1. Debits and Credits

In March 1935, when the stock market began a year-long climb, a fear of inflation was voiced by many leaders of the business community. In some cases the fear was conjured up from memories of what had happened in 1929. In others it was engendered by political motives alone.

This was the year before the Presidential elections of 1936, during which all weapons, including a boomerang, were used to attack the Administration. Those who sought its defeat could say that the Administration's spending program was responsible for the "dangerous inflationary tendencies in the stock-market rise." If the nation was to be spared a collapse of the 1929 variety, then the spending program would have to end. And it could only end by removing from public office all those who were responsible for the offensive program.

While the politics of the hour was the affair of other men, the analysis of economic facts was mine. In November 1935, at the meeting of the American Bankers Association in New Orleans, I joined the discussion then current. Inflation, I suggested to the bankers, implied a state where an excess of dollars competed for a limited amount of goods and services on the existing market. Clearly no such condition existed when the labor supply was many millions in excess of any effective demand for it, or when the capacity to produce goods without any expansion of plant facilities was far in excess of consumer purchasing power.

As a passing comment on the address of Orval W. Adams, who called on the bankers to boycott the government and thereby end the program of government spending, I continued:

The bankers above all have been the beneficiaries of the Government intervention. The Government alone could and did replenish the supply of deposits when individual borrowers were lacking and when banks had no other profitable outlet for their funds than the investment in Government securities. Banks bought Government securities, not because of compulsion, but because they had no other avenue of profitable investment.

Those who talk about boycotting Government bonds suggest to me a drowning man to whom a life line is thrown out but who objects that it is an interference with his individual right and liberty to drown.

The achievement of a stable, orderly economic progress, free from violent extremes, and conducive to maximum productivity and distribution, involves neither a regimented nor a restricted economic order. It calls for Government intervention only to the extent that the exercise of Governmental authority affecting monetary and budgetary factors may be a stabilizing and corrective influence in an individualistic, capitalistic system when it, left entirely to itself, generates distortions, lack of balance, and cyclic extremes. The Government must be the compensatory agent in this economy; it must unbalance its budget during deflation and create surpluses in periods of great business activity.

Neither this address nor others like it silenced the critics of the Administration. Moreover, the fear of inflation, fed by a year-end spurt in the stock market, took hold of more and more minds. In the midst of this, Charles R. Gay, head of the New York Exchange, tried to throw on the Reserve System all responsibility for controlling the stock boom. On returning to Washington from the bankers' convention I felt it was important to make a second attempt at defining what we faced. With the approval of the Reserve Board, on November 22 I restated my conception of inflation; distinguished between it and a stock-market inflation; noted that the rise in security prices was being financed not by bank credit but by cash; denied the charge that the Reserve Board was indifferent to the presence of "unsound conditions" in the stock market, but at the same time pointed out that the Board had only limited powers to deal with events in that quarter.

The aftermath of these words is told in captions over articles financial experts wrote for their newspapers in the next few days:

ECCLES TURNS STOCK TREND TO BULL SIDE.

HANDS-OFF POLICY TAKEN IN STREET AS FAVORING FURTHER SPECULATION AND PRICES SOAR AGAIN.

RAILS REACH NEW HIGHS AS ALL GROUPS CLOSE FROM 1 TO 5 POINTS UP.

ECCLES HOLDS TO "HANDS OFF" IN STOCK BOOM.

WALL STREET PUTS ECCLES ON ITS SIDE.

WALL STREET FEARS POSSIBLE ENCOURAGEMENT TO SPECULATIVE RISE IN STOCK PRICES.

ENCOURAGEMENT OF BULL MARKET SEEN IN DISCLAIMERS OF RESPONSIBILITY BY OFFICIALS: ACADEMIC DEFINITION OF INFLATION BY ECCLES MAKES RESERVE BOARD'S ATTITUDE SEEM DISTURBING.

Even *The New Yorker* in late November had something to say on the subject:

Mr. Eccles sees no reason to put a stop on the stock market boom, because it is mostly a cash-and-carry business. After its unfortunate experience with pigs, the government has decided not to shoot the bulls.

I had not meant to be a bull or a bear. I simply meant to state a few facts. But I read to my dismay that what I had said was "reminiscent of former days when spokesmen for previous Administrations came to the support of the stock market on some of its most disastrous days." I was associated "with President Coolidge's unfortunate remark that the volume of brokers' loans for stock market purposes appeared to be not too high" and that "this was the first time a high government official had given his blessings to the stock market." And more of the same kind.

