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DISCUSSION

War Finance, Inflation and Postwar Financial Policy

BY WILLIAM O. WEYFORTH

The general pattern of war finance in the United States is now fairly clear. It is obvious that reliance has been placed and will be placed to a large extent upon government borrowing. On June 30, 1940, which may be taken as about the beginning of the defense program, the total public debt of the United States stood at $42,968,000,000. Up to June 30, 1942, the debt had increased $29,454,000,000.[1] It is estimated that during the fiscal year ending June 30, 1943, the increase will be an additional $62,408,000,000; and during the succeeding fiscal year, $75,719,000,000. The total estimated increase up to June 30, 1944, is therefore $167,581,000,000, making the estimated debt at that date $210,549,000,000.[2]

Up to the present time government borrowing for war finance has been to a large extent accomplished by the sale of securities to commercial banks. Between June 30, 1940 and June 30, 1942, the government security holdings of these institutions increased by $9,836,000,000.[3] During the first half of the fiscal year 1943 commercial bank holdings of government securities increased by about $14,000,000,000. At the same time those held by Federal Reserve banks increased by $2,900,000,000.[4] If this rate of increase should continue, the total expansion of bank credit to finance government borrowing for the fiscal year ending June 30, 1943, would be in the neighborhood of $34,000,000,000. In view of the contemplated

1. *Bulletin of the Treasury Department,* November, 1942, p. 3.
2. General Budget Summary in the budget message of the President, January 11, 1943.
3. Federal Reserve Bulletin, January, 1943, p. 72.
4. The National City Bank, *Economic Conditions, Governmental Finance, United States Securities,* January, 1943, p. 5.

program of borrowing as announced in the President's recent budget message, it is possible that for the fiscal year 1944, the expansion of bank credit might be equally large.

This program of war finance raises important questions with respect to the possibilities of inflation during both the war period and the postwar period. On the assumption that marked inflation may be avoided during the war period by means of direct controls that have been established, it is proposed in this paper to examine the possibilities of inflation in the postwar period; to indicate the financial and credit policies that may be necessary in that period in order to check inflation; and finally to consider the manner in which these policies may be affected by the type of securities sold to banks during the war and by the particular theory of banking that underlies the operations of commercial banks.

There is little doubt that as a result of the methods of war finance now being pursued there would be a marked inflation during the war were it not for the system of direct controls in the form of price fixing, wage regulation, priorities, allocations, and rationing that is being tried. How effective these controls will prove remains to be seen. But without them there is every possibility that serious inflation would occur. On June 30, 1940, the total demand deposits in all banks and currency in circulation outside of banks was a little less than $39,000,000,000. By June 30, 1942, this figure had grown to approximately $53,000,000,000.[1] If borrowing from commercial banks during the fiscal year 1943 reaches the amount above indicated, it is probable that by June 30, 1943, total demand deposits and currency in circulation will have grown to $87,000,000,000. Thus within a period of three years, demand deposits and currency in circulation will have more than doubled. If the necessity for war financing should continue for another year until June 30, 1944, and similar methods of financing be employed, it is possible that by the latter date demand deposits and currency in circulation will amount to over $120,000,000,000.

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1. *Federal Reserve Bulletin*, November, 1942, p. 1149.

This vast expansion in purchasing power provides the basis for violent inflation. It is conceivable, however, that such consequences may be avoided by means of a rigorous system of direct controls. If such controls are effective in the face of the assumed expansion in purchasing power, it will mean that individuals and business concerns will be holding large amounts of idle funds, that is, funds in excess of their customary requirements for future transactions. It is to be noted in this connection, however, that inasmuch as these funds will be yielding no interest, it is not unlikely that they may be invested to a considerable extent in government bonds, especially war savings bonds. The purchase of the latter securities would not only satisfy patriotic desires but would at the same time provide an investment which, while substantially as liquid as cash, would also yield something in the way of interest. It is quite possible, therefore, that the sale of savings bonds by the government may be appreciably in excess of present estimates. Hence it is probable that, if direct controls are really effective during the war in holding price increases within reasonable limits, the expansion of demand deposits and currency may be considerably less than the amount above suggested.

Nevertheless it would appear that under the fiscal policy now being pursued by the government, if serious inflation is avoided during the war it will be because the direct controls set up have been successful in holding private spending in check. Whether the unspent funds remain in the form of idle bank balances and currency hoardings or are used to purchase war savings bonds, the direct controls will have been largely responsible for the results achieved.

But if we are thus successful by means of a system of direct controls in preventing serious inflation during the war, it is probable that the danger will present itself in its most critical form in the postwar period. Perhaps this may seem strange doctrine. It may appear that the real danger is that of a terrible business slump when war production comes to

an end. What will happen in fact will depend largely upon government policy with respect to spending, finance, and credit.

In analyzing possible postwar situations let us first make the extreme assumption that the policy pursued is one of a return forthwith to "normalcy." Assume that war spending is cut to the bone, taxes are reduced, and direct controls of the nature of price fixing, wage regulation, priorities, allocations, and rationing are removed. Such a policy might be inspired in part by mere war weariness and the longing to return to the relatively free economic atmosphere of prewar days. But the policy might also be based upon an economic philosophy having many elements of truth. It may be reasoned that there has been accumulated during the war a tremendous backlog of unsatisfied private demand for durable consumers goods and for capital goods suited to peace-time industries, and that a greatly increased demand for non-durable consumers goods will arise after the deprivations of war. If war-time restraints are removed and taxes are reduced, the resulting expansion of private spending will offset the proposed contraction of public spending, employment will be maintained, while production will be directed towards improving the economic welfare of individuals rather than towards the economically wasteful pursuits of war. It may be contended, moreover, that there will not only be a desire on the part of individuals and business concerns to engage in all of this spending but that there will also be available the necessary funds for the purpose. This will be made possible by the activity of previously idle balances or by the redemption of war savings bonds.

Now, while it is perhaps true that all of this may be the eventual pattern of the course of events, it is scarcely practicable as an immediate program. When we have been devoting from one-half to two-thirds of our productive activities to the output of war goods and services, it is inconceivable that we could suddenly abandon such activities, however great the demand for peace-time goods, without causing a

vast amount of unemployment. There is not sufficient mobility in the factors of production to make possible the necessary readjustments without such consequences.

After the war, however, there will in all probability be insistent demand that this should not be permitted to happen, that wartime spending should be tapered off gradually, and that it be maintained on a scale sufficient to prevent widespread transitional unemployment. But if this program is followed, it is under just such circumstances that the greatest danger of postwar inflation will arise.

The underlying factors involving the potentiality of inflation would be the greatly expanded condition of deposits and currency together with the large outstanding volume of war savings bonds. If redemption of the latter should be demanded and the funds necessary for the purpose should be obtained by the government through borrowing from the banks, the amount of demand deposits and currency would be further expanded. Thus there would exist the basis for a great increase in private spending. As we have seen, there would also be present the desire to spend. To what extent actual expansion of spending will occur will depend upon expectations with respect to the future. If hard times or unemployment are expected because of the difficulties involved in the transition of a war economy to a peace economy, there will probably be a disposition to hold on to idle balances and to refrain from demanding redemption of savings bonds. On the other hand, if expectations are optimistic, the great backlog of demand created by the preceding deprivations of war will doubtless lead to a violent increase in private spending. Idle deposits will become active and new deposits will be created as savings bonds are redeemed. The outcome will depend largely upon the magnitude of government spending after the war. A precipitous drop in government spending would probably lead to such widespread unemployment as to induce the most pessimistic expectations and a commensurate hesitancy about spending on the part of private individuals if government spending is continued on a scale sufficient to

prevent appreciable unemployment and optimistic expectations are thereby induced, the very success of this policy will open up another danger, as Professor Slichter has pointed out,[1] namely that of an inflationary boom consequent upon the great expansion of private spending. Hence we see that the most skillful management by the government will be necessary after the war if we are to avoid the danger of unemployment on the one hand and that of an inflationary boom on the other.

Appropriate management in the postwar period will involve policies with respect to government spending, taxation, government borrowing, and credit control.

Government spending will have to be adjusted so as to avoid either serious unemployment or an inflationary boom. Spending that is not necessary for meeting the essential requirements of government operations should be reduced to whatever extent it is not needed for maintaining employment, that is, to whatever extent postwar expansion of private spending can fill the gap left by the reduction of government spending.

Care will need to be exercised, however, to ensure that the maintenance of full employment is not accompanied by an inflationary expansion of private spending made possible by the existence of idle balances and the potential spending power represented by the war savings bonds subject to redemption on demand. For this purpose it will probably be necessary even after the war to continue for a time, doubtless in some modified form, the direct controls, such as price fixing, wage regulation, priorities, allocations, and rationing, set up during the war. But if we ever expect to return to a system of predominantly free enterprise it will be essential that the price mechanism be permitted to perform eventually its fundamental function of effecting an appropriate adjustment "between ends and scarce means which have alternative uses."[2] Hence it will eventually be desirable to abolish most of these

1. Sumner H. Slichter, "Postwar Boom or Collapse," *Harvard Business Review,* Autumn, 1942.
2. Lionel Robbins, *An Essay on the Nature and Significance of Economic Science,* 1940, p. 16.

direct controls. When these controls have been removed, however, it will be necessary, if inflationary developments are to be avoided, that the volume of potential spending power — keeping in mind the great inducements to spend — shall be brought into the proper relationship with the volume of output. Otherwise we shall by means of our direct controls have escaped the worst features of inflation during the war only to succumb to them after the peace. If, after the reduction of government spending to a minimum, the expansion of private spending—made possible by the use of heretofore idle balances, or the conversion of war savings bonds into cash—is proceeding at such a pace that a tendency towards inflation is apparent, measures must be taken to reduce the volume of private spending. After direct controls have been removed it will probably be necessary to combat the inflationary possibilities that are inherent in the expanded condition of demand deposits and currency and in the large holdings of war savings bonds by a program that will reduce the volume of these factors within reasonable proportions.

It is under these circumstances that postwar tax policy, government borrowing policy and bank credit policy will be of special importance.

Tax policy and government borrowing policy may both be used as means of reducing the swollen volume of money and of war savings bonds. High taxes may need to be maintained even after the reduction of government spending to a minimum, and the sale of a large volume of long-term bonds to purchasers other than commercial banks will probably need to be effected. The fiscal surplus that may result from the tax policy and the proceeds of the sale of bonds could then be used to reduce the amount of government borrowing at the commercial banks and to meet the demands for redemption of savings bonds that are likely to materialize. By these means the volume of purchasing power could not only be prevenetd from expanding but could be actually reduced.

It is apparent, therefore, that in order to avoid inflation after the war it will probably be necessary to pursue policies—high taxation and heavy long-time borrowing from sources

other than commercial banks—that might have been employed as non-inflationary methods of finance during the war. If, in view of the failure to employ these methods, serious inflation does not develop during the war it will be because of the effectiveness of the direct controls that have been established. But if, after the war, direct controls are removed, it will then in all probability be impossible to avoid resort to the more orthodox financial policies in order to prevent a postwar inflation.

Now assuming that, after the war, the government finds it necessary, for the reasons just considered, to sell long-term securities on a large scale, these securities must be offered at rates of interest that will be attractive to investors. If the demand for loanable funds from private sources together with the government demand is such as to cause a rising tendency in rates, it will not be possible to check this tendency by expansion of bank credit, inasmuch as *contraction* of bank credit is the objective that must be sought if we are to be resolute in our purpose of avoiding inflation.

This brings us to the final type of policy that should be at our disposal in case the dangers of an inflationary boom should become apparent in the postwar period. This is bank credit policy. The reduction of government borrowing at commercial banks by the methods outlined above will be of little avail in achieving the desired objective if it should be accompanied by a commensurate expansion in bank loans to private borrowers or in bank investments in securities other than government bonds. In the absence of any contraction in the absolute size of member bank reserves, the reduction of government borrowing at the banks would in itself strengthen their reserve ratios and place them in a better position for the expansion of their private loans and investments. Hence in the postwar period the Federal Reserve System must be unhampered in a program of contracting member bank reserves when such a policy seems to be required for the maintenance of sound credit conditions and the avoidance of inflation. This means that in the pursuit of such a policy the System must

not at the same time feel itself under obligation to protect indefinitely the market for government securities.

It is in this connection that the type of security sold to banks for the purpose of war finance is of primary importance. Broadly speaking, three types of securities may be distinguished: (1) short-term securities with maturities of perhaps not more than one year and certainly not more than five years; (2) long-term securities with maturities of twenty years or more; (3) middle-term securities with maturities ranging up to ten years. Some proposals have been to the effect that commercial banks should confine their purchases to maturities of one to five years.[1] The Treasury has announced as its policy that securities sold to banks should have a range of maturities running from three months in the case of Treasury bills, to ten years in the case of Treasury bonds.[2] The recommendations of the Economy Policy Commission of the American Bankers' Association are to the same effect.[3] The Comptroller of the Currency, however, has announced that although the Treasury has of late been limiting its offerings of securities eligible for commercial bank investment to a ten-year maturity, national bank examiners are not critical of any government securities in banks' portfolios, whatever their maturity.[4] A joint statement was issued on November 22, 1942, by the principal bank supervisory agencies—the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve System, and the Executive Committee of the National Association of Supervisors of State Banks—that "there will be no deterrents in examination or supervisory policy to investment by banks in Government securities of all types, except those securities made

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1. See "Treasury War Borrowing and the Banks," Report by the Economic Policy Commission of the American Bankers' Association, April, 1942, p. 20.
2. Speech of Daniel W. Bell, Under Secretary of the Treasury, before the Investment Bankers' Association of America, *Commercial and Financial Chronicle,* October 29, 1942, p. 1534.
3. "Treasury War Borrowing and the Banks," p. 20.
4. Address by Preston Delano, Comptroller of the Currency, before the National Association of Supervisors of State Banks on November 17, 1942, *Commercial and Financial Chronicle,* November 26, 1942, p. 1896.

specifically ineligible for bank investment by the terms of their issue."[1] It would appear, therefore, that there is no clear-cut concensus upon the type of security that the Government should sell to commercial banks and that the bank supervisory authorities are prepared to conform to the decisions of the Treasury.

