, but solely to avoid misunderstanding of our position.

The second reservation is directed toward coupling a reduction in individual surtax rates (which seem, we believe, to be admittedly far too high, and which must be reduced substantially if one of the most serious deterrents to private investment and industry is to be removed) with the taxation of future issues of Federal, State and municipal securities. We have advocated measures to reach both objectives. But we can not agree that they are so closely interrelated that neither should be brought about unless both are, and that the former should await the attainment of the latter.

**Magnitude of the Problem**

We are very far from the fulfillment of our objectives at the present time. In the years since 1931, we have "bought time to think", perhaps, but we have made little progress towards a permanent recovery.

(a) Maintenance of Sound Public Finances. — On June 30, 1940, we shall have completed a ten-year period of continuous deficits, since the deficit of 1931. The books of the Federal Government will show the following results of operations over the period:

1. Total expenditures of $72 billions, or $7 billions annually (in the last two years, $9 billions annually);

2. Total deficits of $31 billions, averaging $3 billions a year;
(3) Gross Federal debt which will approximate $45 billions, excluding
guaranteed obligations of about $5 billions;

(4) Gross Governmental debt, including State and local debts, of about
$63 billions;

(5) An increase in the per capita debt, Federal, State, and local, from
$289 to $482, in the space of ten years;

(6) An annual interest burden on the Federal debt of more than a billion
dollars.

Tables marked (1) and (2) indicate the receipts, expenditures, deficits
and debt, by years, from 1931 to 1940.

(b) Promotion of Private Investment. — While public expenditures have
more than doubled in the last decade, private investment has dwindled even more
rapidly. In fact, new private investment seems almost to have disappeared.

At least two positive indications of this trend are at hand. Table (3)
shows the decline in the volume of corporate security issues. Table (4) indicates
the extent of the shift from private to public construction.

Professor Adolf A. Berle, in his recent testimony before the Temporary
National Economic Committee, summarized the situation as follows:

"The flow into capital construction may be said to have
found its norm at a level of somewhere between eight and ten
billions of dollars during the decade from 1920 to 1930. Of
this, at least six billions went through the public markets —
that is, occurred by sale of stocks and bonds. The balance
went into construction through the mortgage markets or through
private placement. By 1931, the amounts going through the
public markets had fallen to approximately half that amount;
then withered to a mere fraction. At a maximum, since 1931,
not more than two and one-half billions of true capital money
has gone through the mechanism of the public markets. The
average is considerably less.

"The conclusion is obvious: American private markets
are not funneling capital funds into capital construction at
more than (roughly) one-third to one-half the rate they were
doing in the 1920-1930 decade. This means that private activity
in heavy industry is not being continuously generated in suf-
ficient volume to keep those industries busy, or to keep the
country continuously on an even economic keel."
To some extent, Government expenditure has taken up the slack in private financing. But, it has been estimated, also in testimony before the Temporary National Economic Committee, that in the years 1930-1937, inclusive, there was an accumulated deficit of $17 billions in new purchasing power, despite the billions expended by the Federal Government. If, as Chairman Eccles recommends, the Government had attempted to make good this shortage of private investment, it would have required an additional Federal deficit of more than $2 billions in each of these eight years.

(c) **Attainment of Recovery.** — Our recovery goal may be stated as the sum of the following:

1. The maintenance of a democratic form of government;
2. Adequate provision for national defense;
3. Reduction of unemployment, at least to 1929 levels;
4. A balanced budget, including provision for orderly debt retirement;
5. A substantial increase in our national income — to $80 billions to $100 billions annually.

How close are we now to this goal?

There are now between 15 and 20 million persons receiving public assistance financed by Federal, State, or local funds. The cost of relief to the Federal Government alone this year approximates $2-3/4 billions.

Industrial production last month was only 92% of the 1923-5 average; factory payrolls only 85% of wages paid in the period 1923-5, more than fifteen years ago.

The national income has not approached $80 billions since 1929 — has not, in fact, in all the intervening years been within $10 billions of our minimum objective.

The indexes of business recovery, and the statistics of relief, given
in tables (5) and (6) tell their own story of our failure to achieve recovery. They will repay study.

**A Permanent Fiscal Program**

It seems clear that a full, healthy and permanent recovery requires a transition from Government spending to private investment, a sound constructive fiscal program for the Federal, State, and local governments, a decrease in the demands for Federal assistance, a reduction in relief rolls with a corresponding increase in private payrolls, and a substantial increase in the national income.

These results can only be attained by the encouragement of private industry, private investment, and private employment.

In terms of a general fiscal program, this means:

1. **Adjustment of tax rates to the point of maximum business activity and hence maximum productivity:**
   
2. **Removal of tax barriers to private enterprise and investment:**
   
3. **Assurance of stability and certainty in the revenue system:**
   
4. **Simplicity and ease of administration:**
   
5. **An effective control expenditures, so that they may be kept within the revenue yields of a reasonably permanent tax system enacted to carry out the foregoing program.**

**Control of Expenditures**

We commend for the consideration of the Congress, the recommendation of the Secretary of the Treasury that Congressional procedure be devised for the consideration of revenues and expenditures together as two interrelated aspects of a single problem. Stability and certainty in our fiscal program cannot be maintained without effective legislative control over expenditures and coordination of receipts and expenditures.
We are confident that the Congress can readily devise legislative procedure to improve the existing control. For example, a special Budget Committee of the House might be created, to consist of the Speaker, the Majority and Minority Leaders, and the ranking members of the Committee on Ways and Means, Appropriations, and Rules. This Committee could consider the Budget as a whole — that is, the estimated revenues and the proposed expenditures — and report to the House its recommendation as to the total appropriations to be made. The Committee's report could be subjected to full debate and the House decide upon a total for all appropriations, thus placing an effective "ceiling" below which they must be kept. The Appropriations Committee would then adjust its various appropriation bills and keep them within the maximum thus fixed. No appropriation could exceed the "ceiling", unless specially approved by the Budget Committee. If the Budget Committee concluded that the appropriation was essential, despite the previously fixed aggregate total, it could approve a Special Rule permitting its consideration; otherwise the appropriation would not be considered.

A similar committee, suitable to Senate procedure, might be developed for the Senate, which, of course, could act independently of the House.

Such a plan would seem to be flexible enough to allow extraordinary and emergency expenditures but it would permit fixation of a definite and well considered limit to expenditures and to legislation authorizing expenditures.

**General Tax Recommendations**

Obviously, it is not feasible to complete a revision of the revenue system before the end of the present session. Nevertheless, progress can be made. A stable, permanent revenue system is sorely needed as a foundation for maximum business activity, the first requisite of maximum yield of a revenue system.
As the first step in such a program, and for immediate action by Congress, we recommend the following specific changes:

1. A flat-rate normal corporation tax of 15%, with a specific credit of $2,000 to reduce the applicable rate on small incomes.
2. Outright repeal of the 2-1/2% undistributed profits tax.
3. A carryover of net business losses for three years.
4. Simplification of the individual capital gain provisions, eliminating the unnecessary distinction between assets held 18 and 24 months and substituting a shorter holding period.
5. The treatment of "long-term" capital gains and losses of corporations as ordinary gains and losses, thus more nearly according to corporations the treatment now accorded individuals.
6. An annual declaration of capital stock value, beginning with the current year.
7. Permission for affiliated groups to file consolidated returns.
8. Elimination of double taxation by exempting all intercorporate dividends from tax, and excluding corporate dividends from individual normal tax.
9. Remedyi the existing defects in the so-called technical or administrative provisions of the present law.

We believe that a long range program of tax revision should include the following:

1. A reasonably permanent revenue system, based upon the principles above advocated — that is, a system the basic principles of which are to remain in force, for example, for a period of ten years;
2. Simplification of the present law, which can be effected in large part by the elimination of unnecessarily complicated policies and refinements;
3. The reduction of individual surtaxes to the point where they will
not discourage private investment and individual initiative;

(4) A substantial reduction in the tax upon capital gains;

(5) An effective earned income credit;

(6) A revision and simplification of the present estate tax laws, including a substantial reduction in the present confiscatory rates;

(7) A provision for the setting aside of adequate funds (through insurance or otherwise), free of estate tax, for the payment of the estate tax;

(8) The repeal of the capital stock - excess profits tax system, as soon as the revenue requirements permit;

(9) Removal of the inequities now existing in our excise tax system;

(10) A procedure for the collection of excise taxes corresponding to the existing procedure for the collection of income taxes.

Attached, as Appendix A, are a series of examples, showing the effect of existing surtaxes upon the investment of individuals.

Corporate Normal Tax

The normal tax on corporations should not and need not exceed 15%. It is agreed, of course, that some allowance from the maximum rate should be made for corporations having an income, for example, below $25,000. A specific credit of $2,000 for this purpose is preferred on the ground of simplicity. Such a credit would reduce the effective rate to 9% on incomes of $5,000; 12% on $10,000, and 13.5% on $25,000.
It is usually assumed that a rate above 15% will produce more revenue. With this assumption, we can not agree. The fundamental factor in an income tax is the amount of income subject to tax. There is a point of maximum productivity. Above that point, increases in the rate diminish business volume and the total profits subject to tax.

Prior to the undistributed profits tax of 1936, general corporate rate was 13-3/4% for the years 1932, 1933, 1934 and 1935. The present normal corporate tax is 16-1/2%, which in itself constituted a very substantial increase — attributable solely to the enactment of the undistributed profits tax. Adding other taxes, many corporations today are paying more than 50% of their net income in taxes. In our opinion, this is well above the point of maximum productivity. Attached is a table (Table 7), prepared from Registration Statements filed with the Securities and Exchange Commission, showing the total taxes paid and their relation to the net incomes of certain groups of corporations. It would seem that further proof is unnecessary.

The only way in which more revenue can be realized from corporations is by stimulating increased business activity. The possibilities are revealed by the following table, showing the rate of industrial production, the amount of corporate income subject to tax, and the revenue collected from corporations, by calendar years, from 1922 to date:
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<th>Year</th>
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1936
<table>
<thead>
<tr>
<th>Year</th>
<th>F.R. B. Index Industrial Production</th>
<th>Corporate Net Income</th>
<th>Rate of Corporate Tax</th>
<th>Revenue from Corporate Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>105</td>
<td>6732 (8-15 surtax)</td>
<td>7160 (on undistributed profits)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

1937
<table>
<thead>
<tr>
<th>Year</th>
<th>F.R. B. Index Industrial Production</th>
<th>Corporate Net Income</th>
<th>Rate of Corporate Tax</th>
<th>Revenue from Corporate Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>110</td>
<td>4700E</td>
<td></td>
<td></td>
<td>795.0 Est.</td>
</tr>
</tbody>
</table>

1938
<table>
<thead>
<tr>
<th>Year</th>
<th>F.R. B. Index Industrial Production</th>
<th>Corporate Net Income</th>
<th>Rate of Corporate Tax</th>
<th>Revenue from Corporate Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>101</td>
<td>4700E</td>
<td></td>
<td></td>
<td>795.0 Est.</td>
</tr>
<tr>
<td>99</td>
<td></td>
<td></td>
<td></td>
<td>1,111.0</td>
</tr>
<tr>
<td>98</td>
<td></td>
<td></td>
<td></td>
<td>1,160.0</td>
</tr>
<tr>
<td>92 p</td>
<td></td>
<td></td>
<td></td>
<td>1,005, Est.</td>
</tr>
<tr>
<td>92 p</td>
<td></td>
<td></td>
<td></td>
<td>1,005, Est.</td>
</tr>
</tbody>
</table>
Given an industrial production index of about 105 and a corporate
tax base of $7 billions, a 15% rate would produce over a billion dollars,
approximately the amount which will be collected for the current calendar year
at present rates. It appears from the table that this is only a moderate
expansion of business volume over the present estimates of 100 for the index
and $6200 millions for the corporate base.