Roosevelt read the same papers. Having often before mocked the misguided assurances of his predecessors regarding stock-market activity, he was naturally sensitive when the head of the government banking agency made a bullish statement at a time when security prices were rising and Wall Street was in an enthusiastic mood. He could admit privately that there was no resemblance between stock-market conditions in late 1935 and those which preceded the crash of 1929; but as a political leader he had to respect the taboos of his craft. On December 3, 1935 he sent me the following note from Warm Springs:

> I have read your press statement of November 22nd and I think it is entirely sound.
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> We must remember, however, that there is real danger in any statement relating, even remotely, to actual stock market operations. This is where Coolidge, Mellon and Hoover got into such trouble.
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> A word to the wise!

The word *from* the wise was heeded in the future.

As Chairman of the Board of Governors of the Federal Reserve System, I could not take part in the political campaign of 1936, though there were suggestions that I do so. It was felt that since the government's spending and lending program was the campaign issue, as one who had helped sell that program to the Administration I should get out and defend it when it came under political siege guns. But Roosevelt agreed with me that such action would be highly inappropriate. It would violate the organic conception of the Board of Governors as an independent agency of the government, whose members were chosen on a nonpartisan basis for the nonpartisan purpose of helping to maintain stability in the nation's economy.

I quickly add that the outcome of the election would have been unaffected one way or the other by either my silence or my volubility. The Democratic victory was based on figures of this sort which were more tangible stuff than talk:

The net increase in the debt from the time Roosevelt took office in 1933 until June 1936 was $7 billion, exclusive of the stabilization fund. This figure was about equal to a month's national income in 1928–9, with the total carrying charges on the debt amounting to about one per cent of the national income then current.

As against this debt, the national income in that same period rose from approximately $40 billion to $60 billion, an increase of $20 billion. Stocks on the New York Exchange increased in value by $35 billion. Listed bonds increased in value by some $10 billion. The output of industry was sixty-five per cent greater than in the depths of the depression. The deposits of all commercial banks rose by more than $10 billion, so that the contraction in the money supply which occurred in the deflation was largely offset. Tax collections ran about $2 billion a year more than in 1932. Notwithstanding the increase in the public debt, some issues of government bonds, which sold as low as 83 in 1932, when the debt was $21 billion, were selling at 104 in June 1936. The corporations of the country, whose combined operations in 1932 reflected a loss of $3.75 billion as evidenced by their tax returns to the Treasury, were showing profits comparable to predepression levels.

But the volume of unemployment remained heavy. This was due, among other things, to an increase of between 3.5 and 4 million more new workers who came of employment age during the depression years. It was due also to the introduction of new labor-saving machinery, which increased the output per worker. But more particularly it was due to the fact that millions of workers who formerly worked only one or two days a week and yet were listed as employed had increased their work days to four or five and thereby forestalled the need of employers to hire additional men.

To the party politicians the degree of improvement that had been achieved was a source of deep satisfaction. It enabled them to win the decisive political victory of 1936. But to those of us who were more concerned with true economic balance than with political power, the continued presence of a large number of unemployed was a cause of grave concern. We knew that the federal government could not decrease its expenditures any faster than private industry was able profitably to take over the employment load; that any reduction in consumer buying power would retard if not reverse the progress of recovery. The flow of money had to be maintained and increased in an expanding economy, but it could only do so if private business as a whole disbursed its income. In so far as it failed to do so, the flow had to be maintained by government expenditures, either on the basis of deficit financing or by taxes on funds that individuals and corporations otherwise would accumulate and keep in idle pools.

Some nine or ten months before the November election the Treasury Department advanced the conception of an undistributed profits tax as one means by which idle funds could be pumped back into the nation's economy. The idea of such a tax had been under discussion for several years, but many factors brought the discussion to a head at this time. To begin with, there was the requirement of politics itself. In an election year the Administration felt the need to make some sort of show at closing the gap between federal income and outgo. Thus any talk of large planned deficits for the sake of achieving ultimate economic balance got nowhere. On the other hand, if the federal deficit was to be either reduced or left at the level then current, the only way this could be done, while at the same time meeting the needs of the unemployed, was by increasing the government income through taxation. But this alternative ran into difficulties of its own. Sales taxes of the kind that are regressive, or an increase in the normal tax on personal income, would reduce consumer purchasing power and thereby act as a damper on recovery. Furthermore, in an election year any such increase would stir up a violent political storm.