Questions of fiscal policy, banking policy, and general credit policy are involved in this matter. From the point of view of fiscal policy long-term securities would be advantageous to the Treasury through minimizing the size of the short-term debt and avoiding the embarrassment that may at times be experienced in refinancing such obligations. It should be remembered, moreover, that savings bonds will be demand obligations and may need to be refinanced. According to the traditional theory of commercial banking, however, short-term securities would be the most suitable type of investment for commercial banks. Is there any possibility of reconciling this apparent conflict of interest between sound fiscal policy and sound banking policy? In order to answer this question it is necessary to keep in mind the fundamental idea in traditional commercial banking theory and the modifications in this theory that have developed since the first World War.

At the time of the passage of the Federal Reserve Act one of the outstanding features of commercial banking theory was the principle that the most suitable type of earning asset for the commercial bank was the short-term self-liquidating loan for commercial purposes. It is true that in practice there had been for a period of years some departure from this principle in that the bond holdings of banks had shown a steady increase. But this development was looked upon not without misgivings[2] and the Federal Reserve Act in its original form adhered to the orthodox theory. According to its provisions the only paper eligible for rediscount at the Reserve Banks was that "arising out of actual commercial transactions." This theory, if applied to government borrowing, would indicate

1. *Federal Reserve Bulletin*, December, 1942, p. 1174-5.
2. Jacob H. Hollander, "The Security Holdings of National Banks," *American Economic Review*, December, 1913, pp. 813-814.

the short-term type of security as most suitable for purchase by commercial banks.

The years immediately following the passage of the Federal Reserve Act, however, brought revolutionary changes in the nature of commercial banking assets. During the first World War the banks were largely concerned with financing government borrowings. During the boom of the 1920's, although the absolute volume of commercial loans remained practically unchanged, this type of asset declined decidedly in relative importance, whereas loans on real estate, loans on securities, and security holdings became of relatively much greater importance. During the long depression of the thirties commercial loans not only fell further in relative importance but declined decidedly in absolute amount. On the other hand, this period was characterized by a phenomenal growth in the holdings of government securities.

It is not necessary to examine the causes of these well known facts since they have been the subject of frequent analysis. It may be pointed out, however, that these changes represented a wide departure from the old theory of commercial banking. If that theory were still accepted the new developments might well occasion serious apprehension. On the other hand, if the changed investment practices of the banks were to be justified, decided modifications in the theory of commercial banking were in order. According to the old theory the great virtue of commercial loans, in addition to their satisfactory yield, lay in their safety and liquidy. They involved less risk than long-term loans since it was necessary for the lending bank to judge the borrower's financial prospects for only a short period in the future. They were liquid because they matured in a few months at the most. Consequently the bank whose portfolio consisted mainly of *well selected* commercial loans ran little risk of shrinkage in the value of its assets, and was in a favorable situation to modify its cash position according to need simply by allowing its loans to run off. Both safety and liquidity were considered essential qualities in bank investments because of the nature of their deposit obligations.

But how are these qualities to be secured in the case of long-term loans such as real estate loans, or in the case of long-term bonds? Long-term loans may not mature with sufficient rapidity to meet heavy drains on the bank's cash position. Long-term bonds may be convertible into cash by sale, but they are subject to fluctuation in price and the market situation may be such at time of sale that heavy losses are involved. Moreover, even if the bank is not under the necessity of selling its bonds, a serious decline in their prices might show an impairment of capital on the bank's statement if the bonds must be carried at market prices.

Recognition of the changes in the practice of commercial banking and an attempt to alleviate the difficulties just considered are shown in two significant alterations of the law and regulations with respect to commercial banks during the thirties. In the first place the Banking Act of 1935 greatly enlarged the borrowing privileges of member banks at the Federal Reserve banks by providing that any Federal Reserve bank, under rules and regulations prescribed by the Board of Governors of the Federal Reserve System, may make advances to any member bank on its time or demand notes having maturities of not more than four months and having security satisfactory to such Federal Reserve bank. The *Federal Reserve Bulletin,* in commenting upon this provision, stated that experience had demonstrated that the solvency of banks is better safeguarded by careful regard to the quality of the paper that they acquire than by strict observance of the form that this paper takes.[1] Thus the strict eligibility provisions of the old law were radically modified and any sound asset of a member bank became liquid in the sense that it might be used as a basis for a loan from its reserve bank.

Shortly after this, in 1938, a revised procedure for bank examination was announced as having been agreed to by the Secretary of the Treasury, the Board of Governors of the Federal Reserve System, the directors of the Federal Deposit Insurance Corporation, and the Comptroller of the Currency. As explained in the *Federal Reserve Bulletin,* according to this

1. *Federal Reserve Bulletin,* October, 1937, p. 979.

new procedure "the principle is clearly recognized that in making loans, whether for working capital or fixed capital purposes, the banks should be encouraged to place the emphasis upon intrinsic value rather than upon liquidity or quick maturity."[1] With respect to banks' bond holdings the new procedure provided that in the case of bonds classified in Group 1,[2] which was estimated to include about ninety per cent of the total securities held by banks, neither appreciation nor depreciation should be shown in the examiner's report. Thus the appraisal of the principal portion of bank investments was severed from current market quotations. By this means it was believed that banks would be encouraged to purchase securities of sound business and industrial concerns, whether large or small, for their true worth and not for speculative gain. It was stated that the new procedure recognized the principle that bank investments should be considered in the light of inherent soundness rather than on a basis of day to day market fluctuations. It was based on the view that the soundness of the banking system depends in the last analysis upon the soundness of the country's business and industrial enterprises, and should not be measured by the precarious yardstick of current market quotations which often reflect speculative and not true appraisals of intrinsic worth.[3]

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1. *Federal Reserve Bulletin,* July, 1938, pp. 563-564.
2. Group I securities are defined as "marketable obligations in which the investment characteristics are not distinctly or predominantly speculative. This group includes general market obligations in the four highest grades and unrated securities of equivalent value." Neither appreciation nor depreciation in Group I securities is shown in the report.
   Group II securities are defined as "those in which the investment characteristics are distinctly or predominantly speculative. This group includes general market obligations in grades below the four highest and unrated securities of equivalent value." Group II securities are valued at the average market price for eighteen months just preceeding examination and 50 per cent of the net depreciation is deducted in computing the net sound capital.
   Group III securities are those in default, and Group IV securities are stocks. In the case of these two groups net depreciation is classified as loss.
   [*Twenty-fifth Annual Report of the Board of Governors of the Federal Reserve System for the Year 1938, pp. 89-90.*]
3. *Federal Reserve Bulletin,* July, 1918, pp. 563-364.

These changes with respect to borrowing privileges at the reserve banks and examination procedure represent a recognition of the changes that have taken place in the character of banking. As a result of the decrease in the demand for commercial loans banks have been forced to find outlets for funds through channels other than those which were customary in former days, and this development has now been given official encouragement. In this way a marked modification in the theory of commercial banking has occurred. The commercial loan, with its qualities of safety and liquidity, has lost its primacy among bank assets, and investments in securities have risen to first place. A higher degree of liquidity has been provided for these investments by making them available as collateral for loans from the reserve banks, and the member banks have been protected against the effects on their statements of temporary fluctuations in the market prices of their security holdings by the device of valuing securities according to "intrinsic worth" rather than market price.

Now if the modified theory of commercial banking, as implicit in the provisions of the Banking Act of 1935 and the revised examination procedure announced in 1938, is fully accepted there would seem to be no conflict between the interests of sound fiscal policy and sound banking policy. The Treasury could sell long-term securities to the banks and thus lessen the volume of its short-term debt. The banks would hold securities whose "intrinsic" worth in the sense of certainty of payment of principal and interest would be second to none. Hence fluctuations in the market value of such securities could be disregarded for balance sheet purposes. At the same time the necessity for forced sale of such securities at sacrifice prices to meet emergency depletion of reserves would be avoided by the possibility of borrowing upon them at par value from the Federal Reserve banks. Moreover, because of the larger yield on long-term securities as compared with short-term, the earnings of the banks would be enhanced. This would make possible an increase in their capital funds more nearly commensurate with their enhanced volume of deposits either through the possibility of enlarged undistributed profits or through

the sale of additional stock, whose attractiveness to investors would be increased by the greater earnings.

Keeping in mind then the theories of commercial banking that have just been considered and the requirements of sound fiscal policy and sound credit policy, what are the types of securities most appropriate for sale by the government to the banks?

First let us suppose that government borrowing from the banks is in the form of long-term securities. Then if a post-war increase in interest rates should occur there would be a decline in the market value of fixed-interest-bearing securities. Such a decline might seriously impair the capital of banks, in view of their probable large holdings of long-term government bonds, if the bonds were valued at market prices. But let us suppose that under the new theory of commercial banking market prices were disregarded and government securities continued to be valued in the books of the banks at par with the approval of government supervisory authorities. Then the balance sheets of banks would show no impairment of capital. But the real situation would be generally known. How would this knowledge affect the attitude of the public towards the banks? Would confidence be maintained? There is the possibility that at the first signs of declining security values some banks would begin to unload their government holdings. This doubtless would not occur during the war when patriotic motives and some fear of incurring government or public censure would act as deterrents. But these forces would be greatly weakened after the war. The incentive to sell before the expected depreciation in prices occurred might arise in part from a conservative distrust of the new method of valuing securities according to "intrinsic" worth and a desire to maintain solvency according to the older traditional standards. It might also arise from the quite justifiable desire on the part of any bank to maintain its assets in such a form that ready convertibility into cash without loss could be achieved on a scale sufficient to take care of any changes in the bank's reserve position without the necessity for long continuous borrowing from the Reserve System. This

does not mean, of course, that purely *temporary* deficiencies in the bank's reserve position might not be met by borrowing from the System.

Once banks began disposing of their government securities because of the expectation of a decline in their prices, the actual decline in prices would be accelerated and the danger would appear of a demoralized market in government securities. If the expectation of price decline were due to some temporary factor as in 1939, demoralization could probably be prevented by prompt action on the part of the Federal Reserve System. But the expected increase in interest rates would not be a temporary factor and the danger of a wave of security selling would continue as long as the expectations of decline in security prices persisted. This danger could be prevented only by a Reserve credit policy designed to keep interest rates low. Such a policy, however, might be in opposition to the policy of credit contraction required for avoiding inflation.

Hence, if the new theory of commercial banking were set up as a justification for war borrowing from the banks in the form of long-term securities, there is the possibility that a serious dilemma would confront the Federal Reserve System after the war. The necessity for protecting the value of government securities held by the banks might conflict with the need for contracting credit as a means of preventing inflation. In this connection it should be noted that the Board of Governors, in its 1939 Report, when referring to its open-market operations of that year for the purpose of maintaining an orderly market, expressly stated that the System had neither the obligation nor the power to assure any given level of prices or yields for government securities and that prices of fixed interest rate securities, including those of the government inevitably adjust to changes in long-time interest rates.[1]

There would be, however, one way out of the dilemma that has just been described. This would be for the government to raise the rate of interest on long-term government

1. *Twenty-sixth Annual Report of the Board of Governors of the Federal Reserve System for the Year 1939*, p. 5

securities held by the commercial banks in case rising market rates of interest served to impair the value of these securities.

This would really introduce a new element into the theory of commercial banking, namely the idea that, in view of the fact thatat banks have become in a sense agents of the government for the purpose of war finance, it is the obligation of the government to insure the banks against losses that might be involved in carrying out their agency functions. Indeed, in the final analysis, recognition of such an obligation would seem to be unavoidable. It is inconceivable that the government should permit widespread distress among the banks caused primarily by the fact that these institutions had rendtred patriotic support to the government during the war.

It is probable, however, that if this policy were pursued, the interest rates on all outstanding long-term government securities, including war savings bonds, would have to be commensurately increased,—in order to avoid charges of discrimination and special privilege. Perhaps for other reasons some such program will be necessary. For example, raising the yield on defense bonds, if held to maturity, would be one way of discouraging early redemption of these securities. But doubtless the government would undertake a wholesale increase of interest rates with great reluctance and only as a last resort because of the enhanced burden of interest charges on the budget.

At the other extreme from the policy of borrowing from the banks on long-term securities would be the policy of borrowing entirely on strictly short-term securities. This program would be in accordance with the tenets of the older theory of commercial banking. The assets of the banks would be liquid. Any individual bank could improve its cash position at any time simply by allowing its holdings to run to maturity and there would be no danger of depreciation in the market value of its assets.

But such a program would be unsatisfactory from the Treasury point of view because of the serious unwieldiness of the short-term debt thereby created. If government borrowing from the banks reached $70 or $80 billion—not an extravagant

estimate—and average maturities were maintained at, let us say, one year, this would mean that each year new borrowing from the banks to the above amount would need to be effected. Under such circumstances, if restriction of credit in the post-war period were undertaken in order to avoid inflation, such loans could be renewed only at rising rates of interest. Exact interest charges would always be a matter of uncertainty depending upon varying conditions in the short-term money market and budget estimates would constantly be in danger of being upset as the result of unpredictable changes. There would be a temptation to the administration in power to use all its influence to keep them within budget estimates. Hence there would be pressure upon credit authorities to ease credit conditions because of Treasury requirements and thus a possible conflict with the credit policy that would be appropriate for the purpose of avoiding inflation.