In the recent publication "Taxation and Capital Investment" issued
by The Brookings Institution, the author concludes:

"As has been pointed out earlier in this analysis, the means of securing fiscal stability is to be found
in the expansion of total national production. Taxa-
tion revenues will pretty much take care of themselves
if we can achieve full economic recovery."

We are thoroughly in accord with this analysis.

Undistributed Profits Tax

There is no legitimate excuse for retaining the 2-1/2% undistributed
profits tax. The principle of a penalty tax on earnings was repudiated at
the last session of Congress. The tax produces no substantial revenue. The
computation of a dividend paid credit introduces complexities which are wholly
out of proportion to the importance of the tax.

It has been asserted that the repeal of the 2-1/2% undistributed
profits tax will encourage tax avoidance by wealthy stockholders, who will
prefer to leave profits in corporations under their control rather than to pay
high personal surtaxes thereon. Naturally, every effort should be made to
prevent tax avoidance in this or any other form. The whole problem, however,
of tax avoidance by corporate stockholders has been grossly exaggerated. The
personal holding company provisions, enacted in 1934 and strengthened in 1936
and 1933, are adequate to take care of "incorporated pocketbooks." In the
rare case of an operating company being used for tax avoidance, section 102.
imposing penalty taxes on the unreasonable accumulation of surplus, affords sufficient protection to the Government. This section can be enforced, as the National Grocery Company case (304 U. S. 282) demonstrates — despite representations to the contrary before this Committee last year when the Title IB tax on closely-held operating companies was proposed. It will be recalled also that section 102 was purposely strengthened last year to make it more easily enforceable, by putting the burden of proof on the taxpayer to show the absence of a purpose to avoid surtax.

Net Loss Carryover

We urge that the privilege of carrying forward net operating losses be restored to the Revenue Act immediately.

The selection of a single year as the taxable period is admittedly arbitrary, and results in great hardship to industries and particular companies in which years of profit and loss alternate. If such companies are taxed in years of profit, without allowance for prior years' losses, their tax burden is wholly out of proportion to the income actually earned over the period as a whole. As compared with businesses having a stable income from year to year, moreover, they are at a severe competitive disadvantage. There are attached a series of computations (Appendix B) illustrating the effective rates of taxation upon corporations sustaining losses during one or more years of a five-year period.

The Revenue Act, from 1921 to 1933, recognized this hardship and permitted a net loss carryover. The privilege was abolished in the National Industrial Recovery Act in 1933, solely by reason of the urgent necessity of protecting the revenues at that time. It has never been disputed that such a provision is an essential feature of an equitable tax system.

The determination of the carryover period is necessarily arbitrary. The British income tax permits losses to be carried forward for six years.
shorter period may be desirable for revenue purposes. In view of the abnormal conditions of the last ten years, and the wide fluctuation of business activity, incomes and values we have experienced, a carry-over of at least three years should be allowed.

Capital Gains and Losses

The capital gain and loss provisions applicable to individuals, as revised by the 1938 Act, distinguish between assets held less than 18 months, taxable in full; assets held 18 to 24 months, taxable at a maximum flat rate of 20%; and assets held more than 24 months, taxable at a maximum flat rate of 15%. The "intermediate" period of holding, 18 to 24 months, appeared as a compromise provision, for which no real necessity existed. As a practical matter, it greatly complicates the structure of the section, and for purposes of simplification, it should be eliminated.

The dividing line between "short-term assets" and "long-term assets" is intended to separate speculative from investment transactions. Since assets bought for speculative purposes are rarely held longer than six months, a substantially shorter holding period than the 18 months now prescribed should be considered.

Corporate capital gains were ignored in the 1938 revision of the section. Such gains continue to be taxed in full regardless of the period of holding; while corporate capital losses are deductible only to the extent of gains plus $2,000. There is an obvious injustice in this situation which should be corrected. We recommend that "long-term" losses be allowed as a deduction, without limitation.

Capital Stock and Excess-Profits Taxes

While it is undoubtedly desirable to repeal these taxes, we believe that it is necessary to retain them, as a temporary proposition, for revenue purposes. The most serious objection to them is that they do not impose a tax
on true excess profits. The iniquitous feature of the present law is that it requires a corporation to declare a value for its capital stock which will serve as a basis for the computation of profits for the next three years. Since no corporation can estimate its profits beyond the current year with any degree of certainty, the declaration of a proper value is sheer guesswork, and no proper basis is established for determining excess profits.

Accordingly, we recommend that the capital stock tax be revised to permit an annual declaration of value, beginning with the current year, with adequate precaution, if necessary, against any immediate reduction in its yield.

Consolidated Returns

The requirement of separate returns for a group of affiliated corporations is indefensible. Such a requirement leads to the statement of nonexistent profits and losses on intercompany transactions and distorts the presentation of earnings of particular units. Accountants, the Stock Exchange and the Securities and Exchange Commission uniformly require or permit consolidated returns to reflect the financial position of the affiliated group. The Treasury Department has consistently supported the use of consolidated returns.

A mandatory requirement for consolidated returns is impracticable owing to constitutional and administrative difficulties. An elective provision similar to the one in force prior to 1934 is therefore recommended.

Double Taxation of Dividends

Prior to 1936, corporate dividends were excluded from the individual normal tax, since the corporation had already paid the tax upon the earnings out of which the dividend was paid to its stockholders. In the 1936 Act, dividends were subjected to the individual normal tax, but only because the undistributed profits tax, as originally drafted in the House, did not require the corporation to pay a tax on income which it distributed. With the restoration of a corporate normal tax, the imposition of a second normal tax upon the stock-
holders cannot be supported.

Intercompany distributions offer an even more severe instance of double or multiple taxation of corporate earnings. Such distributions are subject to taxation in the hands of the originating corporation, again to the extent of 15%, thereof in the hands of the receiving corporation, and finally when distributed to its stockholders.

On the other hand, bond interest, as distinguished from dividends, is allowed as a deduction to a corporation in computing net income and is taxed only once, as income to the bondholder. This situation has led the 20th Century Fund to conclude in a recent study that borrowed money is more attractive than venture capital, both to corporations and investors, with the result that a heavy permanent debt structure may be created which becomes unmanageable in times of depression.

We recommend that the exemption of dividends from normal tax be restored and that the intercorporate dividend tax be repealed.
Administrative and Technical Recommendations

In addition to the foregoing major recommendations, we believe that consideration of the following amendments of a technical nature should not be delayed, and should be acted upon at the present session:

(1) Correction of the Effect of the Hempler Decision. — In United States v. Hempler, 303 U.S. 564 (1938), the Supreme Court held that the assumption and payment of bonded indebtedness by the transferee in a 112(b) (4) reorganization constituted "other property" taxable to the transferor under section 112(d). This decision was contrary to the long-established Bureau rule that the assumption of a liability was not "property" of the character referred to in 112(d), since it was not capable of distribution to stockholders. It also seems contrary to the policy and interest of Congress to accord similar treatment to reorganizations effected by consolidations or mergers, by acquisition of control, or by acquisition of assets. The Hempler decision has created great confusion in the reorganization field, not only because of uncertainty as to the scope of the Hempler rule for the future, but also because it affects countless prior reorganizations, opening the way to claims by the Government for increased taxes and claims by taxpayers to stepped-up bases with respect to transactions long since closed. In addition, under the definition of a "reorganization" in section 112(g)(1)(B) of the 1934 and subsequent Acts, there is a serious question whether reorganizations carried out after that date involving the assumption of liabilities were not taxable transactions in their entirety. A general retroactive amendment confirming the Bureau rule seems to be the only satisfactory method of avoiding these complexities, both for the Government and the taxpayer.

(2) Correction of the Effect of the Rosenfield Decision. — H.S. 3186 provides for an automatic lien of the Federal Government for unpaid tax liabilities. The lien is not valid against a purchaser for value unless notice thereof
is filed in accordance with the law of the State in which the property subject to
C.C.H. 3204), the Federal Court in Michigan enforced such a lien upon negotiable
securities in the hands of a firm of Detroit stockbrokers, who had purchased the
stock without actual notice of the lien. The lien had been properly recorded
under Michigan law and the decision obviously conforms to the strict terms of the
statute. Nevertheless, the fears and uncertainties of purchasers and security
dealers created by the decision are apparent, since it is virtually impossible in
the course of normal dealings in securities to determine whether there may be
liens filed against securities presented for delivery. It is recommended that
the Federal statute be amended to conform to the Uniform Stock Transfer Act, by
providing that no lien shall attach to negotiable securities unless notice of
the lien is stated on the certificate, or actual notice can be proved.

(3) Correction of the Effect of the Koshland and Gowran Cases. — From
1921 to 1936, the Revenue Act provided that all stock dividends were tax-free.
The Treasury Regulations required, where a stock dividend was declared, that the
basis of the original shares be apportioned between those shares and the dividend
stock for computing gain or loss on the sale thereof. In Koshland v. Helvering,
298 U.S. 441 (1936), the Supreme Court held that a dividend of common stock on
preferred stock was a taxable distribution. The Court further held, contrary to
the Regulations, that where a stockholder had received such a dividend, and had
sold the preferred stock, no part of its cost could be allocated to the dividend
stock in determining gain or loss. In Helvering v. Gowran, 302 U.S. 223 (1937),
the converse situation was presented, where the dividend stock had been sold, and
the Court held that the cost of such stock to the taxpayer was "zero". These
decisions overturning the Regulations may adversely affect either the Government
or the taxpayer, depending on which stock the taxpayer may have parted with, a
wholly fortuitous circumstance. It is suggested that the proper remedy is a
statutory ratification of the Department's regulation with respect to a taxpayer who still has one of the stocks and in disposing of the other computed gain or loss in accordance with that regulation.

(4) **Inventory Amendment.** — Section 22(d) of the 1938 Act recognized, for the first time, the "last-in, first-out" method of valuing inventories, but severely limited its area of application. In accordance with the instructions of the Senate and House Conferences on last year's Bill, further study has been given to the amendment by the Treasury Department with a view to action at this session. It is understood that the Department is ready to present an appropriate redraft of the amendment, which should be incorporated in the Bill.

(5) **Purchase of Bonds at a Discount.** — There is no specific provision in the Act with respect to the tax treatment of purchase or cancellation of indebtedness, but the Regulations provide that the purchase or cancellation of indebtedness at less than par results in taxable income to the extent of the indebtedness discharged, except where the taxpayer is insolvent after the cancellation. This regulation, in our opinion, is unsound. The purchase of indebtedness at less than par produces no real gain or income. Moreover, the regulation works extreme hardship on corporations in distressed financial circumstances, which are unable to reduce unhealthy debt structures because of the amount of taxable gain which would be realized in the transaction. A partial relaxation of the strict Treasury rule was afforded by the Chandler Act at the last session of Congress, which contained a specific provision that no taxable income shall be realized by virtue of indebtedness cancelled or reduced in a proceeding under that Act. The sound principle thus expressed, however, is too limited in application, since it does not apply to the purchase of indebtedness generally, or to reduction of indebtedness effected without the aid of a Federal bankruptcy court. A general principle that the purchase of bonds at a discount does not result in
taxable income should be written into the Revenue Act.