While these programs to reduce deficit financing were being examined, two unexpected obstacles were introduced by actions of the Supreme Court and the Congress. In early 1936 the Supreme Court invalidated the processing tax, which underwrote the costs of the Agricultural Adjustment Act. This represented a loss to the government of an estimated $500 million, which had to be made up from some other source to sustain the AAA program. At about the same time Congress passed the Adjusted Compensation Act, which provided for the payment of veterans' bonuses in 1936 instead of 1945. The annual carrying charge on this payment came to $120 million.

Thus an additional $620 million in revenue had to be supplied to offset both losses and costs that had not been contemplated when the 1937 budget had earlier been presented to Congress. Borrowing was ruled out for the political reasons already indicated. An increase in the schedule of personal income taxes was ruled out for economic as well as political reasons. A third alternative proposed at the time was that an effort should be made to rewrite the processing tax in a form that could stand up in the Supreme Court. But there were few adherents to this idea. Though Roosevelt added this Court decision to his indictments against the Nine Old Men, few people behind the scenes shed any real tears when the processing tax was knocked out. Apart from its legality, most of us viewed the tax as being a regressive revenue measure because it decreased consumer purchasing power. It was bad for that reason alone.

It was in this setting that the Treasury drew out its plan for an undistributed profits tax and gained the President's support for it. The Treasury's accent was on the added revenue that would be brought in, this being the President's immediate concern. Concurrently, with the help of several staff members of the Reserve Board, I developed a different version of the tax. I shared the Treasury's concern for revenue, but the primary emphasis of my own thinking was on the use of the tax instrument as a major device for achieving economic balance.

My intrusion at this time in the field of fiscal policy was to bring an acid comment from the *New York Herald Tribune.* It observed:

> This was the first time the head of the nation's banking system assumed the responsibilities of the Secretary of the Treasury. When the Secretaryship of the Treasury is permitted to go to seed as it has under Mr. Morgenthau, and when the head of the banking system is a man who loses no opportunity to appropriate any financial prerogatives that are not nailed down, the inevitable result is what we are now witnessing.

I have no doubt that Morgenthau was deeply offended by my actions; yet fiscal policy and debt management are of interest to the Federal Reserve System, just as monetary and credit policies, with which the System is primarily concerned, are of interest to the Treasury. As I have said many times in these pages, government spending, borrowing, and taxation exert a powerful influence on the volume of money and on its use by the public. Since the Federal Reserve System is called on to do what it can to maintain economic stability it has a vital interest in the fiscal policies pursued by the government. On the other hand, the Treasury Department, which borrows, taxes, and spends, must be assured that the Reserve System, within the limits of its power, will create monetary and credit conditions of the sort that will help the Treasury carry out its responsibilities. These should also be directed toward the maintenance of economic balance.

The following general ideas underlay my conception of the undistributed-profits tax:

High surtaxes on private incomes had the social objective of checking the creation of great fortunes. Yet this intention was frustrated by the well-to-do through the simple device of placing their incomes in a position where they would be subjected to the lower corporate tax. It was estimated in 1936 that if all corporate earnings were distributed as dividends, then the individual income-tax rates on the amount disbursed would yield added revenues of about $1.3 billion. On the other hand, if they were not distributed, then the proposed undistributed-profits tax would subject them to a higher tax than was previously possible on their uncollected income. By means of such a tax the people who benefited the most from the recovery program would pay more of its necessary costs.

Apart from what it would yield as a tax-revenue measure and what it would do to help check the growth of great personal fortunes, it would also help check the growth of huge aggregations of idle capital. The men responsible for these aggregations did not mean to use them for disruptive purposes; they meant only to pursue what they thought was in the best interests of themselves and their companies. Yet the total effect of what they did ran counter to the best interests of everyone, including themselves.

It was only human that the men who ran these corporations should want to build up big reserves. Stockholders could be told that the company was well managed, that it could weather any depression that might come along and meet all competitive situations. (A liquid cash position, incidentally, helped secure these men in their positions at satisfactory compensations.) But it so happened that the reserves that were built up in good times and were withheld from stockholders on the excuse that they were needed for bad times seldom were used when bad times rolled around. In the rainy day of the thirties, for instance, the excuse for not using the reserves was that no one knew how long the depression would last.

When you pierced the veil of this sophistry, the better reason why these accumulated reserves were withheld from stockholders could be readily seen. It was simply that the reserves were often used to extend a plant and buy up competing concerns. The capital accumulations enabled the directors of corporations who represented a negligible proportion of the stockholders to manage the financial and economic policy of the undertaking without let or hindrance from the numerous investors who were the real owners.