It would seem, therefore, that if the credit policy necessary to check inflation is to be put into effect in the postwar period, serious difficulties would be involved whether the securities sold to commercial banks were mainly long-term in conformity with the new form of commercial banking theory, or very short-term in accordance with the older form of the theory. In the first case, the appropriate Federal Reserve policy might be impeded by the necessity of protecting member banks against a disastrous shrinkage in the value of their assets. In the second case impediments might arise through the necessity of having regard for the requirements of the Treasury in its huge program of incessant refinancing.

Apparently the actual policy that the Treasury intends to pursue with respect to borrowing from commercial banks is a compromise between the two extreme plans that have just been considered. The Treasury is not making its longest-term bonds available for purchase by commercial banks. For example, the twenty-six 2½% bonds maturing 1963-68, provided for in the Treasury financing of November, 1942, cannot be purchased by such banks until ten years after date of issue. However, neither is the Treasury depending entirely upon the sale of short-term securities. In a speech before the

Investment Bankers Association of America in October, 1942, Daniel W. Bell, Under Secretary of the Treasury, recognized that it was important that commercial banks preserve a high degree of liquidity and stated that it had been decided by the Treasury that securities sold to them should have a range of maturities running from three months in the case of Treasury bills to ten years in the case of Treasury bonds.[1] This program corresponds to the recommendations of the Economic Policy Commission of the American Bankers' Association made in April, 1942.[2]

Now if the sales under this plan could be so arranged as to provide for a fairly even spacing of maturities held by each bank over the ten-year period, as has been suggested,[3] such a program of bank borrowing would seem to be the most acceptable solution of the problem.

Under this arrangement the average maturity of commercial bank holdings of government securities would be approximately five years, or in other words, one-fifth of their holdings would mature each year. If each bank followed such a plan in its government holdings, it is probable that it would have sufficient liquidity to take care of any loss of reserves that it might experience without the necessity of any long-continued borrowing from the Reserve System. Moreover, with average maturities of five years, although an increase in interest rates would cause some decline in the market value of the banks' holdings, such effects would be relatively moderate and would probably not be sufficient to induce any widespread attempt at sale of holdings or to cause any significant loss of confidence in the soundness of the banks.

From the point of view of the Treasury this plan has the advantage that it reduces the short-term debt to more manageable proportions than if all borrowing from commercial banks were strictly short-term. For example if average maturities were only one year then all government bank borrowing would have to be renegotiated every year; whereas

1. *Commercial and Financial Chronicle*, October 29, 1942, p. 1534
2. Report on "Treasury War Borrowing and the Banks," April, 1942, p. 20.
3. A. M. Massie, "Commercial Banks and the War Finance Program," *Bankers Magazine*, July, 1942, p. 6.

with average maturities of five years, the amount of refinancing each year would be only one-fifth as great.

Moreover, this compromise plan of government borrowing, as I have called it, is likely to involve less interference with a restrictive credit policy that may be necessary in the postwar period for the purpose of avoiding inflation than would probably be the case with either one of the extreme plans that have been considered. For there would be less sense of obligation to maintain easy money conditions in order to protect bank security holdings on the one hand or to lighten the problems of government refinancing on the other hand.

It is not meant to imply, of course, that this plan of borrowing from the commercial banks in itself provides a solution to the problem of avoiding postwar inflation after direct controls may be removed. It means merely that the problem should be less difficult to handle than if either one of the other plans of borrowing from the banks had been pursued.

Finally it may be asked, what is the bearing of all of this upon commercial banking theory? Again it may be said that the plan pre-supposes a theory which is a compromise between the extreme form of the old theory and the extreme form of the new theory. It assumes that short-period liquidity in every item of a bank's assets is not an essential prerequisite of sound commercial banking. But it also assumes that there should be a succession of maturities in assets sufficient to take care of any relatively permanent shift of deposits from any particular institution. So much might be said to represent a recognition of the old theory. At the same time the plan might be said to assume that any severe *temporary* drain upon a bank's reserves that cannot be met through current maturity of assets may be taken care of by borrowing from the Reserve banks with relatively long-term securities (up to ten years) as collateral. It probably also assumes that if any minor decline in the market value of these securities occurs, they may still continue to be carried at their "intrinsic" value so that no unfavorable effect need appear on the balance sheet of the bank. So much might be said to represent a recognition of the new theory.

The Effect of the War on Investing Institutions

BY MARSHALL D. KETCHUM

Capital flows into the investment markets directly from the accumulations of savings in the hands of individuals and indirectly through institutions. Institutions as sources of investment funds are often classified into investing institutions and institutional investors. Investing institutions consist of those types of firms the principal function of which is to provide investment management, and generally also, diversification for individual investors for whom they are acting. In this process investing institutions usually receive possession and control of the funds of such individuals. Important examples of such institutions are the savings bank, the savings department of the commercial bank, the investment company and its variants, the mortgage bank, the savings and loan association, and the trust company. Institutional investors, on the other hand, include agencies which are formed primarily to carry on other functions, but the nature of the services which they perform is such that accumulations of funds become available for investment. Investment is an incidental function in their operations, but success of the enterprises may depend as fully upon adequate performance of this function as is the case with investing institutions. The principal types of institutional investors are the insurance company, the business corporation, the commercial bank; institutions such as hospitals and religious and educational foundations; and private and government pension and retirement funds.[2]

While this is the standard classification of institutions providing long-term capital for government and industry, and while it has a number of valuable uses under ordinary conditions, a somewhat different classification of investment firms will be adopted in this paper. The primary function of finan-

2. See H. P. Willis and J. I. Bogen, *Investment Banking* (New York; Harper & Bros., 1936), Chs. V and VI.

cial institutions in time of war is to serve as an instrument of fiscal policy in financing the war and in the controlling inflation. In view of this fact the term "investing institution" as here used will refer to all institutions so designated in the foregoing paragraph and in addition will include all institutional investors except the commercial banks. This terminology will make it possible to emphasize the contrast between the commercial bank, with its function of deposit-creation, and all other financial institutions which transfer rather than create purchasing power when securities are purchased. The term "investing institution" will be understood as having this context except when it is necessary to distinguish "investing institutions" for "institutional investors."

The effect of the war on investing institutions may be considered in three aspects, i.e., its effect (a) on investment policy; (b) on growth of total resources; and (c) on gross income return, expenses and net income return to owners and security holders. The influence of the war on each of these three aspects of the operations of investing institutions will be considered and an attempt will be made to forecast, on the basis of present trends, what may be expected in the future. The questions of investment policy and total growth are so closely related that it is convenient to treat them together.

1. *Effect of the War (a) on Investment Policy and (b) on Growth of Total Resources.*

It is generally recognized that the cost of a war can be financed by taxation, by borrowing through the sale of bonds to individuals and investing institutions, and by inflation through the printing of currency and the sale of bonds to the commercial banks. It is agreed that the first two methods of financing are non-inflationary and it is generally assumed that it is desirable to finance the war by non-inflationary means. No attempt will be made here to question or to enlarge upon these conclusions.

It is impossible, of course, to forecast the total cost of the war to the United States, since it is not known how long the war will last nor what will happen to the value of the dol-

lar in which the costs are computed. It is difficult enough to use data representing estimates of the cost of the war in the fiscal year 1943, since upward revisions of estimated expenditures occur so frequently as to make obsolete whatever figures are used soon after they appear. What seems to be the latest estimate is that federal expenditures in fiscal 1943 will approximate $85.2 billion, which will constitute about one-half of the gross national product during this period. It may be possible to cast some light on the problem of future government financing by noting the methods used in financing the defense and war effort during the fiscal years 1941 and 1942. Table 1 shows the sources of federal revenue during these years.

TABLE 1*

SOURCES OF FEDERAL REVENUE
JULY 1, 1940-JUNE 30, 1942

Source of Income	Amount (in billions)	Percentage
Total Revenue	$ 48.9	100
Taxes and Other Non-loan Revenue	20.4	42
Borrowing	28.5	58
From Banks (direct and indirect**)	9.8	20
From others	18.7	38

Table 1 shows that in fiscal year 1941 and 1942, $28.5 billion of the $48.9 billion of total revenue, or 58 per cent, were secured by borrowing. Of the $28.5 billion borrowed, $18.7 billion, or approximately two-thirds, were secured from the

* Adapted from data in T. K. Hitch, "Alternatives in War Finance," *Survey of Current Business,* U. S. Department of Commerce, October, 1942, p. 15.

** Direct borrowing from banks refers to the purchase of government obligations by banks for their own portfolios; by indirect borrowing is meant the sale of bonds to individuals and institutions but financed through borrowing from banks. Both direct and indirect borrowing lead to an expansion of bank deposits, although indirect borrowing is slightly less inflationary to the extent that bank loans are not made up to 100 per cent of the cost of the securities to the investor and early repayment of the loan is encouraged. During fiscal 1941 and 1942 practically all government borrowing from banks was direct.

sale of obligations[3] to individuals and investing institutions, while the remaining one-third was obtained by selling securities to the commercial banks.

With the greatly increased financial requirements of the government the prospects have become steadily worse for financing the war without resorting to inflationary methods on a large scale. In the first place, the tax program embodied in the Revenue Act of 1942 is hopelessly inadequate both as to the total amount of revenue and incidence. Income tax rates, especially rates on individuals, should have been placed much higher and the graduated scale should have been arranged in such a way as to tax much more heavily the lower income groups which have been the chief beneficiaries of increased money incomes resulting from war activity in industry and agriculture. These statements apply with respect to the objectives both of maximum revenue and maximum control of inflationary potentialities. It is probably impossible, both economically and politically, to finance a war solely by taxation. However, taxation is inherently a more desirable method of war finance than borrowing, especially in view of the dislocations caused in a post-war period by a large federal debt.[4] The inadequacy of the present tax program is stressed here because thereby an added burden is placed on the other method of non-inflationary financing, the sale of bonds to individuals and institutions.

On the basis of anticipated federal expenditures of $85.2 billion for fiscal 1943, it has been estimated that tax and other non-loan revenue will bring in about $21 billion. This necessitates borrowing $64.2 billion. It may be possible to secure $12 billion from the sale of war bonds, $3 billion from the sale of tax anticipation warrants or from at-source tax collections (both of which will decrease ordinary tax revenue in fiscal 1944), $2.5 billion from the sale of bonds to insurance

3. Unless otherwise indicated, the expressions "government bonds, obligations, securities" are to be interpreted as referring only to issues of the federal government of the United States.

4. See B. U. Ratchford, "The Burden of a Domestic Debt," *American Economic Review,* September, 1942, pp. 451-67.

companies and savings banks, $5 billion from the sale of bonds to other non-banking corporations, and $5 billion from the sale of bonds to government trust funds. The total of bonds sold to individuals and investing institutions would thus be $27.5 billion, which leaves $36.7 billion to be obtained by the sale of bonds to commercial banks. The anticipated sources of federal revenue for fiscal 1943 are summarized in Table 2.

TABLE 2*
ANTICIPATED SOURCES OF FEDERAL REVENUE, JULY 1, 1942-JUNE 30, 1943

Source of Income	Amount (in billions)	Percentage
Total Revenue	$ 85.2	100
Taxes and Other Non-loan Revenue	21.0	25
Borrowing	64.2	75
From Banks (direct and indirect**)	36.7	43
From Others	27.5	32

Comparing the percentages given in Table 2 with those in Table 1 it is found that taxes will fall from 42 per cent to 25 per cent of total revenue and that borrowing will rise correspondingly from 58 per cent to 75 per cent. Borrowing "from others" is expected to fall from 38 per cent to 32 per cent, with the proportion to be borrowed from banks rising from 20 per cent to 43 per cent. In the financing of expenditures in fiscal 1941 and 1942, 80 per cent was by non-inflationary means; it is anticipated that in fiscal 1943 only 57 per cent will be derived from non-inflationary sources. These estimates show the seriousness of the tendency toward inflation. They also emphasize the importance of the task before investing

* Adapted from data in T. K. Hitch, *op. cit.*, p. 17.

** See footnote, Table 1. The government has recently reversed its policy of opposition to bank loans to individuals for the acquisition of government bonds, and banks are now offering liberal terms in connection with such loans. Purchases of bonds by individuals and others for which funds are secured through bank borrowing are inflationary. There is even the danger that as individuals and institutions buy bonds the funds for which are procured from banks they may at the same time reduce their purchases from their own idle cash resources.

institutions of attempting to siphon off as large a percentage of consumers' purchasing power as possible and to induce individuals to place more and more funds with these institutions so that they may be available for investment in government securities.

Investing institutions should recognize that the war places them in a peculiar position with respect to service to their owners and clients. This is particularly true of investing institutions as contrasted with institutional investors. Under ordinary circumstances, savings banks, investment companies, trusts, and savings and loan associations can justify their existence only as they protect their owners through providing adequate diversification of investment funds and through managing these funds in such a way that the investor secures a higher average yield than he could obtain by direct investment. Insofar as diversification is concerned, the same rules which are practiced by investing institutions in time of peace can not be allowed in time of war; and, in any case, investing institutions are unlikely to cease their purchases of government bonds as soon as they have bought such large quantities as to throw their portfolios out of balance on the basis of peacetime standards. More significantly, there is little reason why an individual should make use of an investing institution to acquire government bonds. The obligations of the federal government are not purchased today, either by the investing institutions or by the individual, as a result of investment analysis; and the client is thus paying the investing institution for investment service which it does not perform. Not only is the net yield to the investor through the use of the investing institution reduced by its operating costs; but, insofar as the purchase of government bonds is concerned, the gross yield from invested funds to the institution is likely not to be so large as the yield to the individual investor from direct investment. The highest yield (to the call date) at present available to the investing institution from the purchase of government bonds is 2.5 per cent, obtainable by subscription at par to the 2½ per cent Treasury bonds of 1963-68. In contrast,

the individual investor can secure a yield of 2.9 per cent to maturity through the purchase of Series "E" war savings bonds. The yield to the investor who makes use of the investing institution is further lowered by taxes assessed against the institution.