(6) Revision of Section 320. — This complex and technical provision, relating to the correction of errors barred by the statute of limitations, requires revision in several important particulars. For present purposes, however, it is sufficient to call attention to one obvious deficiency. The section authorizes an adjustment against the taxpayer, if a determination establishes the proper year for a deduction or credit erroneously allowed by the Commissioner in a barred year. It does not, however, permit an adjustment in favor of the taxpayer if a deduction or credit has been erroneously disallowed by the Commissioner in a barred year, and a determination is later obtained establishing that fact. Correction of the section in this respect will not afford relief to the taxpayer who has failed to claim a bad debt deduction in the proper year, and seeks to correct the error after the statute of limitations has run; the deduction must have been claimed and improperly denied to get relief. But the amendment does cover an important type of case which the Subcommittee recommended should be covered, and which is necessary to dispense "even-handed justice" between the taxpayer and the Commissioner.

(7) Foreign Tax Credit. — Section 131, allowing a credit for taxes paid to foreign countries, was designed to encourage and protect American citizens engaged in foreign trade or having investments abroad. A recent limitation on the credit, however, had deprived it of much of its effectiveness. This restriction arises from the change in the definition of "net income" made by the 1936 and 1938 Acts. For United States tax purposes, the term "net income" now includes partly-tax-exempt interest and intercorporate dividends, credits against net income being employed to remove these items, wholly or partially, from tax. For purposes of the foreign tax credit, however, the phrase "entire net income", used in computing the limit on the credit, includes both partly-tax-exempt interest
and intercorporate dividends, with the result of distorting the application of the formula and unjustly reducing the amount of the credit. We hope an amendment to correct this error will be promptly adopted.

(6) Pension Trusts. — The pension trust amendment adopted in section 165 of the 1938 Act, together with the stringent new regulations adopted, threatens the creation and continued existence of many pension, bonus and profit-sharing trusts for employees. The amendment denies tax-exemption to these trusts, if there is any possibility, however slight, that funds may revert to the employer prior to the satisfaction of all liabilities — both fixed and contingent — to employees under the trust. The only exception is the possibility of recovery of amounts through erroneous actuarial computation. Since this requirement can be met only by a virtually irrevocable trust, which is usually undesirable, if not impossible, from a business standpoint, the effect will be to curtail seriously the number of these trusts, to the detriment of employees.

The 1938 amendment unquestionably went too far. The original law worked well, and no convincing reason was advanced for changing it. The amendment was based on the assumption that tax avoidance might occur through the use of revocable trusts. No actual cases were presented in support of this assertion. It is our recommendation that Congress, at this session, should return to the original law. If that is impossible, at least an amendment should be adopted to correct the present situation, preferably by limiting the requirement of irrevocability to that portion of the trust fund which is necessary to satisfy liabilities which have become fixed and certain, as contrasted with liabilities which are merely contingent.

(9) Deficiency Dividends. — A credit was provided in the Revenue Act of 1935, permitting personal holding companies subject to the penalty surtaxes of Title IA to declare dividends to offset deficiencies determined by the Commissioner or the courts. All business corporations, with respect to 1936 and 1937
incomes, are liable to the heavy penalty surtaxes of the 1936 Act for failure to
distribute income, if deficiencies are hereafter discovered. In the absence of
a similar credit, a corporation which in good faith distributed all the income
shown on its return for 1936 and 1937 may suddenly be confronted with an unex-
pected increase in its taxable income for these years and become subject to a
heavy undistributed profits tax. We recommend provision for such a credit in
the pending revision of the Act.

(10) Capital Gains of Personal Holding Companies. — A very large
amount of capital assets which have appreciated in value remain "frozen" in
personal holding companies. Under the 1938 Act, complete liquidations could be
effected at capital gain rates (sec. 115(c)) and, under certain circumstances
(sec. 112(b)(7)), without any immediate tax, upon the stockholders. However,
many of these companies could not, and can not now, be completely liquidated.
A partial liquidation is prohibited, for it involves full taxation of the cap-
ital gains. Sale of the assets is out of the question, since the gain would be
taxable first as corporate income and then either as an ordinary dividend at full
normal tax and surtax to the stockholders or as undistributed income of the hold-
ing company at the 65-75% rate.

The personal holding company surtax was intended as a rough equaliza-
tion of the taxes which would have been payable by the stockholders if the in-
come had been realized by them directly. In the case of capital gains, however,
the section goes far beyond this objective, since the stockholders would be en-
titled to the flat 15% rate if they disposed of the assets directly instead of
through the corporation.

One solution would be the exclusion of capital gains from the definition of "undistributed net income" of personal holding companies. Another
possibility is the extension of section 112(b)(7), which would permit the dis-
tribution of the appreciated assets with the tax postponed until subsequent sale
by the stockholders. Other suggestions deserving consideration are to permit
the partial liquidation of such companies at capital gain rates, or with a carry-
over basis and the tax postponed until the gain is actually realized by the stock-
holder, or to allow the corporation to sell its capital assets, paying the cor-
porate rate thereon and thereafter to distribute the gain tax-free to its stock-
holders.

(11) Surtaxes upon Income from Personal Services Extending over a
Period of Years. — A very severe hardship under the existing law, which can be
adequately and simply remedied at the present time, exists with respect to the
taxation of income for personal services rendered over a period of years and paid
for after completion. For example, inventors, authors, engineers, scientists,
lawyers, and others frequently work for years, and receive their compensation
upon the successful completion of their services — usually all in one year.
Consequently, their entire income, being accumulated and received in one year,
is subject to the highest surtaxes. If this income had been received as their
services were rendered, it would have been subjected to the lower rates of tax;
and the aggregate taxes paid would have been substantially less than the amount
payable under the present law. It would seem that the person who invests his
time and services over a period of years should be in the same position as one
who invests his funds in assets which appreciate over a period of years. We
recommend that income from personal services extending over a period of more
than two years should be taxed at the capital gain rates. A reasonably simple
device to prevent evasion will afford effective protection.

Conclusion

We approve the program to revise our existing revenue laws, as exten-
sively as time permits, in accordance with the principles advocated by the Secre-
tary of the Treasury. We urge the Congress to consider seriously other necessary changes, with a view to their enactment during the next session of Congress.

We always stand ready to assist the Congress and the Administration in its consideration of revenue legislation.
Table (1)

Federal Debt and Expenditures, 1931-1940

<table>
<thead>
<tr>
<th>Fiscal Year</th>
<th>Total Receipts</th>
<th>Total Expenditures</th>
<th>Gross Deficits</th>
</tr>
</thead>
<tbody>
<tr>
<td>1931</td>
<td>$3,189,636,632</td>
<td>$4,091,597,712</td>
<td>$901,959,088</td>
</tr>
<tr>
<td>1932</td>
<td>2,005,725,437</td>
<td>5,153,644,395</td>
<td>3,147,919,455</td>
</tr>
<tr>
<td>1933</td>
<td>2,079,696,742</td>
<td>5,142,953,627</td>
<td>3,063,256,885</td>
</tr>
<tr>
<td>1934</td>
<td>3,115,554,050</td>
<td>7,105,050,085</td>
<td>3,989,496,035</td>
</tr>
<tr>
<td>1935</td>
<td>3,800,467,202</td>
<td>7,375,825,166</td>
<td>3,575,357,964</td>
</tr>
<tr>
<td>1936</td>
<td>4,115,956,615</td>
<td>8,679,798,253</td>
<td>4,763,841,643</td>
</tr>
<tr>
<td>1937</td>
<td>5,233,840,237</td>
<td>8,105,159,548</td>
<td>2,911,318,311</td>
</tr>
<tr>
<td>1938</td>
<td>6,241,661,227</td>
<td>7,691,287,108</td>
<td>1,449,625,881</td>
</tr>
<tr>
<td>1939a</td>
<td>5,520,070,000</td>
<td>9,592,329,000</td>
<td>4,072,259,000</td>
</tr>
<tr>
<td>1940a</td>
<td>5,669,320,000</td>
<td>9,095,663,200</td>
<td>3,426,343,200</td>
</tr>
</tbody>
</table>

$41,031,930,142 $72,233,307,599 $31,201,377,462

Source: Annual Report of the Secretary of the Treasury, 1937.

a — Estimated, President's Budget Message, January 3, 1939.
### Table (2)

Federal, State, and Local Debt, 1931-1940

(Millions of Dollars)

<table>
<thead>
<tr>
<th>Year</th>
<th>Gross Federal Debt</th>
<th>Gross Debt, Including State and Local</th>
<th>Per Capita</th>
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<tbody>
<tr>
<td>1931</td>
<td>$16,801</td>
<td>$35,861</td>
<td>$288.94</td>
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<tr>
<td>1932</td>
<td>19,487</td>
<td>38,617</td>
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<tr>
<td>1933</td>
<td>22,539</td>
<td>42,056</td>
<td>334.39</td>
</tr>
<tr>
<td>1934</td>
<td>27,053</td>
<td>45,876</td>
<td>362.29</td>
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<td>1935</td>
<td>28,701</td>
<td>47,673</td>
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<td>1936</td>
<td>33,779</td>
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<td>1938</td>
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<td>41,132</td>
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<tr>
<td>1940*</td>
<td>44,458</td>
<td>63,458 Est.,</td>
<td>482.20</td>
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Source: Annual Report of the Secretary of the Treasury, 1937.