While it was therefore in the interests of equity and sound social policy to tax the undistributed earnings of corporations, such a tax would also facilitate the workings of a compensatory economy. Analysis of corporate reports showed that during the depression the larger corporations substantially reduced their debts and increased their current liquid position even though they suffered heavy operating losses. A study of the balance sheets of some 274 corporations indicated that their cash holdings, which comprised 7.6 per cent of the total supply of deposit currency in 1929, constituted 11.8 per cent of the total at the end of 1932. Subsequent to that date, a substantial part of the new money created through government financing went into the hands of these corporations and was not distributed by them. Individual and corporate demand deposits in New York and Chicago, for instance, were 42 per cent higher in 1936 than in 1929.

The depressing effect of these idle deposits radiated in several directions. They placed corporations in a position where they had no need to go to banks or the capital market for funds. To that degree they tended to nullify any attempts at monetary and credit controls by the Reserve System. In so far as the corporations drained off great portions of the government's newly created money, immunized it from taxation, and then failed to pump that portion back into the expenditure stream in the form of dividends or higher wages or lower prices, they forced the government to create still more money for the use of consumers—at the price of increasing the national deficit.

This, then, was the argument for the tax. Indeed, the argument holds greater interest for me than the subsequent history of the tax. Its history was an inglorious one and can be briefly stated.

The President's request for the undistributed-profits tax was sent to Congress on March 3, 1936, and was imbedded in a stated need both to raise $620 million in additional revenues and to simplify tax procedures. The details for doing this were contained in a Treasury formula that the House of Representatives first considered and in due course generally approved.

For my part, I did not approve of the Treasury formula. It seemed to me that it would fail to achieve the purposes set forth in the President's message. It would fail as a revenue measure because it proposed to repeal all existing corporate taxes and to use the undistributed-profits tax not as a surtax but as a basic taxing instrument. Moreover, the proposed schedule for the new tax was not high enough to induce corporations to disburse their income in the form of dividends that could be taxed under personal income schedules. It would fail to clarify tax procedures since it would apply to all corporate enterprises, large and small, instead of to the handful of corporations where the bulk of the undistributed profits lay.

I argued these points with Herman Oliphant, the Treasury's general counsel, and hoped to get Treasury acceptance of several amendments to its version of the tax measure. But Oliphant did not share my views. With Treasury blessings, the House sent an undistributed-profits tax bill over to the Senate. The Senate Finance Committee rejected the whole of it. With Senator Harry F. Byrd and Senator Walter F. George leading the opposition, the main charge raised against the tax was that it would place many corporations in a difficult position in the event of another depression since it would discourage the building up of surpluses in good years for the maintenance of dividends in bad years.

I have already examined the merits of this charge and need not dispose of it for a second time. Of the other points raised in opposition to the tax, it was said that it would discourage thrift. This could be answered by noting that a stockholder had no chance to practice thrift when his income was withheld from him. It was then said that the tax would curb operations in the capital market because investors would refuse to invest in companies that, in order to avoid heavy taxation, would be compelled to pay out a large proportion of future earnings in dividends. This could be answered by noting that there were no understandings between corporations and investors that any proportion of earnings would be undistributed and there were no indications that this factor ever influenced investors. Finally, it was said that the tax was less a revenue measure than a concealed attempt to redistribute the wealth. This could be answered by noting that the only tax system which could, perhaps, avoid that accusation would be one in which the same amount of revenue was paid by every person in the country, regardless of his income.

The opponents of the tax did, however, have a valid point when they said that it would give the larger corporations, which had already accumulated substantial surpluses, an advantage over the small corporations, many of which were still struggling to accumulate adequate working capital. I felt this objection could be met if, as I argued with Oliphant, corporations earning less than fifteen thousand dollars were exempted from the tax. If this exemption was made, between ninety and ninety-four per cent of American corporations would not have to pay the tax under the economic conditions that then prevailed. Payment would be limited to between six and ten per cent of American corporations. But if this exemption was given to the small corporation, it would require two further changes in the version the House had approved. First, the existing corporate income tax would have to be retained rather than repealed. Second, the schedule of undistributed profits, devised as something apart from the existing corporate tax, would have to be made considerably more stringent so as to avoid loss of revenue.