The liabilities of most types of investing institutions are in dollar form and the type of obligation assumed with respect to the client and the types of assets owned are not such as to protect the individual investor against inflation.[5] The investor is not protected against inflation in the purchase of government bonds either directly or through the medium of an investing institution. To the extent that there is a difference, the individual purchaser of war savings bonds is better protected against this hazard than is the investor in the investing institution which buys Treasury bonds, since war bonds can be redeemed at any time at definite prices, while the realizable value of Treasury issues depends upon the market price at the time of sale.

This argument against institutional investment as a medium for the purchase of government bonds does not apply to the same extent to the institutional investor. This type of institution, such as, for example, the life insurance company, can claim that investment is incidental to some other service which it is performing for its owners. The reduced yield to the life insurance company from purchases of government obligations as compared with the yield from direct investment in government securities supports the contention that the life insurance company should be used only as an agency for the purchase of pure insurance protection, with the savings in premiums to be used for the direct purchase of war bonds.

It would appear from these facts that investing institutions can not appeal for the funds of investors on the ground that such indirect investment is preferable as compared with the direct purchase of government obligations. However, investing institutions are justified in taking the point of view that, if the placement of funds with them is not encouraged,

5. The shares of most investment companies represent an exception to this statement.

the funds may not be used for bond purchases but may be spent for consumers' goods. Once the funds are in the hands of the institutions they are definitely available for government bond purchases and to that extent the funds aid in the battle against inflation. Investing institutions are thus performing a socially justifiable function in encouraging investors to make additional deposits in savings banks, to buy more life insurance, and to acquire more savings and loan shares. If the investor can be induced to make more extensive use of the facilities of the institutions, the proportion of his income saved in the form of placements with institutions plus individual purchases of war bonds is likely to be larger than if all his savings were placed in war bonds alone. From the standpoint of financing the fiscal requirements of the government with as little use of inflationary devices as possible, the expansion of the total resources of investing institutions is desirable.

Investing institutions are interested, of course, in doing all they can to help to win the war through the purchase of government securities. But their defense for the purchase of governments does not need to rest on this purely patriotic motive. The question is not so much one of purchasing bonds to help to win the war, since the government will secure control over the wealth required to wage the war in one way if not another. The primary contribution of the investing institutions is to facilitate the financing of the government's fiscal needs by non-inflationary means. In a sense the future prosperity and even the existence of investing institutions depends upon the avoidance of inflation during the war and post-war periods. The burden of war costs will doubtless become very heavy — so heavy that if these costs are financed by inflationary methods the shock to investment confidence and the discouragement to the accumulation of savings may well make possible a return to normal financial conditions for generations. It is conceivable that the outcome might be a system of collectivism in which private investment would disappear. It is on the basis of protecting themselves and their investing clients against such contingencies that investing institutions can and should defend their attempts to enlarge the

scope of their operations and to serve as a channel to divert consumers' incomes from the markets for consumers' goods to the purchase of government securities.

During the period since 1940 most types of investing institutions have been increasing their rates of purchase of government obligations. Extensive acquisitions of governments by most types of institutions occurred, of course, throughout the decade of the 1930's; but such purchases were prompted by a desire for safety and liquidity and by a dearth of reasonably safe opportunities for investment in private industry. It is unfortunate that investing institutions felt it desirable to enlarge their holdings of governments to such a great extent during the 1930's, since it left them with but small cash resources to purchase government issues when the defense and war effort got under way and since it also complicated the problem of maintaining balance among different types of securities in this latter period. The increased purchases of governments since the middle of 1940 parallel the large-scale absorption of such securities by institutions during World War I.[6]

The principal type of investing institution which has not been a large scale purchaser of governments has been the investment company. This is a result, not of a lack of patriotism on the part of investment company managers, but rather of the addiction of most investment companies to the "common-stock complex." The failure of the investment companies to acquire government bonds is particularly unfortunate because they could acquire large quantities without making their portfolios topheavy with governments, while some other types of institutions are in danger of this. It would appear desirable for investment companies, especially of the closed-end leverage type, to increase the investment caliber of their outstanding bond and preferred stock issues by augmenting the proportion of fixed-interest securities in their portfolios. Apparently the tradition that the investment company in this country

6. For an interesting account of the investment policies of mutual savings banks during World War I, see Weldon Welfling, *Savings Banking in New York State* (Durham, N. C.; Duke University Press, 1949) Chap. IV.

should be a "common stock fund" can not easily be changed.

It is unnecessary to review in detail the extent to which government bonds have been purchased by all types of investing institutions in recent months. Some data with respect to life insurance company purchases will be illustrative of the general tendency. From January 1 to November 28, 1942, purchases of government securities by the 42 leading life companies were $2,165 million, which compares with purchases of $1,100 million during the corresponding period of 1941.[7] At the end of 1941 life insurance companies had about 20 per cent of their admitted assets in the form of United States government bonds and it has been estimated that this figure will be more than 25 per cent at the end of 1942.[8] Total holdings of governments by such companies are now in excess of $8.5 billion. From the first of the year to November 28, 1942, governments accounted for 56.1 per cent of total life insurance company investments. Data with respect to other investments for the first eight months of 1941 as compared with the similar period of 1942 show that purchases of mortgages increased slightly ($538 million to $541 million), purchases of public utility securities fell from $676 million to $344 million, railroad securities purchased decreased from $195 million to $99 million, and acquisitions of municipals declined from $139 million to $33 million.

To date investing institutions have made use primarily of idle funds and of accretions of cash for the purchase of governments, and their purchases have not necessitated the wholesale liquidation of other types of securities from their portfolios. Part of the increases in the money incomes of individuals resulting from war conditions have been transmitted into savings and a part of these savings have served to increase the cash resources of investing institutions. Life insurance policy holders have been paying off their policy loans and the policy surrender-rate is at an all-time low.[9] Sales of new life insurance have held up fairly well throughout 1942, increas-

7. *Wall Street Journal*, December 3, 1942, p. 10.
8. *Best's Insurance News*, November, 1942, p. 7.
9. *Ibid.*, p. 35.

ing the amount of life insurance in force with legal reserve companies at the year-end to approximately $130 billion.[10] The lower income groups whose monetary incomes have been increased most sharply by war influences have been increasing their deposits in mutual savings banks and augmenting their purchases of savings and loan shares. Corporations have been encouraged to reduce their outstanding indebtedness by the provision in the 1942 Revenue Act which permits them to realize immediately part of their post-war income tax credit to the extent to which it is used to pay off debts.[11] This has brought it about that the funds of savings banks and insurance companies for the purchase of governments has been increased both by the redemption of portfolio securities and by cash from deposits and premiums. The decrease in new private residential construction has diminished the normal outlets for funds of savings and loan associations at the same time that many mortgagors have been paying off their indebtedness more rapidly than required by mortgage amortization provisions. Consumers have been reducing the amounts owed to installment and personal finance companies, thus making funds available to these companies for the purchase of governments or for paying off their own indebtedness. Municipalities as well as private corporations and individuals have been redeeming their outstanding debt. Industrial and governmental employment is at a high level and the flow of cash into pension and retirement funds has increased.

The Treasury Department publishes data which reveal the manner in which increases in government debt have been absorbed by various classes of institutions and by individual investors. Table 3 shows the estimated absorption of the increases in the volume of federal interest-bearing and guaranteed issues during the two fiscal years from June 30, 1939 to June 30, 1941.

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10. *Chicago Daily News,* December 5, 1942, p. 21.

11. Corporations have also been reducing their indebtedness to banks, which decreases the inflationary tendencies of bank purchases of government bonds.

TABLE 3*

ESTIMATED ABSORPTION OF THE INCREASE IN INTEREST-BEARING SECURITIES ISSUED OR GUARANTEED BY THE UNITED STATES, JUNE 30, 1939 TO JUNE 30, 1941 BY CLASSES OF HOLDERS, BY VOLUME AND IN PERCENTAGES

(amounts in millions of dollars)

Class of Holder	June 30, 1939-June 30, 1940		June 30, 1940-June 30, 1941	
	Amount	Percentage	Amount	Percentage
Insurance Companies	$ .6	22	$ .4	5
Mutual Savings Banks	.1	3	.3	5
U. S. Government Agencies and Trust Funds	1.2	47	1.4	20
Other Holders**	— .1	— 2	1.5	22
Sub-total "Non-inflationary"	$ 1.7	70	$ 3.6	52
Commercial Banks	$ .9	33	— .3	52
Federal Reserve Banks	— .1	— 3	$ 3.3	— 4
Sub-total "Non-inflationary"	$ .8	30	$ 3.3	48
Total Absorption	$ 2.5	100	$ 6.9	100

* Adapted from data in *Annual Report of the Secretary of the Treasury on the State of the Finances for Fiscal Year Ended June 30, 1941*, Government Printing Office, Washington, 1942, p. 34. The figures on the commercial and savings bank holdings of securities are taken at book value rather than at par value. As a result, the absorption of securities by these institutions tends to be overstated and the absorption by "other holders" to be understated when bonds are selling generally at a premium, as has been the case during the period covered. The errors so involved are not sufficiently large, however, to invalidate the general conclusions which may be reached from the figures in the table. The figures for insurance companies, United States Government agencies and trust funds, and the Federal Reserve Bank are reported at par values. The figures are rounded and will not necessarily add to totals.

** Individuals and corporations other than banks and insurance companies.

It may be observed from the data in Table 3 that increases in the federal debt were absorbed to an increasing extent by commercial banks and Federal Reserve banks in fiscal 1941 with a concomitant decrease in the importance of investing institutions and individuals.

Further light may be thrown on the problem by considering the data published in the monthly Treasury survey of the ownership of securities issued and guaranteed by the federal government. Data based on the Treasury survey are given in Table 4. The tables published by the Treasury include the distribution of only the public marketable interest-bearing securities. This involves the important omission of United States savings bonds and tax series notes, which are not marketable. The Treasury data have therefore been adjusted in Table 4 to give effect to holdings by individuals and by institutions of these two classes of securities. Another difficulty in analysis of the Treasury figures for our purposes arises from the fact that the Treasury department classifies together the securities held by United States Government agencies and trust funds, and Federal Reserve Banks. The figures in Table 4 have likewise been adjusted to place these totals in separate categories. Two dates have been selected for presentation in Table 4; these are November 30, 1941, the last date available preceding the formal entrance of the United States into the war, and August 31, 1942, the latest date available.

TABLE 4*

ANALYSIS OF OWNERSHIP OF FEDERAL PUBLIC INTEREST-BEARING SECURITIES BY CLASSES OF HOLDERS, NOVEMBER 30, 1941 AND AUGUST 31, 1942

(amounts in millions of dollars)

Date		Total Amount Outstanding	"Non-Inflationary"					"Inflationary"		
			Total	Mutual Savings Banks	Insurance Cos.	U. S. Govt. Agencies & Trst.Funds	All Others	Total	Commercial Banks	Federal Reserve Banks
Nov. 30, 1941	Amount	$53,728	$31,424	$3,579	$7,508	$2,503	$17,834	$22,305	$20,121	$2,184
	Percentage	100	58	7	14	5	33	42	37	4
Aug. 31, 1942	Amount	$77,181	$44,442	$4,115	$9,518	$2,861	$28,498	$32,188	$28,762	$3,426
	Percentage	100	58	5	12	4	37	42	37	4

* Based on data in *Bulletin of the Treasury Department*, January, 1942, pp. 31-32, and August, 1942, pp. 46-47, and *Federal Reserve Bulletin*, January, 1942, p. 29, and November, 1942, p. 1107. Data on institutional holders represent reports from the following numbers of institutions: mutual savings banks, 492 on November 30, 1941 and 490 on August 31, 1942; insurance companies, 762 on November 30, 1941 and 758 on August 31, 1942; commercial banks, 5,796 on November 30, 1941 and 5,766 on August 31, 1942. The data exclude certain unimportant non-marketable interest-bearing issues, as follows: special issues to Government agencies and trust funds; adjusted service bonds; depositary bonds; and Commodity Credit Corporation demand obligations. The figures are rounded to the nearest million and the nearest per cent and will not necessarily add to totals.

The data in Table 4 indicate that there has been virtually no change in the percentage distribution of government securities as between "inflationary" and "non-inflationary" holders during the nine-month period.

These data may be compared with still more recent figures issued by the Treasury department. On December 8, 1942, the Treasury announced that $5,586 million of government securities had been sold during the first five days of December, the month which marked the first large scale attempt to place government bonds with non-banking institutions. Of the amount indicated, 60.5 per cent was raised from non-banking sources with the remainder placed with the banks. The 2½ per cent "Victory" issue of 1963-68 accounted for $2,101 million of the $3,381 million sold to non-banking institutions.

While the foregoing data indicate that investing institutions have been absorbing from 55 per cent to 60 per cent of new government issues, we can not conclude that the danger of inflation has been exaggerated. If further inflation is to be avoided, taxes and savings must increase rapidly enough to absorb all increases in consumers' money incomes plus that portion of former money incomes which was spent for consumers' goods which cannot now be produced because of the conversion of industry to war purposes. Taxes and savings have not increased rapidly enough to obviate the necessity for sale of government securities to banks and the "inflation potential" is thus being increased. A considerable portion of the funds for the purchase of government bonds by investing institutions has come from uninvested cash resources, and the same rate of purchases can be maintained in the future only by liquidating other securities. The sale of other securities to secure funds for the purchase of governments is not necessarily anti-inflationary. Whether or not it has this effect depends on what the purchaser of the securities sold from the portfolio would have done with the funds if he had not purchased these securities. If he himself would have purchased government bonds with the funds, total investment in government securities has not been increased by the sale by the investing insti-

tution of a corporate security to give it funds for the purchase of governments. The likelihood is that, to the purchaser of the corporate security from the portfolio of the institution, the alternatives were not those of spending for consumers' goods or purchasing a corporate security; it is far more likely that the alternatives were the purchase of a corporate security or of a government security. Therefore the funds would have been saved rather than spent in either case.