* Estimated, President's Budget Message, January 3, 1939.
<table>
<thead>
<tr>
<th>Year</th>
<th>Total Corporate</th>
<th>Domestic Corporate</th>
<th>Foreign Corporate</th>
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<tbody>
<tr>
<td>1919</td>
<td>2,303.3</td>
<td>2,246.4</td>
<td>56.9</td>
</tr>
<tr>
<td>1920</td>
<td>2,710.0</td>
<td>2,563.4</td>
<td>146.6</td>
</tr>
<tr>
<td>1921</td>
<td>1,823.0</td>
<td>1,700.7</td>
<td>122.3</td>
</tr>
<tr>
<td>1922</td>
<td>2,335.7</td>
<td>2,211.5</td>
<td>124.2</td>
</tr>
<tr>
<td>1923</td>
<td>2,702.5</td>
<td>2,635.4</td>
<td>67.1</td>
</tr>
<tr>
<td>1924</td>
<td>3,322.3</td>
<td>3,027.1</td>
<td>295.2</td>
</tr>
<tr>
<td>1925</td>
<td>4,100.7</td>
<td>3,604.5</td>
<td>496.2</td>
</tr>
<tr>
<td>1926</td>
<td>4,357.0</td>
<td>3,754.0</td>
<td>603.0</td>
</tr>
<tr>
<td>1927</td>
<td>5,391.0</td>
<td>4,656.8</td>
<td>734.2</td>
</tr>
<tr>
<td>1928</td>
<td>6,079.6</td>
<td>5,346.1</td>
<td>733.5</td>
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<tr>
<td>1929</td>
<td>8,639.4</td>
<td>8,022.0</td>
<td>637.4</td>
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<tr>
<td>1930</td>
<td>4,944.4</td>
<td>4,484.7</td>
<td>469.7</td>
</tr>
<tr>
<td>1931</td>
<td>1,763.5</td>
<td>1,550.7</td>
<td>212.8</td>
</tr>
<tr>
<td>1932</td>
<td>325.4</td>
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<td>1933</td>
<td>160.7</td>
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<td>1934</td>
<td>178.3</td>
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<td>1936</td>
<td>1,216.9</td>
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</tr>
<tr>
<td>1937</td>
<td>1,158.5</td>
<td>1,158.5</td>
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Source: Commercial and Financial Chronicle.
<table>
<thead>
<tr>
<th>Year</th>
<th>Total Construction</th>
<th>Public Construction</th>
<th>Private Construction</th>
<th>Percent of public to total</th>
</tr>
</thead>
<tbody>
<tr>
<td>1920</td>
<td>8,563</td>
<td>2,044</td>
<td>6,519</td>
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<td>1921</td>
<td>8,062</td>
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<td>1922</td>
<td>9,346</td>
<td>2,358</td>
<td>6,988</td>
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<td>1923</td>
<td>10,920</td>
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<td>8,692</td>
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<td>1924</td>
<td>12,049</td>
<td>2,555</td>
<td>9,494</td>
<td>21.2</td>
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<tr>
<td>1925</td>
<td>13,063</td>
<td>2,819</td>
<td>10,244</td>
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<td>1926</td>
<td>13,779</td>
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<td>10,917</td>
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<td>3,189</td>
<td>10,755</td>
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<tr>
<td>1928</td>
<td>13,710</td>
<td>3,330</td>
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<td>13,488</td>
<td>3,309</td>
<td>10,179</td>
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<td>1930</td>
<td>11,814</td>
<td>3,733</td>
<td>8,081</td>
<td>31.6</td>
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<td>1931</td>
<td>8,689</td>
<td>3,424</td>
<td>5,265</td>
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<td>5,445</td>
<td>2,539</td>
<td>2,906</td>
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<tr>
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<td>4,044</td>
<td>1,918</td>
<td>2,126</td>
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<td>1934</td>
<td>4,860</td>
<td>2,474</td>
<td>2,386</td>
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<td>1935</td>
<td>5,578</td>
<td>2,548</td>
<td>3,030</td>
<td>45.7</td>
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<tr>
<td>1936</td>
<td>7,731</td>
<td>3,496</td>
<td>4,235</td>
<td>45.2</td>
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<tr>
<td>1937</td>
<td>8,440</td>
<td>3,329</td>
<td>5,111</td>
<td>39.4</td>
</tr>
<tr>
<td>1938</td>
<td>8,396</td>
<td>3,711</td>
<td>4,685</td>
<td>44.2</td>
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</table>

<table>
<thead>
<tr>
<th></th>
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<th></th>
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</tr>
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<tbody>
<tr>
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<td>75.8</td>
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<tr>
<td>1929</td>
<td>119</td>
<td>109</td>
<td>79.8</td>
</tr>
<tr>
<td>1930</td>
<td>96</td>
<td>89</td>
<td>73.6</td>
</tr>
<tr>
<td>1931</td>
<td>81</td>
<td>67</td>
<td>62.6</td>
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<tr>
<td>1932</td>
<td>64</td>
<td>46</td>
<td>49.8</td>
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<tr>
<td>1933</td>
<td>76</td>
<td>49</td>
<td>47.9</td>
</tr>
<tr>
<td>1934</td>
<td>79</td>
<td>63</td>
<td>52.4</td>
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<tr>
<td>1935</td>
<td>90</td>
<td>71</td>
<td>55.1</td>
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<tr>
<td>1936</td>
<td>105</td>
<td>82</td>
<td>62.6</td>
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<td>1937</td>
<td>110</td>
<td>98</td>
<td>69.3</td>
</tr>
<tr>
<td>1938</td>
<td>86</td>
<td>78</td>
<td>64.0 Est.</td>
</tr>
<tr>
<td>1939</td>
<td></td>
<td></td>
<td>68.0 Est.</td>
</tr>
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<td></td>
<td>Jan.</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>101</td>
<td>83</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Feb.</td>
<td>99</td>
<td></td>
</tr>
<tr>
<td></td>
<td>99</td>
<td>85</td>
<td></td>
</tr>
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<td></td>
<td>Mar.</td>
<td>98</td>
<td></td>
</tr>
<tr>
<td></td>
<td>98</td>
<td>87</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Apr.</td>
<td>92 p*</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>85 p*</td>
<td></td>
</tr>
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</table>

p — preliminary
### Table (6)

**Federal Relief Costs (1)**

<table>
<thead>
<tr>
<th>Year</th>
<th>Households</th>
<th>Persons</th>
</tr>
</thead>
<tbody>
<tr>
<td>1934</td>
<td>1,856</td>
<td></td>
</tr>
<tr>
<td>1935</td>
<td>2,361</td>
<td></td>
</tr>
<tr>
<td>1936</td>
<td>2,342</td>
<td></td>
</tr>
<tr>
<td>1937</td>
<td>2,467</td>
<td></td>
</tr>
<tr>
<td>1938</td>
<td>1,953</td>
<td></td>
</tr>
<tr>
<td>1939</td>
<td>2,741</td>
<td></td>
</tr>
</tbody>
</table>

**Source:** "Actual & Estimated Receipts and Expenditures of the Government for the Fiscal Years 1931-1939 on the Basis of Present Classification Shown in Daily Treasury Statement", published by Treasury Department, September 16, 1938. Year 1939, estimated, Bulletin of Treasury Department, April, 1939.

(1) Includes direct relief, work relief (W.P.A. and C.W.A.), and Civilian Conservation Corps.

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### Number of Persons and Households Receiving Public Assistance Financed From Federal, State, or Local Funds

<table>
<thead>
<tr>
<th>Year</th>
<th>Households</th>
<th>Persons</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dec. 1933</td>
<td>7,000,000</td>
<td>24,800,000</td>
</tr>
<tr>
<td>* 1934</td>
<td>6,547,000</td>
<td>25,475,000</td>
</tr>
<tr>
<td>* 1935</td>
<td>5,886,000</td>
<td>19,851,000</td>
</tr>
<tr>
<td>* 1936</td>
<td>5,868,000</td>
<td>18,872,000</td>
</tr>
<tr>
<td>* 1937</td>
<td>5,390,000</td>
<td>15,605,000</td>
</tr>
</tbody>
</table>

**Source:** Preliminary Report, Special Committee to Investigate Unemployment and Relief, United States Senate, pp. 4-5. S. Rep. No. 1625, 75th Cong., 3d Sess., April 30, 1938.
Table (7)
Corporation Taxes - 1937

<table>
<thead>
<tr>
<th>Industry</th>
<th>Number of</th>
<th>Principal Companies</th>
<th>Principal Companies and subsidiaries</th>
<th>Taxes (1) (Exclusive of sales, excises, etc.)</th>
<th>Net Income after Taxes</th>
<th>% of Taxes to net Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>Steel Producers</td>
<td>10</td>
<td>316</td>
<td></td>
<td>$149,315,305</td>
<td>$199,742,515</td>
<td>74.7</td>
</tr>
<tr>
<td>Meat Packers</td>
<td>4</td>
<td>157</td>
<td></td>
<td>21,495,637</td>
<td>19,324,716</td>
<td>111.2</td>
</tr>
<tr>
<td>Chain Variety Stores</td>
<td>10</td>
<td>30</td>
<td></td>
<td>29,804,997</td>
<td>64,516,968</td>
<td>46.2</td>
</tr>
<tr>
<td>Automobile Mfrs.</td>
<td>10</td>
<td>129</td>
<td></td>
<td>152,866,266</td>
<td>251,435,246</td>
<td>60.8</td>
</tr>
<tr>
<td>Tire and Rubber Mfrs.</td>
<td>16</td>
<td>219</td>
<td></td>
<td>43,934,899</td>
<td>27,178,443</td>
<td>161.7</td>
</tr>
<tr>
<td>Agricultural Implement Mfrs.</td>
<td>10</td>
<td>56</td>
<td></td>
<td>39,410,325</td>
<td>65,918,418</td>
<td>59.8</td>
</tr>
<tr>
<td>Cigarette Mfrs.</td>
<td>6</td>
<td>16</td>
<td></td>
<td>24,786,185</td>
<td>83,357,761</td>
<td>29.7</td>
</tr>
<tr>
<td>Sugar Refiners</td>
<td>14</td>
<td>53</td>
<td></td>
<td>15,745,628</td>
<td>19,720,972</td>
<td>79.8</td>
</tr>
<tr>
<td>Mail Order Houses</td>
<td>6</td>
<td>33</td>
<td></td>
<td>25,327,215</td>
<td>53,479,005</td>
<td>47.4</td>
</tr>
<tr>
<td>Oil Refiners</td>
<td>19</td>
<td>567</td>
<td></td>
<td>223,581,402</td>
<td>522,722,343</td>
<td>42.8</td>
</tr>
<tr>
<td>Office Equipment Mfrs.</td>
<td>10</td>
<td>92</td>
<td></td>
<td>14,963,832</td>
<td>34,728,285</td>
<td>43.1</td>
</tr>
<tr>
<td>Cement Mfrs.</td>
<td>8</td>
<td>21</td>
<td></td>
<td>2,888,433</td>
<td>6,571,240</td>
<td>44.0</td>
</tr>
<tr>
<td>Department Stores</td>
<td>27</td>
<td>332</td>
<td></td>
<td>30,759,286</td>
<td>28,940,073</td>
<td>106.3</td>
</tr>
<tr>
<td>Container Mfrs.</td>
<td>10</td>
<td>48</td>
<td></td>
<td>18,631,304</td>
<td>44,161,686</td>
<td>42.2</td>
</tr>
<tr>
<td>Chain Groceries</td>
<td>13</td>
<td>52</td>
<td></td>
<td>15,338,924</td>
<td>9,439,804</td>
<td>162.5</td>
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<tr>
<td>Chemical and Fertilizer Mfrs.</td>
<td>21</td>
<td>217</td>
<td></td>
<td>55,138,294</td>
<td>193,517,916</td>
<td>28.5</td>
</tr>
</tbody>
</table>

| TOTALS                    | 194       | 2,238               |                                      | $863,886,932                                   | $1,624,755,391          | 53.2                     |

Source: Compiled from published reports sponsored by the Securities and Exchange Commission.

(1) Above figures on taxes exclude all excises, sales taxes and other imposts which may be regarded as "consumers' taxes", with the possible exception of minor amounts, if any, of such taxes which may not have been excluded from the data issued by the Securities and Exchange Commission. It is understood, however, that certain other taxes which might properly have been included in the total borne by the registrants were ignored.
Appendix A

Examples Showing the Effect of High Surtax Rates on Individual Incomes Under the Revenue Act of 1938

(Amounts of incomes here referred to are "surtax net income" after allowance for exemptions, etc. Amounts of tax are combined normal and surtax rates.)

I. (a) A man with $50,000 of net income (taxable at from 4% to 31%) will have a tax to pay of $9,700 (an average rate of 19.4%). He will have left, after tax, a net amount of $40,300.

(b) An additional $1,000 of income will be taxable at 35%, so that the tax will take $350 of that amount, leaving him net, after tax, $350, or 6% of such additional income.

II. (a) A man with $100,000 of net income (taxable at from 4% to 59%) will have a tax to pay of $34,000 (an average rate of 34%). He will have left, after tax, a net amount of $66,000.

(b) An additional $1,000 of income will be taxable at 62%, so that the tax will take $620 of that amount, leaving him net, after tax, $380, or 38% of such additional income.

III. (a) A man with $150,000 of net income (taxable at from 4% to 62%) will have a tax to pay of $55,000 (an average rate of 36-1/3%). He will have left, after tax, a net amount of $85,000.

