

L4645

THE ARMY INDUSTRIAL COLLEGE
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Industrial Mobilization Course

LECTURE

Policies and Procedures in Procurement

Lecture XVII - "Profit Limitations I"

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I. Introduction.

Apparently, the subjects that I'm assigned require me to stick my neck out. The last time I stood on this platform and stuck my neck out we heard from the Inspector General himself! Today at this time and at 10:40 we are again taking up a subject which, to say the least, is controversial. Among other things, profit limitation is a subject on which people have strong feelings and quite often strong emotional biases. Limitation of profits hits the war contractor in the spot where the blow hurts most and I do not mean on the chin, over the heart, or in the solar plexus, all of which any of you former pugilists will admit are pretty vulnerable spots. I said profit limitation struck the spot where it hurts most, meaning squarely in the middle of the pocketbook. Accordingly, I feel constrained to make clear in the beginning the attitude which I shall attempt to assume toward the subject of profit limitation.

Perhaps an incident may bring out my point better than any words of my own. Some of you may recall that several years ago the magazine TIME published a photograph of a nudist wedding. The wedding party was dressed in a manner which would please the Amalgamated Sunbathers of the World, Incorporated. For weeks afterward TIME received letters from ministers, spinsters, etc., attacking publication of the photograph or from self-styled liberals cheering the magazine for its broadmindedness. Finally one reader wrote a letter to the editor in which he stated, "This is neither to condemn nor to condone publication of this much discussed photograph, but would you please tell me the name and address of the second bridesmaid from the left?"

During this hour and the next I shall attempt neither to condemn nor to condone limitation of profits from wartime contracts. Rather, the effort will be to seek and present the whole truth and to let the chips fall where they may.

In this first lecture we shall cover the reasons why we have government limitation of war profits, a brief history of wartime profit limitation in this country, some of the direct and indirect methods of limitation and their relative advantages and disadvantages. At 10:40 we shall attempt to go more deeply into statutory renegotiation of war contracts. This hour's lecture will end several minutes early to provide time for questions and discussion. Details will be avoided in both lectures.

It seems unnecessary to spend a great deal of time pointing out to such a group that the desire for profit is the motivating and directing force in our type of economic system. It is a cliché to say that the

American enterprise system is run in response to the "profit motive." Anticipation of profit determines what particular goods will be produced. It also determines how much will be produced and when quantities and qualities will be increased or decreased. It determines what measures will be taken to decrease waste and promote efficiency and economy in production and it directs the allocation of the various factors of production among both industries and firms.

It also is well known that in peacetime under relatively competitive conditions profit tends to be "limited" by the free play of such competitive forces. If profit increased in a certain industry or firm to any marked degree, capital and other factors of production would eventually enter the industry or firm, there would be an increase in supply or production, and eventually a driving downward of prices and profits. We may illustrate this principle by a simple diagram here on the blackboard. Competitive bidding therefore can protect the Government against exorbitant profits in peacetime. Profits from legal monopolies such as utilities are regulated by public bodies.

We have already seen in early lectures that, in wartime, competition is actually nonexistent in many markets and, therefore, unable to "limit" prices. It is consequently, unable to limit "profits," which, together with costs, make up prices.

In earlier lectures we have seen some of the reasons why huge profits are possible in wartime. These will be merely mentioned again and not elaborated here. The size of wartime requirements, the need for emphasis

on speed of procurement, and the desire to escape the policy of "too late and too little" make it unwise to spend too much time analyzing costs and attempting close pricing. This was especially true early in the war. The fact that the duration of the tremendous demands of wartime is uncertain discourages increase of privately-owned plant capacity and supply to meet increased demands. It is impossible to estimate accurately or predetermine costs of production because of changes in the scarcity of the factors of production, inexperience of contractors with new items of materiel, and variation in unit costs due to changes in volume of production. It should be emphasized strongly that excessive war profits are not usually caused by greed on the part of contractors or by incompetence on the part of contracting officers.