It has been reported in the financial press that there has recently been heavy liquidation of municipal bonds by investing institutions to permit them to purchase federals. While the desire of institutions to purchase large amounts of governments is commendable, it is questionable whether any benefit results from the sale of securities to others who, as a result of their purchases, themselves have smaller sums available for the purchase of governments. The sale of municipals to individuals is likely to lower the receipts from income taxes because of the exemption from taxes of the income from municipals. There has been an increasing tendency, also, for managers of sinking funds to purchase governments as funds become available. The extent of this practice will be limited by the provision in many sinking fund contracts which requires that funds be invested only in the securities for whose retirement the funds are being accumulated. Payments into most sinking funds are based on an expected rate of return which is in excess of the yield on government bonds. Managers of sinking funds should recognize that paying off debt is just as anti-inflationary as the purchase of governments.

It should be understood, also, that the purchases of non-governmental securities by investing institutions may also be in the interest of the war effort and the attempt to control inflation. Although new issues of private securities have been very small during recent months, the corporate issuer of such a security may be engaged in an industry vital to the war effort and the acquisition of new capital from the sale of securities removes the necessity of securing the funds from the government. If a new plant is needed, for example, the corporation may build it with its own funds obtained in the capital mar-

ket; and if this is done it will not be necessary for the Defense Plant Corporation to construct the plant with government funds. So far in World War II there has been insufficient control over the determination of the essentiality to the war effort of new capital issues. In view of the small volume of new issues. In view of the small volume of new issues, however, the lack of control is probably unimportant. There is a greater need for the effective rationing of bank credit than of private investment credit.

Investing institutions can and should follow policies with respect to the administration of their portfolios of non-governmental securities so as to encourage the use of capital only in industries performing essential activities. This may be done by purchasing the securities, both old and new, of those companies which are contributing most to the war effort, and avoiding the purchase of securities of companies whose activities are unessential. Such a policy might dictate, for example, the purchase of the bonds of a steel company and the sale of the bonds of an instalment finance company or of a municipality.

While it has been made clear that individuals, corporations, and municipal and state governments have been increasing their savings, we cannot conclude that the future of investing institutions is necessarily bright. How investing institutions will fare during the war period with respect to the growth of total resources will depend upon the volume of saving and the disposition of savings. Investing institutions will grow to the extent that saving is encouraged and to the degree that savings are transferred into government hands through the medium of institutions rather than by direct purchase of war bonds. Certain trends in saving in different forms in recent years may be observed from data on the volume and composition of saving by individuals published by the Securities and Exchange Commission. Data are given in Table 5 on the savings of individuals in the form of quarterly averages for 1940 and 1941 and quarterly figures for the first three quarters of 1942.

TABLE 5*
GROSS SAVING OF INDIVIDUALS IN THE UNITED STATES QUARTERLY AVERAGES, 1940 AND 1941, AND QUARTERLY, FIRST THREE QUARTERS, 1942
(in billions of dollars)

	1940	1941	1942		
			Jan.-Mar.	Apr.-June	July-Sept.
Gross Saving	4.14	6.32	6.50	8.96	11.40
Liquid Saving**	1.14	2.71	4.18	6.45	9.13
Gross Saving by Type					
Currency and bank deposits***	+ .95	+1.40	— .10	+2.40	+4.20
Savings and loan ass'ns	+ .06	+ .09	0	+ .05	+ .03
Insurance and pension reserves					
Private insurance	+ .43	+ .51	+ .57	+ .53	+ .62
Government insurance	+ .31	+ .44	+ .40	+ .60	+ .72
Total	+ .74	+ .95	+ .97	+1.13	+1.34
Securities					
Federal	+ .13	+ .83	+2.40	+ 2.20	+2.80
Municipal	— .06	0	— .06	— .03	+ .04
Corporate and other	— .14	— .15	+ .28	+ .01	0
Total	— .07	+ .68	+2.62	+ 2.18	+2.84
Nonfarm Dwellings****					
Purchases#	+ .64	+ .75	+ .51	+ .52	+ .32
Change in debt	+ .22	+ .27	+ .12	+ .15	+ .11
Saving	+ .42	+ .48	+ .39	+ .36	+ .21
Automobile and other durable consumers' goods†	+2.32	+2.86	+1.82	+1.99	+1.95
Liquidation of debt, not elsewhere classified‡	— .24	— .17	+ .80	+ .85	+ .83

* Adapted from data given in Securities Exchange Commission Statistical Series Release No. 726, November 15, 1942, p. 3. Data do not include business or government saving. Figures are rounded and will not necessarily add to totals. The Commission warns that because of the nature of the figures, current data are necessarily estimates and are subject to revision.

** Gross saving excluding purchases of homes as well as of automobiles and other durable consumers' goods.

*** Includes currency, deposits in checking accounts, and deposits in savings accounts.

**** One- to four-family nonfarm homes.

All new construction less net acquisition of properties by non-individuals.

† Purchases. The figures shown include all passenger cars sold in the United States. No adjustment has been made for dealers' overallowances on trade-ins.

‡ Largely attributable to purchases of automobiles and other durable consumers' goods, although including some debt arising from purchases of consumption goods. The other segments of individuals' debt have been allocated to the assets to which they pertain, viz., saving in savings and loan associations, insurance, securities and homes.

The data in Table 5 reveal upward trends in savings in the form of currency and bank deposits, in insurance and pension reserves, in federal securities, and in the liquidation of debt. Saving through savings and loan associations remained stable throughout the period at a small positive figure. Purchases of municipal and corporate securities showed only slight changes. Savings in the form of nonfarm dwellings and of automobiles and other durable consumers' goods declined. Particularly pronounced is the growth in recent months of liquid savings and the increasing proportion of liquid to gross savings. Most of the rise in saving in the third quarter of 1942 is attributed to the large increases in cash holdings and deposits in checking accounts. Saving in this form accounted in this period for more than 40 per cent of all liquid saving. The increase in liquid saving reflects the higher level of individuals' incomes, and the Securities and Exchange Commission concludes that practically all of the increase in such incomes went into liquid saving rather than consumption. Additions to cash on hand and checking accounts represent accumulations which can easily be diverted into consumption and therefore have inflationary potentialities. Part of these cash reserves are probably kept to meet tax liabilities, but they are also indicative of "liquidity preference" in time of uncertainty. It would be desirable to bring about the investment of these cash funds in less liquid form or to divert them, especially the cash hoards, into the hands of investing institutions.

The outlook for investing institutions so far as growth of total resources is concerned is complicated by a number of factors. In recent months resources have increased as a result of saving accomplished by those who have experienced the greatest increases in monetary income as a result of the war effort — especially those with incomes up to $4,000. As time goes on, increases in the cost of living, higher taxes, and increased pressure for direct saving through the purchase of war bonds will probably decrease the ability and willingness of this group to expand their investments with investing institutions. In future months monetary incomes will not increase

so rapidly as in the past. Monetary incomes have been increasing recently because of increased hours of employment and number employed as well as because of rising wage rates. Total volume of employment can not rise so rapidly from this point on, and this will affect money incomes regardless of the success of wage stabilization measures.

As the pressure on individuals for the purchase of war bonds increases and as the full impact of 1942 tax rates strikes them in 1943, many will liquidate their investments with institutions in order to meet these obligations. Already there has been a considerable decline in deposits with mutual savings banks by those who wished to use their funds for the purchase of war bonds. There is an added danger to the investing institutions in the fact that the greatest increases in income tax rates have not been in those brackets where there have been the greatest increases in income. The lower income groups, those with incomes to $4,000, have received the largest share of the national income and of the increases in such incomes in recent months, while the schedule of income tax rates is so arranged as to hit hardest those in the $4,000 to $10,000 income range. It is these latter income classes which in the past have been the best customers of investing institutions. Many families in this class will adjust for increased taxes, not by decreasing their standard of living, but by decreasing the amount of new investments with investing institutions, or by actually withdrawing some funds previously invested. The government has failed to see that tax rates should be increased the most at these points where there has been increased income and that taxes on the better-to-do classes are ineffective in controlling inflation if these classes decrease their savings as their taxes increase. The situation in this respect would seem to call for an enlarged application of the federal tax system to the lower-income classes. Although such a plan would not follow the time-worn principle of "ability to pay," the resulting inequities might be reduced by

taking a part of the increased tax payments in the form of deferred credits which would be returned after the war.[12]

The government has not yet taken the action required to meet the menace of inflation. The controls instituted to the present time have not been adequate to avoid inflation in prices and in the cost of living. It is probable, however, that during the coming months the government will adopt additional devices to retard price increases. The particular methods of control which are put into effect will have much to do with the future of investing institutions. To the extent that tax rates based on incomes are increased, the growth of investing institutions will be retarded. This will be particularly true if high income tax rates are applied to those income groups which in the past have been the principal users of the services of the institutions. The collection of taxes brings about the flow of purchasing power into the hands of the government without affecting the assets of investing institutions. This conclusion applies also with respect to the effect of increased payroll taxes, social security taxes, and any other taxes based on income. Any plan for increases in revenue through taxes based on transactions or sales will also increase the cost of living and leave smaller margins to consumers for investment. Similar results will follow the use of any tax plan based on incomes in which the principle of forced saving, or, to use the Treasury's term, "rebatable taxes," is involved. The taxpayer would receive a deferred credit, perhaps in the form of a non-negotiable obligation to be redeemed after the war. It is obvious that to the extent that individuals can be induced to help finance the war by the purchase of war bonds the growth of investing institutions will be retarded.

In contrast, there are a number of plans under consideration by the government which would stimulate the growth of investing institutions. To the extent that the government appreciates that the problem of war finance is as much

12. This point is well developed by W. J. Schultz in "Fiscal Control of Inflation," *The Conference Board Economic Record*, National Industrial Conference Board, October, 1942, pp. 349-56.

one of controlling inflation as it is one of securing revenue, it will adopt a fiscal policy which accomplishes both objectives. One way of attacking the problem of inflation is to make it profitable for people to save, and unprofitable for them to spend. This could be accomplished by a spending tax, in which the tax base would not be income, but rather the amount spent for consumers' goods. In the case of taxes based on income, there is no incentive not to spend what is left after payment of taxes and there is no penalty for dissaving to maintain an accustomed standard of living, while in the case of taxes based on the amount spent, there is an incentive to save as much as possible. Any tax plan in which credits are given for saving might well bring about an expansion in the assets of investing institutions. Some of the savings would, of course, be used to purchase war bonds and to retire debt; but credits for such types of saving as life insurance premiums paid and sums deposited in banks would have a direct effect on institutional assets. The credit provisions of the new "Victory" tax represent a beginning along this line.

Various plans have been suggested to reduce spending by direct rationing of consumption — sustems in which the consumer would be permitted to spend only a certain number of dollars, or a certain percentage of his income, or a designated number of "points" for goods, with the requirement that the remainder of one's income be saved. Considerable portions of incomes thus saved would no doubt find their way into the resources of investing institutions.

If the government continues to rely upon taxes based on income to control inflation, sooner or later it will be forced to immobilize liquid savings by rationing withdrawals from such funds. While it will probably be unnecessary to do this if the spending tax principle or the direct rationing of consumption is adopted, the rationing of withdrawals from investing institutions would serve to prevent decreases in the resources of investing institutions which might otherwise take place. Such rationing would have other effects, also, such as

making it unnecessary for institutions to place so much emphasis upon portfolio liquidity and marketability.

Considerable divergence in the growth of assets of different types of institutions may be expected. Most seriously affected will be the educational and charitable endowments and research foundations. So great will be the pressure on the incomes of the very wealthy that additions to such funds from gifts will greatly decline.[13] The trend toward "egalitarianism" will probably also decrease the number of large trust funds. As the average size of savings accumulations decreases the problem of finding a way of providing efficient low-cost investment advisory service for small investment funds will come to be even more insistent than at present. Perhaps the commingled trust fund administered by trust companies may prove to be the answer.

2. *Effect of the War (c) on Gross Income Return, Expenses, and Net Income Return.*

The outlook for the net income return to the patron of investing institutions is for a continuation of the decline which began in 1929. During the decade of the 1930's this decline in net return resulted from decreases in yields on investments not completely offset by decreases in operating expenses. The war so far has not caused any increase in yields from long-term high-grade securities. Although there has been some slight tightening of short-term interest rates, investing institutions are not important holders of securities with a short maturity. The enormous supply of government securities which will have to be sold in the future may in time cause some rise in long-term rates, but the government will, of course, do its best to prevent such a rise by the use of the powerful controls available to it. Even if long-term rates should rise, it would do investing institutions more harm than good in that they would have previously invested such large sums while rates were low that rising rates would bring about large "paper"

13. See a series of articles entitled "The New Poor" in the *Wall Street Journal*, November 11, 13, 14, 16, 17, 21, 24 and 28, 1942.

losses on their marketable investments. High corporate tax rates will lower the gross income of many types of institutions, especially those holding corporate common stocks in their portfolios. The liquidation of corporate securities and the purchase of governments will likewise lower the average yield of many institutional portfolios.