(b) An additional $1,000 of income will be taxable at 64% so that the tax will take $640 of that amount, leaving him net, after tax, $360 or 36% of such additional income.

(c) Considering the $150,000 net income by $50,000 blocks, the result is as follows:
### Appendix A

<table>
<thead>
<tr>
<th>Net Income</th>
<th>Average %</th>
<th>Tax Amount</th>
<th>% Remaining</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>First $50,000 I(a)</td>
<td>19.4%</td>
<td>$9,700</td>
<td>80.6%</td>
<td>$40,300</td>
</tr>
<tr>
<td>Second $50,000</td>
<td>48.6%</td>
<td>$24,300</td>
<td>51.4%</td>
<td>25,700</td>
</tr>
<tr>
<td>$100,000 II(a)</td>
<td>34.0%</td>
<td>$34,000</td>
<td>66.0%</td>
<td>66,000</td>
</tr>
<tr>
<td>Third 50,000</td>
<td>62.0%</td>
<td>$31,000</td>
<td>38.0%</td>
<td>19,000</td>
</tr>
<tr>
<td>$150,000 III(a)</td>
<td>43-1/3%</td>
<td>$65,000</td>
<td>56-2/3%</td>
<td>85,000</td>
</tr>
</tbody>
</table>

IV. Considering 4% as the rate of interest which a reasonably safe industrial might yield, 6% as the rate for a bond or loan which carried a reasonable business risk, and higher rates of 8%, 10%, 15% and 20% as the possible yields which might be expected as greater elements of risk might be involved; then we find the net yields, after the federal income tax (but without considering state income or other taxes), if these represented additional income to A who already had $50,000 of net income, to B who already had $100,000 of net income, and to C who already had $150,000 of net income would be as follows:
Possibly A might feel that the net yields which he could hope for would be sufficient to justify such investments if conditions were reasonably satisfactory. B and C could hardly be expected to make investments which involved such business risks as would normally call for 6%, 8% or 10% returns to make them attractive investments when B and C would only have 2%, 3% or 4% net left to themselves from such investments.

V. (a) If A, a man who already has $50,000 of net income, is contemplating investment of $100,000 in a business which he hopes will yield 10% a year, he finds that the $10,000 he hopes to receive will be subject to $3,660 tax so the net yield to him from his $100,000 investment will be $6,340, or slightly more than 6%. He may feel that this is sufficient to justify the investment.

(b) If B, a man who already has $100,000 of net income, is contemplating investment of $100,000 in a business which he also hopes will yield 10% a year, he finds that the $10,000 he hopes to receive will be subject to $6,200 tax, so the net yield to him will be only $3,800 or less than 4%. He
can hardly feel that such a net return is sufficient to justify him in making the investment.

VI. The high surtaxes work out to place excessive penalties on variations in income from year to year.

(a) A man with $50,000 a year net income pays $9,700. For 2 years on $100,000 of income thus received his tax would be $19,400, leaving to him a net amount, for the 2 years, of $80,600.

(b) A man with $20,000 net income in one year, on which he has to pay $2,060 tax; and $80,000 net income in the next year, on which his tax would be $22,600; would also have $100,000 net income for the two years, but his taxes thereon would be $24,660, leaving him a net amount, for the two years, of $75,340. Because of the irregularity of his income, he has to pay 27% more tax than if his income had been received in equal amounts in each of the two years.

(c) If a man had $50,000 loss in one year and $150,000 of income in the next, he also would have a net income of $100,000 for the two years, but his tax would be $65,000, leaving him net only $35,000. His tax will be over 3 times the amount of tax payable on $100,000 realized in equal amounts each year.
Appendix B

The Effect of Net Losses Upon Business Investment

Any man considering a new investment will be faced with many possible conditions which may develop. He must consider possibilities of success and possibilities of failure; possibilities of losses in some years and gains in others. He must balance the probability of a final result with gains to outweigh losses.

The man who would make a substantial business investment is probably a man who already has a substantial amount of other income. In measuring the advantages to him of making the investment, he will take into account the net result of the new venture to him, applying to it the rates which would be applied to it on top of his other income. Manifestly, unless this will yield to him a return in addition to his other income which is sufficient to cover the risk, he would be better off to be contented with his present income and not make the new investment, or possibly to make the investment in some conservative low-yield security.

In trying to determine the net result of the business the investor should take into account the possibility, or even probability, of having one, two or three years' losses before the new business could get on its feet and really start its earnings. Even after it has reached a point where it can show earnings in good years, he must still consider the possibility of some years of loss falling in any extended period of years. Of course, if he can feel well assured of the absence of serious risk in the investment and the reasonable expectation of steady income from it, he can make his investment with little regard to possibility of loss. Only rarely, however, will this condition exist with regard to any new enterprise.

A man may consider the results of the investment if he engages in it
individually (or through a partnership) so there will be no corporation tax to pay but only the individual income tax. In that case he can figure the additional tax he would have to pay on income from the enterprise received in addition to his other income, and may count on being able to apply losses on the enterprise in years of loss against his other income, with reduction of the amount of tax he would otherwise have to pay.

If, however, he makes an investment through a corporation, then the net amount remaining to him will be what is left after paying the corporate tax in any years in which the corporation has a gain (with no corporate tax to pay in years of corporate loss) and after paying his individual income tax on any net profits the corporation distributes to him.

We have set up certain rather typical examples of how this situation would work out as to tax and net gain from investments. First, as to a man with $100,000 of other income, so that any taxes he would have to pay on additional income would be at a rate of at least 62%; and second, for a man who had such income that the average rate of tax he would have to pay on additional income would be 31%. (This latter computation cannot be related to specific amounts of income as the 31% falls at a point where the gradations between rates are quite rapid. However, we are justified in making the computation on an assumption that a man might happen to have this exact rate to pay on additional income, or that he might be one of a number of men who were participating in the investment so that he would have an average rate of 31% to pay.)

For convenience of computation, we have assumed earnings of $100,000 a year in years of profit, with possibility that there might be a year or years in which there would be losses of $100,000. (Computations could, of course, be made as to fluctuating amounts of income in various years and fluctuating amounts of possible loss, but the computations are at best so complicated that the simple
case seems sufficient to illustrate the tendencies involved.)

For simplicity also we are assuming that the investor has a steady income from other sources which does not fluctuate from year to year. Perhaps the real tendency would be for his other income to be higher in the years when the new enterprise had income for distribution, and be lower in years when the new enterprise was sustaining loss, with the effect, as hereinbefore noted, that this would serve still further to increase the average rates of tax which he would have to pay.

On these assumptions we have set up various examples which in each case show the results for a five-year period:

(A) If the enterprise had steady earnings of $100,000 a year, with no years of losses;

(B) If the enterprise had earnings of $100,000 a year for four years of the five-year period and had one year of loss of $100,000;

(C) If the enterprise had three years of earnings of $100,000 a year, and two years of loss of $100,000 a year;

(D) If the enterprise had two years of profits of $100,000 a year and three years of loss of $100,000 a year each.

Some of these may seem rather extreme figures, but they are by no means beyond the possibilities with which an investor may be faced with regard to a new business.

The computations show how this would work out –

I(a) – For an individual conducting the business directly.

I(b) – For an individual who had the business conducted by a corporation under existing provisions where taxable income of each year was computed without deduction for losses of another year.

I(c) – For an individual who conducted the business through a corporation if the net income of one year was computed after allowance for deduction of losses of other years.
As a final computation we have figured what would be the average net
return under the various conditions which would remain to the investor after pay-
ing the income taxes involved –

(1) On the assumption that a $1,000,000 investment
was required to yield the estimated earnings
(so that in years of profit the business would
be earning 10% on its invested capital); and

(2) On the assumption that a $500,000 investment was
was required to yield the estimated earnings
(so that in years of profit the business would
be earning 20% on its invested capital).

First, these are presented on the assumption that the individual has
other income of $100,000, so that on any income from this enterprise he would be
taxed at 62%.

As to computation I(a) if the business were conducted individually,
it is assumed that the losses in any years of loss would have the result of off-
setting $34,000 of tax which the individual would otherwise have to pay on his
$100,000 of other income.

On computations I(b) and I(c) it is assumed that even though the cor-
poration might have to pay tax on the full amount of income which it earned in
years of profit, it would not be penalized for failure to distribute earnings
to the extent that it was necessary to apply such earnings to offset the losses
of other years.
Such computations, briefly summarized, show as follows:

<table>
<thead>
<tr>
<th>5 years</th>
<th>A</th>
<th>B</th>
<th>C</th>
<th>D</th>
</tr>
</thead>
<tbody>
<tr>
<td>I(a) Business conducted by individual having other income of $100,000.</td>
<td>No losses</td>
<td>1 year loss</td>
<td>2 years losses</td>
<td>3 years losses</td>
</tr>
<tr>
<td>Business earnings $100,000 per year except for losses as indicated.</td>
<td>$500,000</td>
<td>$300,000</td>
<td>$100,000</td>
<td>-$100,000</td>
</tr>
<tr>
<td>Net earnings</td>
<td>$310,000</td>
<td>$214,000</td>
<td>$118,000</td>
<td>$22,000</td>
</tr>
<tr>
<td>Net tax</td>
<td>$190,000</td>
<td>$86,000</td>
<td>-$18,000</td>
<td>-$122,000</td>
</tr>
<tr>
<td>Net gain</td>
<td>$38,000</td>
<td>$17,200</td>
<td>-$3,600</td>
<td>-$24,400</td>
</tr>
</tbody>
</table>

| Average net gain per year | $38,000 | $17,200 | -$3,600 | -$24,400 |

Percentage of earnings remaining to represent net gain to investor:

- 38% 38.67% -18%

Average annual net return on capital:

1. (1) On $1,000,000 investment,
   - 3.8% 1.72%
2. (2) On $500,000 investment,
   - 7.6% 3.44%

There is here, of course, no inducement for investment if two years' losses or three years' losses are a probability, as in Columns C and D. Even an assumption of one year's loss in five would certainly leave no inducement for investment of $1,000,000 in such an enterprise. There is practically no inducement for the results in Column B to be obtained on a $500,000 investment.

If the business could reasonably be expected to make 20% a year on a $500,000 investment, with no years of losses, as in Column A, the possible 7.6% return on the investment might be sufficient to offset the probability of loss.

There would hardly be sufficient inducement if it was necessary to make a $1,000,000 investment to obtain these results.
If, however, such a business is to be conducted by a corporation, under the existing law which denies right to apply losses of one year as deductions from profits of other years, and all earnings in excess of taxes and losses are to be promptly distributed to a stockholder (or to stockholders) taxable thereon at 62%, such computations briefly summarized show as follows:

<table>
<thead>
<tr>
<th>I(b)</th>
<th>5 years</th>
<th>A</th>
<th>B</th>
<th>C</th>
<th>D</th>
</tr>
</thead>
<tbody>
<tr>
<td>No losses</td>
<td>1 year loss</td>
<td>2 years losses</td>
<td>3 years losses</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Corporation earnings $100,000 per year except for losses as indicated.</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net earnings distributed to stockholder taxable @ 62%.</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net earnings</td>
<td>$500,000</td>
<td>$300,000</td>
<td>$100,000</td>
<td>-$100,000</td>
<td></td>
</tr>
<tr>
<td>Total tax (corporation and individual)</td>
<td>341,350</td>
<td>211,080</td>
<td>80,810</td>
<td>33,000</td>
<td></td>
</tr>
<tr>
<td>Net gain</td>
<td>$158,650</td>
<td>$88,920</td>
<td>$19,190</td>
<td>-$133,000</td>
<td></td>
</tr>
<tr>
<td>Average net gain per year</td>
<td>$31,730</td>
<td>$17,784</td>
<td>$3,838</td>
<td>-$26,600</td>
<td></td>
</tr>
<tr>
<td>Percentage of earnings remaining to represent net gain to investor</td>
<td>31.73%</td>
<td>29.64%</td>
<td>19.19%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Average annual net return on capital:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(1) On $1,000,000 investment</td>
<td>3.173%</td>
<td>1.778%</td>
<td>.3838%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(2) On $500,000 investment</td>
<td>6.346%</td>
<td>3.557%</td>
<td>.7676%</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

This gives some variation from the results under Example III(a) where the business is conducted by the individual. In Column C (2 years losses), the tax would take substantially all the net earnings under I(b) but would not actually exceed the net earnings as it would under I(a).