On May 11, 1936 I secured an appointment with the President. At this time I pointed out that the Treasury-backed House version of the tax would not meet the revenue needs he had asked for earlier. I also suggested to the President ways in which a few amendments could meet the more serious objections raised in the Senate Finance Committee. The upshot of this conference with the President was that my version of the tax replaced the Treasury version and became the Administration's bill.

When it was sent to the Senate Finance Committee, the forces headed by Senators Byrd and George pounced on it. This was just the beginning of a melee. Within the Administration Secretary Morgenthau felt aggrieved because my plan had been substituted for one developed in his Department. The chairman of the House Ways and Means Committee was aggrieved because the Senate Finance Committee categorically rejected his work. And meanwhile, in the Union Station, there were trains waiting to take both the Senators and the Representatives to the party nominating conventions. Congress could keep its appointment with politics only if the work of the Senate Finance Committee was quickly ratified. But this was going to require some drastic action when the committee itself could not agree on a tax bill. Senator Pat Harrison, as chairman of the committee, tried to pressure his way to a decision by threatening to carry the tax fight to the floor of the Senate if there was no agreement in his group. The fight would delay adjournment.

The response was a "compromise" tailored to the wishes of Senators Byrd and George and approved by a crushing majority of 18–1 in the committee. Since this represented an "agreement," Harrison was bound not to make a floor fight. The compromise, in my view, not only failed to meet the President's immediate objectives, but was a backward step in the growth of tax philosophy. It was of the sort that would penalize small corporations; make the cost of the corporate form of enterprise well-nigh prohibitive for small businessmen; constitute a departure from the principle of taxing according to ability to pay; permit wealthy stockholders to continue to evade their fair share of taxation; favor rather than check the growth of uneconomic bigness, and be ineffective in forcing more purchasing power into circulation.

In a note sent to the President on the morning of May 27, I showed how all this would result from the committee's tax bill. On the night of this same day the President called a meeting at the White House, attended by the Democratic members of the Senate Finance Committee. Senator Harrison sent word that he was ill, but Senator Joe Robinson, the majority leader, was on hand. Using all his arts of persuasion, Robinson tried to bind the conferees to accept the "Eccles Plan" as the basis for a new attempt to write a tax measure. In the bitter and acrimonious discussion that followed, Senator Hugo L. Black suggested a modification of my plan in the hope that it would be acceptable to people like Senators George and Byrd. But all that emerged from this session was an agreement that the Finance Committee would again consider the "Eccles Plan."

At its meeting the next day the Finance Committee remained unmoved. It clung to its original regressive tax measure, and it was without further change that the Senate, pressing hard for an adjournment, approved it. Unfortunately, very little could be salvaged in the conference committee that was to consider the Senate and House versions and write the final bill, because neither the Senate nor the House bill expressed what was needed. The result was a bill that was better than nothing, but not very much better. It at once became the target for attack throughout the nation. Force was lent to opposition voices in 1937 when those who claimed a need for "depression reserves" now could do so against the background of the recession, which seemed to support that claim. Other opponents of the tax could easily take the next rhetorical step and say the tax had brought on the recession.

For instance, in an appearance before a Senate committee investigating unemployment relief in January 1938, I was told by Senator Byrnes, the committee chairman, that he had sent a questionnaire to all the leaders of business, labor, and the press, and "with marked unanimity, certainly the newspaper editors and the business executives were of the opinion that one factor that contributed to the business recession was the fear on the part of capital or investors, and, in turn, that fear was due in great measure, to this [undistributed-profits] tax."

The answer to this charge was an easy one.

> I would like to point out [I said to the Byrnes committee] that we had this tax in effect during the last half of 1936 and the first half of 1937 when the activity of business in forward buying and in its general expansion would in no sense indicate that the tax deterred the rapid expansion that occurred.
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> To repeal the undistributed profits tax now, despite my disagreement with details of the tax, would have a deflationary effect. It would discourage the payment of dividends. It would encourage the payment of debts and the keeping of funds idle as rainy-day reserves. We do not want a reduction of debt, because if we get a further reduction of private debt we are going to have to get an expansion of public debt. Neither do we want the funds to remain idle. We want them to be disbursed, if only to stockholders.

Though the House Ways and Means Committee in 1938 gained House approval for a still more enfeebled version of the undistributed-profits tax as a substitute for the one on the statute books, the Senate rejected the whole principle of such a tax. In conference committee the House managed to keep the concept of the tax alive until December 31, 1939. On that day it expired. There is still talk in responsible quarters of reviving it.