The war has increased the operating expenses of investing institutions as it has those of other types of companies. This has been more true of institutional investors than of investing institutions in the strict sense, owing to the fact that the former perform many functions for their clients other than those of an investment nature. The turnover of personnel and the expense of retraining replacements have been serious problems. The expense of investment analysis has in many cases decreased because of the investment of accretions of cash in government issues, but this is the only aspect of the operations of investing institutions which have decreased in cost because of the war. For many types of institutions the war has brought new problems which the institutions were not well prepared to meet. The life insurance business may be used as an example. In this industry the war has created such problems as the suspension of disability and double indemnity coverage; insurance coverage for service men; dealing with nations to which payments have been blocked; and the obtaining of "proof of death" and the administration of claims.[14] Inability of many institutions to secure equipment to handle these new problems is a complicating factor. Other difficulties include the administration of payroll deduction plans and the uncompensated efforts of personnel to push the sale of war bonds.

As a result of these factors, income available for the clients of investing institutions has been decreasing. The net rate of interest earned by life insurance companies on their funds during 1941 was 3.41 per cent as compared with 3.61 per cent in 1940 and 3.70 per cent in 1939. This has led to

14. See H. C. Bates, "War Impact on Life Insurance," *Best's Insurance News*, October, 1942, pp. 14-16 and 44-49.

dividend reductions and rate increases in recent years. The net rate has declined continuously for 13 years from a pre-depression level of approximately 5 per cent.[15] Savings and loan associations are reducing their dividend rates because of lower mortgage rates, a dearth of good mortgage risks, and a belief that additional amounts should be placed in reserves. Downward pressure continues to be exerted upon the dividend rates of mutual savings banks. Reduced incomes from trust and endowment funds together with increased living and operating costs are seriously affecting the beneficiaries of such capital accumulations.

In summary, it may be said that if investing institutions are to survive and to maintain their importance in American economic life, we must (a) win the war; (b) prevent further inflation and thereby save from extinction the capitalistic system; and (c) so revise our institutional economic structure that there will be entrepreneurs who desire to secure the use of capital funds and savers who feel that they are offered a sufficient return to induce them to assume the normal risks of investment.

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15. See "War Trends of Life Insurance," *Best's Insurance News*, August, 1942, p. 13.

Provisions of the Revenue Act of 1942 Affecting Corporations

BY LEWIS A. FROMAN

Before entering into the discussion of the specific provisions of the Revenue Act of 1942 which affect corporations, it seems desirable to discuss briefly some general aspects of our whole tax problem. After all, we cannot separate corporation tax problems from the overall money raising problems of our government when we realize that the amount coming from corporations is only one of the several important sources of revenue.

It seems to me that the general problem of raising money by means of taxation can be envisaged as a dilemma On the one hand, it is of the utmost importance to raise as high a percentage of our current expenditures as possible. By doing this problems of inflation, post-war over extension and collapse, and price control are greatly reduced. On the other hand, we must be careful not "to kill the goose that lays the golden egg." We may tax until it hurts but we must not tax until it destroys.

With respect to the proposition that we must raise as high a percentage of our total expenditures during war time as possible, (and this would apply to other periods also), I think most of us agree that even the present increased taxes are in no sense likely to be considered as maximum limits. Scarcely was the ink dry on the signing of the present Revenue Act when officials of the Treasury Department suggested that the normal income tax provision affecting corporations was probably too low. Discussion is already under way and formal hearings will no doubt open soon on measures designed to further increase our tax incomes. Regardless of the general clamor against the increased taxes, which will probably be even greater among the general public come next March, a most important aspect of this problem is that totally considered, the people of this nation probably have made little or

no sacrifice up to this point. Let me quickly add that I am not saying here that various individuals and groups have not made considerable financial sacrifices, but that our general citizenry as a whole up to this time is better fed, better housed, and better clothed than it was during most of the years of 1930s. How can we as a nation siphon off approximately one-half of our total productive effort for use in our all-out war effort and at the same time maintain our usual standard of living?

Even with the increased taxes which now have become a part of our law, we have not yet taken nearly as much in additional taxes as the additions to the total national income. It is this spread existing between the higher national income and the reduced volume of consumers' goods and services which are available for purchase by consumers which seems to be the number one consideration in any tax problem and also, as you will recognize, in any problem of inflation and price control on an overall basis.

Thus, recognizing the need for still greater tax revision, we turn next to the aspect of the dilemma which cautions us against taxes which may destroy the sources of our tax income. We are hearing a lot about destroying private initiative, especially with respect to recently enacted maximum salary regulations. It is difficult to know just how important such limits may become in preventing individuals from putting forth their best efforts. But we are here concerned only with provisions which may prevent corporations from putting forth their best efforts. Corporations are legal entities existing, in this sense, apart from their owners; and with the recent tendency toward the separation of ownership and control, we may be justified in speaking of tax provisions which affect the corporations' initiative.

Principal Provisions

So much for some of the general problems which in turn affect the specific problem of corporation taxes. Let us now turn directly to the problem at hand. The provisions of the Revenue Act of 1942 affecting corporations, some of which

are new and some old, but revised, are principally as follows: (The Revenue Act of 1942 is a document of 208 pages most of which are entirely unintelligible to the average layman. In addition, many provisions are amendments to previous statutes which need to be understood in order to grasp the significance of the amendments. Experts who digest the provisions are not always agreed as to their meaning, so there is always room for some interpretation. For these reasons, any brief and somewhat general discussion, such as this one, must omit most of the detail. The present discussion is not meant to be of assistance to those who are charged with the responsibility of making corporate tax returns but rather to be a discussion of the economic significance of the principal provisions.)

1. The normal corporate income tax is raised, with some minor exceptions, to a flat 40%. (This includes both regular and surtax charges.)
2. The excess profits tax is raised to a flat 90%.
3. Provision is made for a 10% refund of the excess profits tax to take place at the end of the war.
4. All tax levies may not exceed a maximum of 80% of the corporation's income.
5. Provision is made for the treatment of preferred dividends, in some instances, in the same manner as interest on bonds.
6. Favorable tax consideration under certain circumstances is given to corporations which reduce their funded debt.
7. There is a carry-over and carry-back provision for corporate losses.
8. There is a carry-over and carry-back provision which may be used in the computation of excess profits.

Taxing Both Normal and Excess Profits

We need not spend time discussing the normal tax or the excess profits tax provisions which, in principal content, are carried over from previous Revenue Acts. There is, however, a general question with respect to the normal corporation income tax and the excess profits tax which I should like to pose. As our general philosophy seems to be to tax corporations

during this war period, so that only a reasonable return upon investments will be left as earnings, why is it necessary to have provisions for taxing the income of the corporation and then superimpose upon this a provision taking away most of excess profits? In other words, might not the same end be accomplished if we had only the excess profits tax?

The new Revenue Act clearly separates the amount on which the normal tax is levied from the amount on which the excess profits tax is levied. Last year's law provided that the excess profits tax might be deducted in computing net income for normal profits tax purposes. If our excess profits tax accomplishes the end of preventing our corporations from making great profits from the war effort, could we not rely upon this tax only? In order to make this problem more clear, let us consider an illustration:

Assume that a corporation has a net income of $1,000,000, and according to its calculations, its excess profits began at $500,000. This would mean that the corporation has $500,000 of excess profits and when taxed at the rate of 90%, the excess profits tax becomes $450,000. The normal tax applied to the first $500,000 of earnings would be $200,000 (4% of $500,000). Summarizing, this corporation with a net income of $1,000,000 would pay $650,000 in taxes and have $350,000 available for surplus, dividends, etc.

The possible inconsistency in such a system seems to me to lie in the fact that by definition, we have assumed that this corporation could have $500,000 of earnings before those earnings were considered excess profits, and yet in the final computation, the corporation is permitted to keep only $350,000 of its earnings. Either the $350,000 is not enough to be considered a normal return for the corporation or else we have set up our definition of normal profit in such a way that the excess profits tax does not apply until after the corporation has received more than what may be considered a reasonable return. May I repeat, that at least for the duration, we seem to be interested in keeping the return to corporations at a reasonable level, and if this is our intent, why not take all earnings above the normal or reasonable earnings point, and

none prior to that point? One may say in answer to this that it is next to impossible to arrive at a suitable criterion of what constitutes a reasonable or normal profit. Indeed, it may be difficult, but in setting up our current excess profits tax, we have had to set up such a criterion so that this problem faces us in our present system as well as in any system which would use the excess profits tax alone. Going back to the illustration cited of the corporation with a $1,000,000 income before taxation and which pays $650,000 in taxes, the $350,000 which remains may or may not be a reasonable return to the corporation. If we had some criterion of what is a reasonable return then we could be sure that corporations are left with an amount which would not work any undue hardship upon them.

Eighty Per Cent Maximum Limit

The provision which states that a maximum of 80% of the income of a corporation may be taken as taxes would seem to be an admission that our system may work inequities and this provision is just thrown in to make sure that all earnings are not taken. There is no way to determine whether or not the 20% of income which the corporation under any circumstances is allowed to retain is reasonable or represents a normal return. In some cases it might be but certainly in many cases it would not be. It has recently been reported that some corporations are so confused and find the application of the various tax provisions so complex that they have automatically set aside 80% of their income for taxes. This applies to corporations which report earnings quarterly. When the final report for the year is made, the regular procedures will be used, but it certainly is a great time saver for the corporation if it sets aside 80% of its income for taxes.

Ten Percent Refund of the Excess Profits Tax

One of the new provisions of the Revenue Act of 1942 is that which provides a 10% refund of the present payments under the excess profits tax; this refund to be made at the end of the war. Actually the provision states that bonds of a non-negotiable and a non-redeemable nature are to be issued to

the corporations at the present time and these bonds are to become negotiable or redeemable at the close of the war. (This provision is very similar to the refund provision applying to the victory tax on individuals). Supposedly the purpose of this provision is to give the government the use of funds for the prosecution of the war and to return these funds to the corporation at a time when the corporation may have great need for them and when there is less need for them by the government. Such a provision is sometimes referred to as a means of 'softening the depression" which is likely to follow the war. All in all, this seems to be a very sensible provision and when corporate taxes are increased still further, it may be wise to provide for still greater refunds.

Credit for Debt Reduction

Another provision of the new Revenue Act which has been given considerable attention is that which applies to the effect upon the corporation's tax bill of reducing its funded debt. Contrary to several public statements, the principal provision here is that which permits a "corporation" to disregard as income the effect of buying in its own bonds at less than the amount at which they are carried on the corporation's books. Thus a corporation carrying its bonds at $1,000 but able to purchase them on the market at $700 need not include the $300 difference as part of its income.

The debt reduction provision of the Act, however, which has received widest attention is that which permits the corporation to take its 10% excess profits refund in the form of a tax allowance which may not exceed 40% of its debt reduction. This can best be explained by an example. Suppose a corporation must pay $100,000 under the excess profits tax provision. Ten per cent of this amount, or $10,000, is subject to the refund provision, which gives to the corporation $10,000 of bonds or permits it a credit of $10,000 against funded debt retired. Since only 40% of the debt retirement may be so counted, this would mean that at least $25,000 of debt would have to be retired.

Treatment of Preferred Dividends by Public Utilities

Another provision of the new Revenue Act which is a distinct departure from previous procedure is that preferred dividends are to be treated in the same manner as interest on bonds. This provision applies only to public utilities (and with some limitations), that is: gas, electricity, street railways, etc., companies; but does not apply to railroads. Railroads as a group have made very little use of preferred stock, and in general public utilities have made less use of this type of security than industrials. The reasons are not entirely clear as to why this group of companies was singled out for the application of such a procedure rather than including all corporations.

It is becoming increasingly evident to students of corporation finance that preferred dividends have many of the same characteristics as bond interest. The corporation which cannot meet its preferred dividends, be they cumulative or non-cumulative, suffers very greatly in general prestige, and credit standing. In some cases corporations have unduly strained their financial resources in order to pay preferred dividends so as not to suffer the consequences of the nonpayment of such dividends. It would seem that this provision may be a step forward in giving recognition to what seems to be an existing condition. There is, however, some question as to why such a provision should be limited to only one type of corporation.

Carry-over and Carry-back Provision for Losses

We come now to what is probably the most significant new provision in the Revenue Act of 1942. In fact, there are really two provisions of a very similar nature. These two provisions are the carry-over and carry-back procedures in computing both the corporation's normal earnings, as well as its excess profits. The carry-over provision is not new; so that in a sense it may be said that only half of these provisions in the new Revenue Act were not included in the previous one. The new provisions, however, when added to the old ones, seem to indicate so clearly the intent of the provisions that we may be

justified in speaking of them as important steps in corporate tax procedure. At this point I would like to say that I consider them important *forward* steps in corporate tax procedures. But let us work up to this conclusion with greater care.

Taking the carry-over and carry-back provisions as applied to normal earnings, let us see how they work by simple illustrations. Assume that a corporation has the following earnings record over a five-year period:

1941—$ 50,000 loss
1942—$ 75,000 net income
1943—$150,000 net income
1944—$ 75,000 loss
1945—$100,000 loss

The carry-over provision refers to the two years previous to the year for which the tax is being computed. For example, in computing the income for which the corporations will be expected to pay the normal tax for 1943 any losses in the previous two years will be carried over as an offset. If, of course, the loss in our illustration in 1941 had been used as an offset to the profit of 1942, then it could not be used again as an offset for 1943. In other words, for the first three years (1941, 1942, and 1943), the corporation will pay a tax on $175,000. The carry-back provision works in a similar manner, except that the earnings of a company in any given year, and hence its taxes on these earnings, may be recomputed and a tax refund requested if losses are suffered in either or both the subsequent two years. In the illustration shown the net earnings for the five year period is zero. In other words, the two years earnings of a total of $225,000 are exactly offset by three years losses of $225,000. Although it would have been true that taxes would have been paid in 1942 and 1943, a refund could be asked upon the entire amount paid as soon as the 1944 and 1945 losses were known.