Probably the only basis which would make such an investment reasonable under these conditions would be the assumption that the corporation could each year earn 20% on its invested capital, with no years of loss.
If, in computing taxes, losses of one year could be deducted from profits of other years, a somewhat better result would be shown, but at least the element of loss due to taxes would be minimized. Making this computation under the conditions of Example I (b), the results would be as follows:

<table>
<thead>
<tr>
<th></th>
<th>A</th>
<th>B</th>
<th>C</th>
<th>D</th>
</tr>
</thead>
<tbody>
<tr>
<td>I (c)</td>
<td>5 years</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

- Corporation earnings $100,000 per year except for losses as indicated.
- Losses deducted in computing tax on profits.
- Net earnings distributed to stockholder taxable @ 62%

<table>
<thead>
<tr>
<th></th>
<th>A</th>
<th>B</th>
<th>C</th>
<th>D</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net earnings</td>
<td>$500,000</td>
<td>$300,000</td>
<td>$100,000</td>
<td>$100,000</td>
</tr>
<tr>
<td>Total tax (corporation and individual)</td>
<td>341,350</td>
<td>204,810</td>
<td>65,270</td>
<td></td>
</tr>
<tr>
<td>Net gain</td>
<td>$158,650</td>
<td>$95,190</td>
<td>$31,730</td>
<td>$100,000</td>
</tr>
<tr>
<td>Average net gain per year</td>
<td>$31,730</td>
<td>$19,038</td>
<td>$6,346</td>
<td>$20,000</td>
</tr>
<tr>
<td>Percentage of earnings remaining to represent net gain to investor</td>
<td>31.73%</td>
<td>31.73%</td>
<td>31.73%</td>
<td></td>
</tr>
<tr>
<td>Average annual net return on capital</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(1) On $1,000,000 investment</td>
<td>3.173%</td>
<td>1.903%</td>
<td>.638%</td>
<td></td>
</tr>
<tr>
<td>(2) # $500,000 investment</td>
<td>6.346%</td>
<td>3.807%</td>
<td>1.269%</td>
<td></td>
</tr>
</tbody>
</table>

The results in the first Column A (no losses) remain the same as in Example I (b) but the possible return under Columns B and C, while not an inducement in itself, is substantially better than in I (b). If the Column D situation should exist, the investor does not have to stand taxes to the Government in addition to a net loss of the business.
The foregoing Examples I (a), II (b) and I (c) are all on the basis of results to a stockholder (or stockholders) taxable at 62%.

We may assume an individual (or individuals) taxable at 31%, without attempting to say exactly where in the tax scale that average result would come. Also we may assume that if the business were individually conducted any losses would result in a tax saving to the individual of 15% of the loss. On that basis, with conditions otherwise the same as in Examples I (a), II (b) and I (c), we may make the respective computations of II (a), II (b) and II (c).

II (a)  5 years

<table>
<thead>
<tr>
<th></th>
<th>A</th>
<th>B</th>
<th>C</th>
<th>D</th>
</tr>
</thead>
<tbody>
<tr>
<td>No losses</td>
<td>1 year</td>
<td>2 years</td>
<td>3 years</td>
<td></td>
</tr>
<tr>
<td>$100,000</td>
<td>$300,000</td>
<td>$100,000</td>
<td>$100,000</td>
<td></td>
</tr>
</tbody>
</table>

As in Example I (a) except that individual is taxable @ 31% and losses give tax saving of 15%.

Net earnings: $500,000 $300,000 $100,000 $100,000
Net tax: 165,000 109,000 63,000 17,000
Net gain: 345,000 191,000 37,000 -117,000
Average net gain per year: 69,000 38,000 7,400 -23,400
Percentage of earnings remaining to represent net gain to investor... 69% 63.67% 37% -

Average annual net return on capital:
(1) On $100,000 investment......... 6.9% 3.82% .74% -
(2) On $500,000 investment...... 13.8% 7.64% 1.48% -
<table>
<thead>
<tr>
<th>II (b)</th>
<th>5 years</th>
<th>A</th>
<th>B</th>
<th>C</th>
<th>D</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>No losses</td>
<td>1 year</td>
<td>2 years</td>
<td>3 years</td>
<td></td>
</tr>
<tr>
<td>As in Example I (b) except that stockholder is taxable @ 31%.</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net earnings</td>
<td>$500,000</td>
<td>$300,000</td>
<td>$100,000</td>
<td>$300,000</td>
<td></td>
</tr>
<tr>
<td>Total tax</td>
<td>$211,925</td>
<td>138,540</td>
<td>65,155</td>
<td>33,000</td>
<td></td>
</tr>
<tr>
<td>Net gain</td>
<td>$288,075</td>
<td>$161,460</td>
<td>$34,845</td>
<td>$133,000</td>
<td></td>
</tr>
<tr>
<td>Average net gain per year</td>
<td>$57,615</td>
<td>$32,392</td>
<td>$5,969</td>
<td>$28,600</td>
<td></td>
</tr>
<tr>
<td>Percentage of earnings remaining to represent net gain to investor</td>
<td>57.61%</td>
<td>53.82%</td>
<td>34.94%</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>Average annual net return on capital</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(1) On $1,000,000 investment</td>
<td>5.762%</td>
<td>3.223%</td>
<td>.697%</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>(2) On $500,000 investment</td>
<td>11.553%</td>
<td>6.456%</td>
<td>1.394%</td>
<td>-</td>
<td></td>
</tr>
</tbody>
</table>

II (c)

As in Example I (c) except that stockholder is taxable @ 31%.

<table>
<thead>
<tr>
<th></th>
<th>1 year</th>
<th>2 years</th>
<th>3 years</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net earnings</td>
<td>$500,000</td>
<td>$300,000</td>
<td>$100,000</td>
</tr>
<tr>
<td>Total tax</td>
<td>$211,925</td>
<td>127,155</td>
<td>42,885</td>
</tr>
<tr>
<td>Net gain</td>
<td>$288,075</td>
<td>$172,845</td>
<td>$57,615</td>
</tr>
<tr>
<td>Percentage of earnings remaining to represent net gain to investor</td>
<td>57.61%</td>
<td>57.61%</td>
<td>57.61%</td>
</tr>
<tr>
<td>Average annual net return on capital</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(1) On $1,000,000 investment</td>
<td>5.762%</td>
<td>3.457%</td>
<td>1.156%</td>
</tr>
<tr>
<td>(2) On $500,000 investment</td>
<td>11.553%</td>
<td>6.914%</td>
<td>2.311%</td>
</tr>
</tbody>
</table>
Only a brief review of these is necessary to show how much more of an inducement for investment is offered to the man taxable at 31% than is offered to the man taxable at 62%.

Admittedly, the computations here made deal with certain special situations which are adopted as assumptions for these computations. The results, however, are generally representative of the tendencies which exist in the present law, as will appear from even more extended computations of this kind which can be made.

While it is not perhaps the ordinary contemplation that a single investor will make the complete investment of $500,000 or $1,000,000 for financing an enterprise of this kind, computations made in this way will show the same tendencies as would face an investor if he were contemplating putting in only a part of the total amount, with the balance to be supplied by others.
June 3, 1939

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

My dear Mr. Secretary:

In accordance with your telegraphic request, I transmit here-
with a memorandum concerning Mr. Berle's proposals for a capital credit
banking system.

Sincerely,

[Signature]
Memorandum for: The Secretary of the Treasury
From: Mr. Charles O. Hardy
Subject: Mr. Berle's Memorandum "A Banking System for Capital and Capital Credit"

Mr. Berle's proposals may be conveniently analyzed under three heads: First, his analysis of the way in which the present financial organization of society operates; second, his proposals for the establishment of a new financial mechanism; and, third, miscellaneous criticisms of specific statements.

The essence of his analysis of the present system may be stated briefly as follows: First, that under a modern commercial banking system the needs of the community for liquid loanable funds are met through a process of creating money (bank deposits) by a stroke of the pen, and are costless except for the operating expenses of the commercial banking system and the bad debt losses. Second, that the modern investment banking system, in contrast to the commercial banking system, operates with savings and cannot satisfy the needs of industry for investment funds, except as savings are offered by the public, either directly or through the intermediation of the government, which sells its bonds and advances funds for investment.

His constructive proposal is that there be established a capital credit banking system "which can do for the country what the revised commercial banking system has done in the short-term credit and strict currency field"; that is, create funds for investment purposes in accordance with the needs of industry and of governmental units, without reference to the availability of savings.

The Background of Capital Credit

Mr. Berle's memorandum reflects a misunderstanding on his part of the nature of the way in which the banking system actually functions. It is true, as he says, that a banking system has the power to create, by lending and investing operations, deposits which function...
as money. It is also true, as he says, citing Moulton, that the loans and investments of banks have been the source of a considerable proportion of investment funds. He does not recognize, however, that the "creation" of funds is not the only way, and quantitatively speaking is not the principal way, in which banks are able to finance industry. On page 2 he refers to the supply of bank credit and bank deposits as being "in effect the privilege of commercial banks to create and circulate money." On page 12 he states that there is no reason why a bank is "entitled" to a profit because a bank is a mechanism for creating currency and receives the privilege of doing this from the government.

The fact is that the business of creating currency accounts for a very small fraction indeed of any bank's current operations. A bank may make a loan by creating a deposit (if it has an excess reserve) without having first received a deposit or a capital investment of like amount from a depositor or stockholder. But in the vast majority of cases what it does is to receive funds either from a depositor or from a former borrower who is paying off a loan and allocate these funds to fresh borrowers. It is only the increase in the volume of deposits in any given period which can properly be described as funds created during that period. For years at a time no funds may be created in this way. During the years 1923-29 the annual growth of demand deposits was at the rate of less than 3 per cent per annum. The bulk of the lending operations was simply the redistribution of the existing monetary stock, or was financed from the growth of time deposits which were not currency nor costless.

On page 16 Mr. Berle points out that controls must be in existence which will prevent the creation of currency and credit for capital purposes from so increasing the supply and circulation of currency that it will affect the price level. This would be a much more important limitation on the power of banks to create currency than Mr. Berle seems to recognize. The only reason that it is possible for banks to make something out of nothing, without inflationary consequences, is because in a growing country the stock of money needed to carry on business at a stable price level tends to increase from year to year (both because of increased population and increased wealth). In the absence of a means by which currency can be expanded, the attempt of individuals to increase their cash balances would exert a downward pressure on the price level and the national income. But to create and invest a volume of currency in excess of the needs of the population for cash at stable prices, is definitely inflationary.