II. What Are the Objectives of Government Limitation of Profits in Wartime?

A. At the outset it should be made clear that it was the American people both in and out of uniform that demanded some sort of limitation of war profits through government action. The question of whether you or I may like the policy of limiting war profits, therefore, is really beside the point. The real point is "how can we limit profits best without interfering with production?"

B. Why do the American people and their representatives in Congress feel that profits should be limited in wartime? Undoubtedly the main objective of profit limitation is to protect morale on both home and fighting fronts. The private, who receives \$50 cash per month, while risking his life and under great hardships feels that none should profit inordinately from war. The general public is against profiting from

a tragedy like war. A moral as well as a morale issue is involved.

C. Another important objective of profit limitation is protection of the good name of our American profit-and-loss or "free enterprise" system from the brickbats of politicians, labor leaders, etc. Criticisms of the entire system would be sure to arise if the public felt that the government was allowing undue war profits.

D. Further objectives are economy in the use of taxpayers' money and aiding in the prevention of general inflation of prices.

III. A Brief Glance at the History of Wartime Profit Limitations in the United States.

A. First let's consider the 170 years before 1942.

1. It is important to understand that all of our American wars have resulted in profiteering by some contractors who received widespread publicity. The public reaction against such profiteering has usually been strong.

2. As a result, various measures to limit war profits have been taken during all our wars since the Revolution. Before World War II the chief method of limiting profits attempted was limitation of prices on selected commodities such as shoes, clothing, food and armor-plating for naval vessels. These were spasmodic and inadequate. During World War I not only direct price control but excess profits taxes and cost-plus contracts were used but found unsatisfactory. Price control was begun late and after much inflation. Mr. Baruch himself has admitted this. Excess profits taxes were begun late were too low to achieve the objective of preventing "war millionaires" and were found hard to administer

because of difficulty in determining the rate base. Cost-plus-percentage-of-cost contracts were found grossly inadequate to limit either profit or cost and CPFF contracts were not found satisfactory for limiting profit or costs. You already understand why.

3. Between World War I and World War II about 170 bills intended to "take the profit out of war" were introduced into Congress. The American Legion played a large part in this effort. Out of these 170 bills only the Vinson-Trammel Act of 1934 and the Merchant Marine Act of 1936 became law. These covered only aircraft and vessel contracts. Furthermore, both provided for fixed or inflexible percentage limitations of profits.

B. Now we come to the years after 1942:

1. Soon after Pearl Harbor the newspapers began to publish glaring stories of huge war profits being earned. You will recall the case of Jack and Haintz, the Cleveland contractor which paid the secretary of one of the two owners some \$40,000 a year. When Congress proposed limiting profits on war contracts to a flat six percent on cost through the so-called Case Amendment to an appropriation act, the military procurement agencies protested. They felt it unfair to limit all contractors to the same percentage of profit. The reasons are pretty obvious. Contractors vary greatly as to performance and individual circumstances. The War and Navy Departments, therefore, request legislation providing for flexibility in dealing with the performance and circumstances of individual contractors. It is very important to understand the fact that the military agencies themselves requested renegotiation legislation

and urged its continuation even long after emphasis upon forward or "close" pricing on the basis of cost analysis had begun. This led to passage of the Renegotiation Acts of 1942 and 1943.

2. The 1942 "Act" was actually Section 403 of the 6th Supp. N.D. Appropriation Act, passed on 28 April 1942. It covered both prime and subcontracts of four government agencies, the War, Navy and Treasury Departments and the U. S. Maritime Commission. The number of agencies was later increased to nine. The act applied to contractors whose volume of business having a government end-use was \$100,000 or more.

3. The 1943 Act was really part of the Revenue Act of 1943, passed in February 1944 over President Roosevelt's veto. It covered fiscal years ending after 30 June 1943 and applied to prime and subcontracts with nine government agencies for contractors whose annual receipts or accruals from contracts with these agencies aggregated \$500,000 or more. The nine agencies covered were War, Navy, and Treasury Departments, U. S. Maritime Commission, War Shipping Administration, and four R.F.C. subsidiaries. This 1943 Act provided many important amendments in response to pressures from business interests and as a result of experience under the 1942 Act.