So much for the details of applying the carry-over and carry-back provisions. The most important consideration as far as we are concerned is the desirability of such a feature. It will be recognized that such a provision serves as a sort of

"moving average" for the computation of earnings. Had these provisions not existed, the corporation in our illustration would have paid sizeable tax amounts in two of the five years, and no taxes, and likewise no refunds, in the other three years. Especially for corporations which tend to have fluctuating earnings, the importance of this feature cannot be overestimated.

We can probably agree that the very maximum limit to which tax provisions should go is to take all earnings in excess of a reasonable return on capital investment. There will be considerable controversy as to just what constitutes a reasonable return just as there now is in the public utility field, but there can be no significant criticism of such a tax policy so long as investors are assured a reasonable return. Under former tax provisions the investors in this corporation's securities might have received a reasonable return in two of the years, but no return in the other three. The carry-back and carry-over provisions as applied to the computation of the normal earnings of any given year, of course, in no way assure the corporation of a reasonable return. The same provisions, however, also apply to the excess profits tax, and the application here would seem to be even more important.

Carry-over and Carry-back Provisions for Excess Profits

It is probably not necessary to give another illustration of how the carry-over and the carry-back provisions are used in the computation of the excess profits tax. The same figures we have previously used could be taken to indicate the amounts above or below the corporation's normal profit. In other words, the $50,000 figure for 1941 would indicate that the corporation failed by $50,000 to earn a normal profit, and the 1943 figure could be taken to indicate that the corporation earned $150,000 of excess profit. Here again, therefore, we can say that over the five year period the corporation would pay no tax on excess profits. (True, it would have paid them during several of the years, but could ask for a refund of a like amount during the later years since the total for the five years is zero.)

So far as the excess profits tax is concerned, when it is administered in this way the corporation is assured of normal earnings as long as its earnings, as a minimum, *average* the normal amount. Thus a corporation may be paying some excess profits tax each year; but unless it experiences a period of more than five years when there are total net earnings of less than the normal earnings amount, it will be able to report normal earnings for the period. This would seem to take away much, if not all, of the importance of the criticism that corporations must be allowed to earn more than normal amounts in given years in order to provide for years of subnormal earnings.

One of the difficulties, however, is that the amount of earnings which have here been referred to as normal are also subject to a tax, so that the question arises as to whether or not the corporation receives a reasonable return on its investment if most or all of its excess profits are taken and at the same time it is asked to pay a tax on its normal earnings. This brings us right back to the point taken up earlier; namely the question of whether it might be wisest to eliminate the tax on normal or reasonable earnings, and to take 100% of excess profits. Thus we are ready to give our summary and conclusions concerning corporate tax provisions as they now exist.

Summary and Conclusions

The two principal tax provisions now applied to corporations are the 40% tax on normal earnings and the 90% tax on excess profits. Our fundamental problem is to secure as much revenue from the corporations as possible and at the same time not to tax them to an extent which will prevent their owners from securing a reasonable return upon investment. (What may be considered as reasonable during wartime may differ materially from the concept of reasonableness during peace-time.) It would seem to the writer that rather than the imposition of a 90% excess profits tax and a 40% tax on normal earnings, it would be better to eliminate the normal earnings tax and take 100% of excess profits. In doing this, the normal earnings could be redefined, if that seems

necessary, to include a reasonable return on capital investment. (In other words, as the term normal is now used, it may include the expectancy to pay some taxes. If this be true then the amounts of earnings upon which no tax would be paid should be lowered so as to include only a reasonable return upon investment.) In this way the corporation could be assured of receiving a reasonable return; but under the present law it is not so assured. Corporations are probably not interested in making large war time profits; at least they are resigned to the fact that war time is not the appropriate time for them to show large profits. However, in order not to destroy their willingness and eagerness to go all-out for the war effort, it is necessary that they be assured of a reasonable return. It is realized,of course, that a definition of a reasonable return is hazardous, but no more so than an arbitrary definition of normal profits. Nor is a reasonable return any more difficult to define for industrial corporations than for public utilities. In this latter field we have been defining a reasonable return for a number of years. One method of determining the corporation's excess profits is to base it upon the percentage which the earnings are of the company's capitalization. If corporations were not given the alternative of using 95% of their average profits between 1936 and 1939 as a base for determining normal earnings, we would probably already have a guide for determining a reasonable return.

The writer is aware that there is always danger in discontinuing any tax because the imposition of a new tax or a higher tax inevitably brings some criticism. Corporations usually become resigned to the types of taxes they have paid for a number of years. This does not seem to me, however, to be a sufficiently strong argument to warrant the retention of any tax which may work inequities. So long as we are taxing only a relatively small amount of the corporation's income, the wrong type of tax may not be so important; but when we reach the point which we have now reached, or at least are fast approaching, of taking about all which can be taken from a corporation and still permit it to survive, we must more closely scrutinize our tax provisions. I, for one, would be in

favor of taking all earnings other than the lowest return on capital investment which would seem to keep industry alive and vigorous in its productive effort. The present provisions may do this in some cases, allow extraordinarily high profits in other cases, and in still other cases permit the corporation less than a reasonable return.

The carry-over and carry-back provisions relating to corporation losses and to the computing of excess profits are definite forward steps in the application of taxes to corporations. Only the latter are new in the Revenue Act of 1942. These provisions make it possible to tax corporations to the very limit because it permits them to "average out" their tax base over a maximum period of five years. These provisions would seem to be added reasons for taking all profits beyond the point of a reasonable return upon capital investment.

Other important provisions of the Revenue Act of 1942 include the 80% maximum tax on total earnings which would seem to have been included in order to prevent gross inequities in the application of the other provisions. In other words, it seems to be an admission that the other provisions may work hardships. To permit a maximum of 80% of the profits to be taken, in no way, of course, assures the corporation of a reasonable or normal return. The 10% refund of the excess profits tax will no doubt be helpful to corporations during any depression which may follow the present period of expansion. Another provision, closely related to this one, gives an advantage to corporations reducing their indebtedness. The advantage results chiefly from the permission to disregard as income any difference between the cost to the corporation of retiring the bonds and the price at which they are carried on the books of the corporation. The treatment of dividends on preferred stock as a deduction from earnings for public utilities may have considerable merit but if it does, it would probably have equal merit for other types of corporations.

For the sake of completeness, there are several other provisions which have not been mentioned up to this point but which may be worthy of note. One is a revision of Section 102 which relates to an increase in the surtax if an undue por-

tion of earnings are withheld from the corporation's stockholders. The new provision states that any such additional tax is limited to the normal income and specifically excludes income subject to the excess profits tax. In administering the capital gains provision the new law treats any gains or losses from the sale of real estate (land and buildings) as an ordinary gain or loss, except that the entire gain may be classed as a capital gain if the property has been held more than six months.

"Economic Position of the Cigar Leaf Tobacco Industry in Lancaster County, Pennsylvania"

BY WILLIS N. BAER

Introduction

This study was undertaken for the purpose of discovering what factors tend to determine the economic position of the cigar leaf tobacco industry in the Lancaster, Pennsylvania, area and to evaluate those factors in terms of their economic significance. The study centers about the economic welfare of the producers in terms of monetary returns. Although the economic welfare of the producer depends in part upon the economic welfare of the manufacturer of cigars and of those who consume the manufactured product, it was not the purpose in this study exhaustively to develop this aspect of the problem. To do so would require a difference in analysis and development throughout the study.

The study was confined to ten and twenty year periods because many of the needed data were not available for earlier periods and also because of time for the task at hand was limited.

Any departures from recognized methods of research must be attributed to the personal limitations of the investigator. The method used is both statistical and descriptive; however, the purpose of the descriptive data is secondary to the main object of statistical procedure.

In several instances the figures which are used were taken from or based upon state and federal sources. Those pertaining to the Lancaster, Pennsylvania, area are based upon the above sources, but have been rearranged and regrouped.

Those figures pertaining to production costs and returns per acre do not warrant a final word of exactness. These data do not take account of individual variations and in this sense do not give due credit to the most efficient scientific producer

whose value of product and cost of production per acre would vary considerably from the average figures used in this discussion.

I have not included as a statistical part of the study the variations due to changing price levels as they affect the purchasing power of the producer. I wish, however, to recognize that this has a bearing upon the economic welfare of any industry and as a general truth is accepted.

The study is confined to the Lancaster, Pennsylvania, area and in so far as other areas have been discussed it has been because of the relation they bear to the main purpose of the study. Tobacco cannot be grown successfully except under certain soil and weather conditions. The Lancaster, Pennsylvania, area is unique in this respect. The Miami river valley in Ohio is the only other domestic geographical area in which filler tobacco is grown in large volume; but even there soil conditions, methods of farming, and methods of marketing are not the same as in Lancaster County, and thus would be a subject of sufficient importance for a separate study.

In terms of a general plan I shall first define the underlying concepts as they are used; that is, what is meant by "the industry," the "economic position," and "cigar leaf tobacco." I shall then attempt to answer the question of economic welfare in terms of monetary returns as resulting from the following formula: volume of pounds times margin between cost and selling price per pound.

The various steps leading up to this summary include production methods and trends in the Lancaster and other domestic areas, the relation of trends in consumption of cigars and, leaf tobacco in the hands of dealers and manufacturers, to economic position and welfare, and the relation of marketing methods and trends in prices received by the grower to the problem of economic position and welfare. In the concluding section the position of tobacco production in relation to alternative farm crops in the same area is examined.

The production trend is considered in relation to all filler tobacco grown in the United States. Also production trends in binder and wrapper production areas because of their

indirect relation to filler tobacco in the tobacco manufacturing industry. Under production for the Lancaster area I took up more specifically such determining factors as crop rotation, fertilization, and production costs.

Consumption of filler cigar leaf is considered in terms of cigars released for consumption both as to total quantity and each class, particularly Class A cigars, and the relation of cigar consumption to the trend in cigarette consumption. Trend in quality of leaf tobacco in the hands of dealers and manufacturers is compared with quantity produced. The marketing process and its bearing upon prices as well as the trend in prices received by the producer is evaluated.

The study of tobacco production in relation to other farm crops grown in the same area is particularly important because the producer can by such information direct production according to his best interests.

Now as to the definition of concepts used in the study. An industry is defined as any branch of art, occupation or business especially one which employs much labor and capital and is a distinct branch of trade. The entire field of industry includes extractive, manufacturing, carrying industries; the element common to all is the value of the product created or the service rendered. The chief purpose of industrial work is to create money value—the act of producing goods that can be sold for which a sufficient price will be paid. Agriculture is an extractive industry. Extractive industries create a value of acquisition or possession. Agriculture produces a produce, it takes from the soil a product. An industry then as here used is the process by which the resources of nature are transformed through human effort into services and commodities available for use of which production is the basis, exchange and distribution derivative and contributing factors.

By the economic position is meant the position of the producer in terms of money income as payment for land, labor, capital, management; the income accruing or coming in over a period of time in terms of pecuniary measurement giving an exchange command upon goods and services. The economic position is considered throughout from the standpoint

of being favorable or unfavorable. The emphasis in this respect is upon the position rather than the economics as it might be developed in terms of economic theory.

Now as to the term cigar leaf tobacco as here used it is important to distinguish first between the general use of the term tobacco as applied to a certain commodity in all its various aspects from the raw stage to the ultimate consumer (being green or uncured, cured, sweated, or fermented) and in its final stage in the form of cigars, cigarettes, snuff, and chewing tobacco.

I have used the term as applying particularly to tobacco used for cigar purposes, with special emphasis upon that kind of cigar leaf tobaccos used as a filler in the cigar manufacturing industry as opposed to that used for binder or wrapper purposes. It may be completely stated in the following terms: *filler cigar leaf tobacco*: filler opposed to wrapper or binder; cigar opposed to cigarette; leaf tobacco opposed to tobacco that is manufactured into a form for final consumption.

The basic concepts were used throughout the study in the sense indicated by the above definitions.

Part I

Production of Cigar Leaf Tobacco and its Bearing upon Economic Position

Ten year average production
Lor Lancaster Co.____46,545,000 lbs.
For Pennsylvania_____54,900,000 lbs.
For all filler in U. S.__90,024,000 lbs.
Per cent of county to U. S. filler production—52.5%

All filler production trends for U. S. declined from 11,000,000 lbs. in 1920 to 67,718 lbs. in 1927. Lancaster County production remained practically uniform around 47,000,000 lbs. during this period. Over twenty year period Ohio filler production declined about 36,000,000 lbs. during the same period Lancaster County production increased about 18,000,000 lbs. The variation in wrapper and binder tobaccos followed the trend of Pennsylvania production during the twenty year

period. This created no unfavorable position for Lancaster County filler tobacco.

In terms of acres under cultivation, yield per acre total yield in pounds and total value the ten year average for the Lancaster, Pennsylvania, area was 34,421 acres, 1,354 lbs. per acre, total yield 46,545,000 lbs. Total value $6,994,000.00.

Relative uniformity in number of acres and yield per acre in pounds is partly due to the system of crop rotation and the practice of feeding livestock extensively, particularly steers. From forty to fifty thousand head of steers are fed annually. This assures soil fertility conservation through the using of plant food again and again in the form of barnyard manure. A feed composed of cottonseed meal, bran and corn produce a manure highly adapted to raising tobacco.

Uniformity in production methods contributes toward a uniformity in quality, a factor of particular importance to the manufacturer who requires a uniform product in order to continue brands of cigars containing this filler.

Methods of culture were then briefly discussed as a background for the cost analysis study which follows.