During a period of acute depression the willingness of the population to hold idle cash in preference to active investments tends to rise, and even during the recent recovery years it has been possible to increase the volume of cash rapidly without disastrous inflation, largely for the reason that Mr. Berle points out in another connection; namely, the reluctance of individuals to make capital investments on the scale which characterized most previous periods in our history.
It does not follow, however, that the power to create currency constitutes a limitless reservoir from which any amount of funds can be drawn that are necessary to provide the desired volume of investment.

The Proposed System of Capital Credit Banking

Mr. Berle's proposed capital credit banks are to do what commercial banks have done to a limited extent in the past (and it may be added, what governments have done in the past when they financed their expenses by issuing paper money); that is, supply the capital needs of the country by created currency to any extent necessary for investment purposes.

The check on an excessive creation of funds for this purpose is that when the amount of bank credit and currency created, coupled with an increase in the speed of its circulation, tends to upset the price levels, the amount of currency and credit is to be reduced by "open market operations" (p. 17). 2

It is not intended that the capital credit banks shall themselves create monetary deposits since it is stated that their deposits should not be freely withdrawable and should consist of savings (p. 13). Since the object of the scheme is to free the investor from dependence upon the supply of the volume of savings, however, it is necessary that monetary funds be created in some way. The method chosen is to rediscount the capital credit banks' bond assets at the Federal Reserve Banks. The effect of rediscounting would be to put the borrower in possession of funds which when deposited in the commercial banks would increase their reserves and presumably lead to an expansion of the volume of deposits at the commercial banks.

The probable working of such a plan cannot properly be forecast on the basis of the behavior of bank depositors, investors and business borrowers in a period like the present when the level of investment is low, because the very purpose of the plan is to do away with such periods. If we assume that the plan is in operation in a period of active business when the velocity of circulation and the volume of employment are relatively high and prices are tending to rise, it is clear that the volume of new loans made by the capital credit banks would have to be substantially equalled by the flow of securities out of the portfolio of the Reserve Banks in the form of open market sales. If this were not true, the process

2/ Manipulation of rediscount rates and eligibility is also suggested; but it is not necessary to discuss this, as the basic issues are not different.
would be highly inflationary. This statement needs to be qualified to the extent that the volume of deposits needed to finance business at stable prices was tending to rise, but this qualification may be neglected because ordinary commercial bank operations in a period of good business activity will supply the full amount of currency that can be absorbed in this way, and all the currency created through the investment banks' operations will have to be mopped up by open market sales. Open market sales can be made only by giving buyers a yield on their purchases. This brings us to the question of the rate of interest.

One of Mr. Berle's main contentions is that it is unnecessary to pay the banks in the form of interest sufficient money to enable them to pay dividends on capital. Several comments are pertinent. First, the amount of profits actually made by banks if spread over the entire volume of their lending and investment operations constitutes an almost negligible element in the interest which they collect. In the first half of 1928 national banks collected 586 million dollars in interest and made net earnings of 148 million. In the last half of 1930 they collected 535 million dollars and made net earnings of 45 million. Secondly, if the bank is to take risks it will have to have some capital to cover its losses and the use of that capital represents a cost to some one. If it is not covered out of interest charges it will have to be covered in some other way. Third, if bonds are to be sold in the open market they must either bear a rate of interest sufficient to make them attractive to buyers in times of business optimism, or else they must be sold at discounts and these discounts must be covered in some way. If the funds are to be secured from private depositors, interest must be paid on these deposits; otherwise there is no inducement to any one to hold his funds in this form rather than in demand deposits. It is only because of a depression psychology that it is possible to create funds in large amounts on interest-free basis, without inflationary consequences.

The plan really assumes that after doing away with the depression there will continue to be possibilities of creating funds in a costless manner, although such a possibility only exists because of the prevalence of a high liquidity preference which leads the public to carry abnormally high volumes of bank deposit idle when they get no interest on them.

Finally I do not think Mr. Berle makes an adequate case for so far-reaching a change in the organization of the investment market. On pages 6-9 he points out certain reasons for the "stoppage" in the capital markets. In general his reasons do not seem to me to be closely related to the assumptions of the memorandum. He points out, first, the restricted base of national enterprise caused by the rise of the totalitarian systems. To this I think should be added as an international factor the extreme uncertainty as to whether business men should plan long-range commitments with a view to peace conditions or war conditions. These factors obviously restrict the willingness of enterprise to take the risks of borrowing quite as much as that of lenders to take the risks of lending. The difficulties on this score would seem to be just as great under the proposed system as under the present system. Second, he points out the increases in needed social services (which have to be financed
either by taxation or temporarily by bond issues). Since the existing investment banking mechanism is adapted to the flotation of public issues quite as well as private, this consideration does not point toward the proposed reform. Third, he refers to the fears of capital and capital groups. But these fears, and particularly the specific items that he mentions, have more to do with the willingness of borrowers to borrow than with the willingness of savers to lend. And again I do not see that the new system would change the situation with respect to borrowers (unless it created presumption that they would not have to repay their borrowings).

This third point illustrates a looseness in reasoning which permeates a large part of the memorandum. After enumerating various factors which discourage enterprisers, such as the utility situation, the labor situation, the anti-trust movements and the tax situation, he says "there is something in all these contentions but probably all have been exaggerated entirely out of measure .... I do believe the fears have been badly overstated." Of course the fact that some one has exaggerated a point has no bearing on the question whether it is a valid point or not.

Next he points out that prophesies of complete disaster which have been made when reforms were undertaken usually proved unfounded "once there is acceptance of the reform." (Of course this is true, as a reform would not be "accepted" if it caused complete stoppage and complete disaster.) Then he says "we have not reached this phase, though it is visibly approaching." No facts to substantiate this conclusion are given. Finally, he says "the fact that this third set of objections can be overcome does not eliminate the validity of the first two." He does not, however, give any indication as to why he thinks the third set of objections could be overcome, or how.

Dr. Moulton is cited on page 3 in connection with his articles written in 1916 in which he pointed out that investment was in fact financed largely through bank credit. This is true, though of course the bulk of the investment securities which were absorbed by banks passed from the banks to savers and are replaced by other new flirtations. The banks' contribution to the new investment of any year is merely the increase of their investment created in that year, minus the part which is financed by an increase of saving deposits. Moreover, it does not seem to me true that "Moulton's study pointed to a definite reorganization of the banking structure." On the contrary, the implications of this study are that the present banking structure can take care of both investment credit and commercial credit. The most that could be argued from these studies as to the need of reform would be that banks should have more freedom to make long-term loans. Of course, in this respect the law has been greatly liberalized in the 20 years since the article was written, and more could be done by simple changes in bank examiners' standards and rediscount eligibility regulations without creating a new structure. (Mr. Moulton concurs in this paragraph)

The real objective of the memorandum seems to me to be embodied in the suggestion on p. 11 (amplified on p. 15) that the borrow-
ings of governmental enterprises such as hospitals should bear nominal interest rates such as 1/8 of 1 per cent. This seems to me entirely un- sound. I see no reason why the taxpayer should not carry the cost of financing public enterprises just as much as the costs of operating them. One-eighth of 1 per cent will nowhere near cover the direct cost of making and collecting such loans, nor the probable losses. As a matter of principle it seems to me that the budgets of such enterprises should recognize the fact that capital invested in them is withdrawn from some other use and the cost of the enterprise is what the capital could have earned in that alternative use. Of course, typically, the risks of lending to governmental agencies are lower than the risks of lending to individual enterprises for expansion, but that difference is already recognized in the rates. Even if we accept the argument, rebutted above, that the power to create money makes it unnecessary to offer interest rates to stimulate that creation, it still remains true, unless the amount of money that can be so created is infinitely great, that sound public policy requires that the resource should be used in the way in which it will produce the maximum flow of utility. Certain enterprises must be subsidized, but I see no reason for subsidizing them by lending them money at less than the value of money to business and making it up by charging a higher rate to commercial enterprises, rather than by taxing the community.
June 3, 1939
11:39 a.m.

HM Jr: Hello.

Operator: Mr. Sproul.

HM Jr: Hello.

Allan Sproul: Hello, Mr. Secretary.

HM Jr: How are you?

S: All right.

HM Jr: Well, how does it look to you now?

S: Well, it looks this way, if we were -- if you were selling for cash there would be no question, it seems to me, the right coupon would be five-eighths.

HM Jr: Yeah.

S: If there were no rights values involved.

HM Jr: Yeah.

S: And having knocked off some of the value of rights it's undesirable to put most of it back on again with too high a coupon.

HM Jr: Yeah.

S: And the three-quarter is par and it seems to us it would probably go pretty quickly to 101 and one-half anyway, so you'd have a point and a half premium there.

HM Jr: Yeah.

S: It's a premium at offering too -- anywhere around there, one and a quarter -- one and a half on a five-year note, it raises the question of what the premium would be on a long bond.

HM Jr: Yeah.

S: It would seem to be out of line.

HM Jr: Uh-huh.

S: So our feeling is that a three-quarter at par and a quarter would be plenty generous and that the market is prepared for it.
HMJr: Par and a quarter, huh?
S: Yeah.
HMJr: I see.
S: That would give them about a point -- we figure, about a point premium.
HMJr: Well, would you stay there a few minutes and I'll call you back?
S: Right.
HMJr: Righto!
S: All right.
HMJr: Thank you.
TO Secretary Morgenthau
FROM V. H. Hadley

"Rights"

September 1-3/8's

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8-year Notes

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JUNE 15 REFUNDING

June 3, 1939.
11:40 A.M.

Present: Mr. Bell
         Mr. Haas
         Mrs. Klotz
         Mr. Lochhead
         Mr. Murphy
         Mr. Hadley
         Mr. Seltzer

H.M.Jr: Well, what do you think, Dan?

Bell: Well, three quarters does look awfully sweet, but I kind of hate to attach a premium to the three-quarters coupon, and I think the banks would hate it. I'm not so sure that the banks wouldn't rather have a five-eighths coupon and not have a premium.

Hadley: This morning, talking to Mr. Matteson, he said the banks would prefer the five-eighths straight rather than three-quarters with a premium. They've set the market price either on the basis of five-eighths or three-quarters with a premium.

H.M.Jr: Either five-eighths - they set the price at what?

Hadley: They set the price of the rights on the basis of either a five-eighths issue or three-quarters with a premium.

H.M.Jr: How can they do both?

Hadley: It's in between. They're just judging it.

Bell: Selling the yield.

H.M.Jr: George, what does your gang think?

Haas: We'd like to take it straight, three-quarters.

H.M.Jr: Straight? What a man!

Haas: Mainly on the basis - our figures are just about the same, but we feel, why take the chance? There is some chance in the other. Since it is a refunding offer it will be open a few days, and if
something happens we might get in trouble. Why bother about it on a quarter? That's the way our people think.

Seltzer: This isn't the same as a cash offering or a bond refunding, anyhow, because these fellows had 11/32nds coming to them anyhow because you called their notes early, and if you knock off that 11/32nds from the gross premium, they're not being treated too handsomely.

H.M. Jr: What does it leave after you knock off 11/32nds?

Seltzer: Depends on how you figure. We don't figure on the point and a half, but Sproul does.

Hadley: Figuring the interest at one and a half - that's what the market is going to do Monday. It's 101 and 10, and Monday it's going to jump up to 101 and 16.

Bell: But even at that, you haven't given back by this price all they have lost the last few days by your announcement.

H.M. Jr: I have not.