The cost of production was broken down into man labor, horse labor, tractor labor, rent of land, use of machinery, fertilizer (including barnyard manure), taxes and insurance, cash expense, and contract labor—the total equaled $146.74 per acre as of the year 1926, less a deduction of $5.00 per acre for the value of the tobacco stems returned to the land. Man labor was charged at 30c per hour; horse labor at 25c per hour; tractor and operator at $1.15 per hour; rent and buildings at 5% of the investment; use of machinery—depreciation, repairs, and interest on investment at 5%. Manure was figured at $2.00 per ton, one-half charged to the crop to which it applied. Cash expense included lime and other items not otherwise listed. Taxes and insurance were counted on a proportional basis. Cost of production over a seven year period averaged $146.42 and ranged from $159.23 in 1923 to $135.82 in 1925.

The average yield per acre for a seven year period was 1,337 pounds; the average price received per pound about 15c;

the average cost of production $146.72; and the average return per acre in dollars $186.73.

Part II

The trend in cigar consumption was next analyzed as indicated in the statistics released by the U. S. Treasury Department, Bureau of Internal Revenue. This classification is given in terms of classes A, B, C, D, E, cigars. The classes are based on the retail price of the cigars ranging from not over 5c for Class A cigars to over 20c each for class E cigars.

The general trend in cigar consumption was found to be downward amounting to a decrease of 700,000,000 from 1909 to 1928. However, the trend in Class A cigar consumption from 1919 to 1928 increased from 1,363,000,000 cigars in 1919 to 3,213,000,000 cigars in 1928. Pennsylvania filler tobacco is used almost exclusively in Class A cigars. This indicates a favorable position for Pennsylvania filler tobacco from the standpoint of consumption of cigar trends. The phenomenal growth in cigarette consumption during this period from 50,000,000,000 in 1919 to over 100,000,000,009 in 1928 is a factor generally recognized as unfavorable.

As to the stocks of leaf tobacco in the hands of dealers and manufacturers, the amount on hand in 1928 was near the low point for the ten year period considered. This indicated no significant surplus, which from the standpoint of the producer was economically favorable.

Part III

The significant deduction from the marketing data is that the conditions had changed from that of a competitive market to one in which a monopoly from the standpoint of demand dominated the selling so that by 1928 over 70% of the entire crop was purchased by three large cigar manufacturing corporations one of which bought over 40% of the entire crop. The jobber and wholesaler of leaf tobacco were largely eliminated by 1928. The grower's bargaining position was further affected by the tendency of the buying corporations to divide the buying territory among themselves so that the price is fixed within narrow limits and tends to be uniform regardless

of difference in the quality of the tobacco. Buying takes on the nature of an annual one price offer to each growth at an amount determined by the corporations themselves.

The ten year average price paid the grower was 15.6c per pound, and varied from 22c per pound in 1922 to 10c per pound in 1925. I have concluded that although it is not possible to know what prices would prevail under a marketing process of freer competition it seemed doubtful that a generally higher price would have been realized.

At this point I make an observation based on 10 years' data for production, price paid to the grower, and Pennsylvania tobacco in the hands of dealers and manufacturers. When considered, the price paid the grower seemed to vary with quantity of leaf tobacco on hand rather than the amount produced from year to year. Supply in the hands of growers instead of determining the price they received seemed rather to increase or decrease as a result of price received. Price in the long run thus affected supply and was determined rather by demand as reflected in the quantity of leaf tobacco in the hands of dealers and manufacturers.

The next consideration is the relation between selling price and cost of production per pound. Taking the figures for a seven year period 1921-1928 the seven year average price received per acre was found to be $186.73 reducing this to the price received per pound by dividing it by 1337 pounds, the average yield per acre, I found the average price to be 13.96c per pound. On the other hand the average cost per acre for the seven year period namely $146.42 reduced to cost per pound was found to be 10.95c per pound. The net margin for the seven year average being 03.01c per pound. In terms of net profit per acre the results were $53.50 in 1921, $75.10 in 1922; $87.78 in 1923; $13.60 in 1924; $4.88 in 1925; a deficit of $9.74 in 1926; a profit of $57.07 in 1927; and a profit of $105.58 in 1928. Reducing the figures for 1928 to a cost and selling price per pound basis the margin of profit was 18c less 10.4c or 7.6c per pound.

In conclusion, production in the Lancaster, Pennsylvania, area indicated a gradual increase in net volume; Ohio

production showed a decided decrease; consumption of Class A cigars had increased favorably; stocks of leaf tobacco on hand had decreased. Thus from the standpoint of volume, the situation was economically favorable. Likewise the return in terms of margin of profit per pound was favorable. Combining the two—volume produced times margin of profit per pound—we had the answer in terms of our problem completed. Both in volume and margin of profits per pound a favorable trend was evident.

Part IV

The concluding part of the study was a consideration of the economic position of the grower in terms of return per acre of tobacco to the other farm crops grown in the same area. The alternative farm crops considered were those which appplied to general farming and were pertinent in the area included in this study. The alternative farm crops considered were corn, wheat, hay, and potatoes. The following results were derived: (on the basis of a ten year average).

	Acres	Per Acre Yield	Total Produced	Price Per	Value in Dollars	Value Per Acre	Cost Per Acre	Profit Loss Per Acre
Corn	98,271	55.2	5,412,000 bu.	$ .909	4,893,400	50.00	41.86	+ 1.68
Tobacco	34,421	1354.	46,545,000 lbs.	$ .156	6,994,000	211.70	146.42	+40.31
Wheat	110,655	23.7	2,594,500 bu.	$ 1.39	3,621,300	32,58	30.76	— .61
Potatoes	11,335	1.13	1,293,600 bu.	$ 1.20	1,426,000	123.57	129.44	+ .49
Hay	107,473	1.58	170,661 ton	$18.79	3,131,100	29.36	21.48	+ 5.66

From the comparative study we may therefore conclude that there is no alternative crop which would give a return per acre equal to leaf tobacco and that it exceeds by far all other crops,—the nearest being hay with a return of $5.66 per acre, tobacco having a net advantage of $34.65 per acre.

Research in Rural Taxation---- South Dakota

BY MORRIS J. ANDERSON

From September, 1934, down to the present date several research projects have been outlined by the Department of Agricultural Economics at South Dakota State College designed to guide study of specific taxation problems in South Dakota. The most recent tax study undertaken is designed (1) to investigate the possibilities of improving the assessment of agricultural real estate through land classification, and (2) to determine the extent to which it would be passible to economize in public expenditures by reorganizing local civil units.

Because of the increase in the proportion of publicly-owned land in many counties of South Dakota from 1935 to 1942, and the subsequent narrowing of the tax base, levies on the remaining real estate became increasingly burdensome. In some counties increases of 50 per cent in tax levies on the property remaining on the tax rolls have occurred. This condition has been improved somewhat as farm income has increased during the past eighteen months, but fundamental ills still exist. In this study attention is being focused upon these basic problems.

Purposes of the Study

Every industrialist, every business man is faced with the necessity of increasing efficiency in operation. Efficiency in government is no less important. Constant attention to increasing the efficiency of government is necessary because of the ever changing nature of governmental problems. Even the most public-spirited citizens and public officials frequently find it difficult, if not impossible, to assemble the needed data for a study of taxation because of the time and expense involved. The principal purpose of this study is to perform that function, with special reference to those aspects of taxation affecting agriculture.

Population shifts have created new problems of organization and finance for many school districts,—largely because a few urban centers have gained population, and many rural areas have had their school population reduced to an uneconomically small number of pupils.

In order to give South Dakota the best and most efficient educational system within the limits of available resources, and in order to enable the schools to offer the maximum service in the present national emergency, data as to the present situation must be gathered and analyzed, and plans for improvement proposed.

Objectives of Research

(1) By the use of such data on farm income as are available, to determine the extent to which present assessment levels conform to the legally-prescribed "true and full value" assessment standard.

(2) To analyze the possibilities of attaining equitable assessment by means of land classification.

(3) To determine the extent of the relief to agricultural land brought about by the apportionment of income, sales, and severance tax revenue among local units of government.

(4) To determine the possibility of economizing in public expenditures by reorganizing local civil units without sacrificing essential services.

(5) To reveal the possibility of equalizing local educational costs and opportunities by means of alternative plans for financial support.

(6) To reveal as clearly as possible the agricultural aspects of general property taxation and to determine the relative burdens of farm real estate and other classes of tangible property.

(7) To assemble factual data concerning the relative degrees of success in the attainment of equitable assessment under the county assessor and the locally-selected town or township assessor systems now in operation in South Dakota.

The Association Concept of Corporate Income For Tax Purposes

BY RUSSELL BOWERS

As the portion of national income taken by the federal government increases, greater attention should be given to the question of an equitable income tax base. A federal constitutional amendment was passed in order to legalize the taxation of persons according to their income, yet the income statutes have not resulted in a true personal tax based on a comprehensive definition of personal income. Without the application of a comprehensive definition of personal income, the taxation of persons is likely to be inequitable. The relationship of the stockholder to a corporation is one cause of inequitable income taxation.

The association concept of the corporation for income tax purposes offers a possible solution to the present inequitable income tax as it relates to corporations. The corporation could be looked upon as a productive agent, as in fact it is, and not as a person. Accordingly the income tax would be removed from the corporation as such save at low rates. The stockholder would then be required to report as income his equitable share of the corporate income. This would result in a tax burden on the individual at his appropriate individual tax rate. Corporate dividends of any kind would not be reported as income.

A corporate dividend receipt does not come within any generally satisfactory definition of income. Corporate earnings and dividend policies are often very irregular. Unless the earning of corporate income and the payment of dividends are in phase, the stockholder is often required to report a dividend as income when it is in reality a return of capital. The stockholder often buys in addition to the face value of his stock an interest in corporate surplus to which the dividend is charged. Rarely do buyers and sellers of stock possess sufficient knowledge for properly discounting, in the price of the

stock, future dividends which will be paid and charged to accumulated surplus.

On the other hand, corporate income may be substantial in absence of a liberal dividend policy. In this event, the corporate tax is not consistent with the individual's taxpaying capacity. Stockholders with small incomes share an equal burden with those with higher incomes. Both bear the corporate income tax according to their holding of stock rather than according to their respective individual financial statuses.

Present methods of taxing corporate income are discriminatory as regards financial structure. Net corporate income available to stockholders is used as a tax base, but the share of corporate income available to bondholders is excluded. This feature would seem unnecessarily to encourage the raising of capital through the sale of bonds which require fixed interest charges instead of through the sale of stock which has a contingent claim on corporate income. The economic effects of this are difficult to trace. It might be contended that if all corporate income were included in the corporate income tax base, the nature of the bondholder's contract would result in shifting the tax to the stockholder anyway. This apparent objection, however, might be settled more equitably by lowering the tax rate while extending the tax base to include corporate income available for both dividends and interest.

In considering the association concept of the corporation for income tax purposes two somewhat different problems are presented. One is the accounting problem; the other is the collection of the tax. The two are not entirely separate because of the problem of valuation. An affirmative attitude toward the proposal would seem to require a difference in methods of valuing active stocks and inactive stocks. The former might be valued at market; and the latter might be valued at cost initially, and subsequently adjusted for corporate income, losses, and dividends.

The character of the accounting problem may be somewhat clarified by considering the bookkeeping entries required. Assume a share of stock, par value $100, for which the issuing

corporation has a surplus of $10 per share. The share is purchased at $85. Whereupon the buyer will make the following bookkeeping entries.

X Co. Stock—Par	100.	
X Co.—Equity in Surplus	10.	
X Co. Stock—Market Discount		25.
Cash		85.

Next suppose that at the end of the first fiscal period corporate income is reported as $5 per share. In the meantime the market price of the actively traded share has risen to $100. Income of $15 is recorded as follows:

X Co. Stock—Market Discount	10.	
X Co.—Equity in Surplus	5.	
Income		15.

Next assume a dividend of $3 is distributed. The stockholder simply debits cash and credits his account *X Co.—Equity in Surplus,* there being no loss or gain because of a dividend.

An important accounting problem may be raised with respect to the accuracy of determining the corporate income. Difficulty is often encountered in allowing sufficient depreciation charges. At present this fact no doubt explains why not all "accumulated surplus" or "income" is considered available for dividends. This argument, however, is not an objection to the association concept. On the contrary, a discussion of the association concept should focus greater attention upon present inadequate accounting for corporate income. Pending more satisfactory practices in the measurement of corporate income this question might be answered allowing a so-called reserve for contingencies of a fixed per cent of the computed corporate income. The real nature of such a reserve would be an allowance for a margin of error in the determination of corporate income.

The second major problem concerning the association concept of corporate income for tax purposes lies in the liquidity status of the investor's increment when it comes to paying the tax. If no dividends are paid the stockholder receives no funds from the corporate income source with which to pay the tax. Several replies may be offered to the question

of liquid funds. If the corporation correctly reports income there is ordinarily no valid objection to the payment of a dividend sufficient to assist the individual in the payment of the tax. In the case of actively traded stock the required liquid funds are available at advanced prices in the market. The fraction of total holding required to be sold would usually be very small. Again, in special cases the government could extend credit to the taxpayer. A judicious plan could be administered with interest charges possibly at graduated rates, varying with the length of time involved.

In the case of large holdings the stockholder often has a material influence in determining dividend policy. Moreover the normal individual tax could be collected at the corporate source. This normal tax could with very little injustice be borne by all stockholders alike. Such a provision would solve the tax payment problem entirely for the numerous stockholders of small income. The problem would then be confined only to small holdings of stock by individuals who have large incomes from other sources. Then finally, with the corporate income tax removed, larger dividend payments are possible.

The application of the association concept of corporate income for tax purposes would give rise to many new problems and the importance of these should not be minimized. One new administrative problem concerns the desirability of staggering the individual taxpayers' fiscal years in cases where stock is valued at market price. This might be more difficult than that of "tax sales" which the new plan would be expected to eliminate.

Recently we have seen many changes in business, economic, and governmental policies. Not many years ago we were told that a tax on individual incomes was not practical. Now our efforts are directed only toward a more equitable administration of the income tax.