Bell: These rights were selling at 101 29(32nds) Thursday morning. If you go back to 16, you're docking them 13/32nds. And the fellow who has paid 101 25 for several days - the fellow who has paid 101 25 and 26/32nds isn't going to get a lot of earnings out of his three-quarters coupons. Must have been quite a few of them. They were quite active in the market for the last 10 days.

H.M. Jr: Anybody agree with Sproul that we should add a quarter?

Hadley: I feel that something should be added to it, either a quarter or even a half; that most of these are held in New York City and the banks aren't going to throw away their rights, they're going to turn in for them. It's a question of whether you want a point and a half premium on a five-year note.
H.M. Jr: Henry?

Murphy: The 101 and a half sounds rather high to me. It's a 44/100ths yield basis. Now, the securities that mature a full year sooner yielded last night 45/100ths, so it's assuming that the securities for five years will yield a little less than four. Now that's not an unprecedented situation, there is some theoretical reason for it to happen, but still it is a rather precarious situation, and we normally expect the five year stuff to yield somewhat more than the four. So to state an expectancy of a point and a half premium dogmatically - it seems to me we're going quite a ways; so I would be inclined to expect the premium to go somewhat less.

And as Larry has pointed out, the people have the alternative of holding on until September and picking up the interest accrual at that time. The notes are held almost exclusively by people who know what they are doing, and they won't do that as long as it is worth while to make the exchange. The offer will have to stay open for several days, and if we use up 16/32nds - say that will be a half of our protection premium - by putting out new securities at a premium, and use up another portion of it by the benefit a person can get by letting the securities run to September, we get down to where there are perhaps only 10/32nds of what I can call unappropriated premium, that is, premium that is gravy in every direction. And since you're letting it stay open for several days, something could happen to wipe that out.

Hadley: If a person doesn't turn his securities in for an exchange he automatically loses a point, and he's not going to do that.

H.M. Jr: Well, of course - all right - excuse me - you want to say something else? Didn't mean to shut you off.

Hadley: And so this argument about interest of 11/32nds that they would get anyway - there isn't anybody that's going to do it unless he hasn't heard about the announcement.
Haas: Unless the market itself....
Murphy: It's merely that that much of a premium isn't worth it; that if other circumstances aside from this contract the remaining premium after the premium on the new notes and after this to a negligible or negative proportion, then you would have difficulty.
Haas: You'd only have difficulty under adverse circumstances.
Murphy: That's right.
H.M.Jr: How does my Scotchman feel?
Lochhead: I'm inclined to be a little more generous. A Scotchman usually is. I'll tell you the way I feel about it. As the market looks just now and as far as we can see the market for the next week, I think we could do a five-eighths if we wanted to, or we could offer three-quarters at a premium. I don't like the idea of the premium bond if we can get away from it. Of course, Sproul says there that the market would be prepared to take it, but I think they're going to be reluctant.

And secondly, I think we're watching the market very closely just the last day or two. If we want to look back just a week or so, this doesn't look so bad. I think maybe we've got our nose a little too close to this market, ought to take a little broader view of it. I think we can afford to be generous with a three-quarter rate.

H.M.Jr: We're not being generous. After all, we hoped—when we started in a week ago, we weren't sure we could do three-quarters.

Hadley: A week ago three-quarters would have given them 30/32nds.

H.M.Jr: So what we have gained is at the expense of nobody other than the right-holders. I mean it doesn't
cost the Government any more. I'm inclined to be generous. I'd like these fellows to be satisfied. Three-quarters of a percent - the lowest we have ever had before is one and one-eighth; that's a big drop. Awfully cheap money.

Bell: If it were a one and a half percent coupon, I think you might be talking about a little premium. When it gets below that, it's getting pretty thin.

H.M.Jr: I've got to borrow a lot more money from these boys. The worst they can say is "Morgenthau is getting a little soft."

Bell: Pound of flesh.

H.M.Jr: And I don't want it. I've got to sell these boys a lot more stuff.

And of course, the object wasn't to slap down the right-holders the way the papers have written it.

Lochhead: That was incidental. You have slapped them down a little bit; you put a little more element of uncertainty into the rights.

Bell: You've done that twice - on the Home Owners Loan once. But it doesn't hurt anybody.

H.M.Jr: But nobody says, with the exception of you (Hadley), that three-quarters wouldn't be right. Supposing it does go to 102 and a half; the Home Owners Loan is going to 102.

Hadley: It won't hurt anybody.

Haas: But it would hurt somebody if an adverse situation occurred.

Hadley: Couldn't get that adverse.

H.M.Jr: Well, we've got a lot of stuff yet to do. I'd rather have them say, "Well, Morgenthau isn't as bad as we think he is." What?
Seltzer: That's right.

H.M. Jr.: It isn't costing anybody anything.

Lochhead: If the bond market continues to go up and you're going to have to do some new financing on bonds, I imagine you'll have to continue to give a fair premium in order to have some assurance that the rates will hold. I mean I think the more the market goes up, the more vulnerable it is.

H.M. Jr.: The further it goes up, the more worried I am, because the more airholes it gets.

Bell: As Archie says, the more gravy you're going to have to add the higher the market gets.

H.M. Jr.: Right. But supposing I want to continue to do notes until this thing seeks a level, so I won't - I don't want to charge on the conversion. I don't want to charge a premium. Have we ever done that on a conversion?

Bell: Yes, we have (several additional words not understood).

H.M. Jr.: Well, that was a reopening of an issue.

Murphy: Yes.

H.M. Jr.: Yes.

Bell: Yes, that's right.

H.M. Jr.: But five-eighths - five-eighths is too little.

Hadley: Well, that figures about three-quarters of a point premium.

H.M. Jr.: Huh?

Seltzer: I wouldn't like five-eighths at all. I think you're getting your money awfully cheap - five years, three-quarters. They're a little sore at the whole proposition anyhow. They didn't like a note.
Haas: They think it's almost, like Harrison said, cashing it in, because the three-quarters is so low now. In other words, I think if you got in a tight place, they'd be inclined to make your tight situation worse, because I don't think they like the thing anyway.

H.M.Jr: Right. You can't do much on three-quarters.

Haas: No.

H.M.Jr: And then, you see, all this talk about the Home Owners Loan - that the one and a half percent coupon is why they didn't convert, which is of course ridiculous. And I'll admit that we made a mistake, we should have left that open a week.

Bell: I think so.

H.M.Jr: We should have left that open a week.

Bell: I think that next time we have one of those, what we should consider is leaving it open three days for the par and at a premium for the fourth and fifth days, something like that. Of course, the banks - it puts you in a terrible position and holding the bag for the bankers so they can sit there until the last minute - the boys who are smart. They sit there until you say the books are closed and then they shove them across the counter so that the market changes; they're in a nice position and you're holding all the responsibility.

H.M.Jr: We've got to do it differently next time.

Bell: I agree.

H.M.Jr: (On phone) Allan Sproul.

Bell: Well, we talked about it, but....

H.M.Jr: I know, and of course, Home Owners Loan didn't want all of them to come in.

Bell: That's right, they wanted to close the second day.
H. M. Jr: I've gotten some letters where they say the blanks didn't get out there in time. Got one from Senator Capper.

Bell: We've had several of them. We're writing answers.

H. M. Jr: Whose fault is that, that the blanks didn't get out? Is that us or the Fed or Home Owners Loan?

Bell: Federal Reserve Bank for the district.

Hadley: Some of those districts are so large that it takes quite a while for the small....

Bell: We provide means for that; we provide night telegrams if they can't get there in time, so there was no excuse for that, Mr. Secretary. We provide that they can subscribe by telegram.

H. M. Jr: Would you check up on that for me? I'd like a report on that.

(On phone) Hello. (Conversation with Sproul follows:)

Regraded Unclassified
Hello.

Operator: Mr. Sproul. Go ahead.

HMJr: Sproul?

Allan Sproul: Yes, sir.

HMJr: Well, you've got a -- I'm in a tender, gentle, soft mood.

S: (Laughter) That's nice for the market.

HMJr: I just love my customers, and therefore we're going to give them a straight three-quarters of a cent.

S: Straight three-quarter?

HMJr: Yeah.

S: Well, I think they'll be very happy about it.

HMJr: I want them to be happy.

S: I'm afraid they'll be too happy.

HMJr: Can't be, as long as we've got a four million dollar deficit.

S: Yeah.

HMJr: So we'll be....

S: We'll get a wire from you shortly?

HMJr: Yeah. And -- I don't know who to take it up with, but some of these Federal Reserve Banks didn't get out their blanks in time on the Home Owners' Loan.

S: They did not?

HMJr: Huh-uh. Now, who do I take that up with -- out west.

S: Well, I think you ought to take it up with the individual banks.

HMJr: All right.

S: I think that's the way to do that.
HM Jr: O. K.
S: All right.
HM Jr: Well, thank you. By the way, did they sell any more Home Owners' Loan today?
S: Yes, they sold ten million.
HM Jr: Did they?
S: Yeah.
HM Jr: Well, that's.......
S: Makes twenty-three and a half million.
HM Jr: Oh, you upped me. I thought you only had an order.....
S: Well, you gave us a little more leeway yesterday; thought we got rid of the first ten so fast.
HM Jr: Yeah.
S: So we sold thirteen and a half million yesterday and ten million today.
HM Jr: Oh! I thought the upper was twenty, but -- no, ten a day.
S: Ten a day, that was it.
HM Jr: I see.
S: But a little more leeway yesterday, so we did thirteen and a half.
HM Jr: What did they close at?
S: They closed today at five, seven -- a hundred and two five, seven.
HM Jr: Very good!
S: They closed last night at a hundred and two three, five.
HM Jr: Uh-huh. You're spreading them around. They are not all going to one dealer.
S: No. We've sold them to four dealers.
HM Jr: Good, good!
S: And we -- we'd sell them to anyone who comes in with......
HMJr: .....with the cash.
S: .....with the cash and a bid.
HMJr: All right. O. K.
S: All right, then.
HMJr: Thank you.
S: Good bye.
H.M.Jr: I wish you'd follow up on that. It would be a good thing to ride some of these Federal Reserve Banks who haven't been getting out their blanks on time, because it makes - I have to take all the blame.

Bell: Of course, that Bank that wrote in - it was their fault. If they've been subscribing to Governments, they know very well that they can wire to the Federal Reserve Bank and reserve a subscription. That's all they had to do.

H.M.Jr: Danny, listen, if I was a manufacturer of shoes and I had a day set for Monday for a sale, and if my wholesaler in Topeka wanted me to get his goods, would he say that I knew how to get the order? We've got something to sell, and it's up to - we're paying four million dollars a year to the Federal Reserve System to sell this stuff.

Bell: I agree with you there.

H.M.Jr: We're paying them four million dollars a year to merchandise this stuff. It's up to them to get the order blanks out, not for the customers to have to call for them.

Bell: They should, because they have instructions that if the blanks won't reach there - they have instructions to send them a night letter.

H.M.Jr: All right, gents.
June 3, 1939

To:     The Secretary
From: Miss Lonigan  C. L.

The total number of WPA workers
on May 24, 1939, is 2,606,885.

The decrease from the week ending
May 17 to the week ending May 24 was
14,315 workers.
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Source: Works Progress Administration

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<td></td>
<td>April</td>
<td>2,749*</td>
</tr>
</tbody>
</table>

Source: Works Progress Administration.

*Confidential.

Monthly figures are weekly figures for the latest week of the month. They include certified and non-certified workers.