4. All renegotiation legislation expired on 31 December 1945 but, of course, the renegotiation organization is still going ahead in completing renegotiation of profits from sales to the Government which took place before 31 December 1945.

IV. Analysis of Relative Advantages of Indirect and Direct Methods of Profit Limitation Used in United States.

A. It's pretty obvious that since the profit motive is so important

in relation to production the government must be careful to choose a method of profit limitation which will gain the objectives of limitation without impeding production or interfering with its efficiency. In other words, what is needed is the best possible substitute for competition.

B. What are the possible substitutes for competition in limiting profits? What direct and indirect methods of limiting profits have we tried in this country up to now, and, finally, what have we learned as a result of our experience regarding the strong and weak points of these various methods? In answering these questions it will be apparent that among the more indirect methods of profit limitation are: price ceilings, comparison of prices without cost analysis, cost analysis during original negotiations, redetermination and readjustment of prices on industrial contracts after cost experience, cost-plus-percentage-of-cost contracts, and CPFF contracts. Among the direct methods of limitation are: excess profits taxes, statutory limitation of profits to inflexible percentages, and statutory renegotiation. All these methods are related parts of the general picture. Let us compare them one by one.

1. First we may examine price ceilings. Ceilings were found inadequate to control war profits during both World War I and World War II.

a. In the first place, they did not apply to strictly military items during World War II. You recall the agreement between OPA and the military procurement agencies, previously discussed here.

b. Again, profit limitation is merely a potential or incidental by-product of price control and not its major objective. For example,

the OPA policy was to attempt prices which were "generally fair and equitable," not to limit profits on individual contracts or even for individual contractors.

c. Furthermore, during both World War I and World War II price ceilings were applied after a considerable amount of inflation had taken place.

d. To some extent this was intentional, inasmuch as it was necessary to allow prices to rise enough to encourage marginal producers to supply war materiel. It is obvious that if prices were high enough to allow some profit to marginal producers they could allow large profits to more efficient suppliers.

e. Finally, it should be mentioned that quite often price ceilings were determined before producers reached volume production, with the result that when volume production and lower unit costs were attained contractors found themselves earning high profits.

2. During early stages of the war when time was precious, contracting officers followed the policy of comparing prices of given contractors with those of other contractors or with their own previous bids, without analyzing costs. Sometimes contracting officers set their own "ceilings" and negotiated with high bidders to come under such "ceilings." For obvious reasons such a policy, while better than none, was inadequate for estimating and limiting profits.

3. Earlier speakers have made it clear that cost analysis during original negotiation of individual contracts provides maximum incentives for conserving scarce manpower, materials and facilities during production and should be encouraged. These same earlier lecturers have shown that erroneous estimates of costs often result from lack of cost experience

and deliberate inflation in estimates of cost and profit to avoid risks. There are also practical considerations such as pressure of time, inadequacy of accounting personnel, and the need to concentrate on "production first," which made it impossible to analyze costs on all contracts and, therefore, to prevent excessive profits. The administrative burden is especially acute in connection with cost analysis for subcontracts.

4. Of course, it may and undoubtedly should be urged that in any future emergency better provision must be made for adequate trained accounting personnel in both procurement offices and contractors' plants. The fact remains that unless such provision is made it would be impracticable to handle the vast administrative job involved in original pricing, and the redetermination and readjustment of prices, on the basis of cost analysis. Furthermore, there will always be some point at which there is a question as to whether it would not be better to use time and personnel on production rather than accounting. There is a point of diminishing returns for cost analysis, as for anything else, and, of course, new items of material and inability to forecast costs due to changes in volume, wage and material costs may be expected to exist in any future war. There will probably always be contractors with no cost systems or whose accounting department consists of the proprietor's wife, who in spare time keeps records on the backs of old envelopes.

5. Let us look at redetermination and readjustment of prices on individual contracts after cost experience. This, of course, should be emphasized and practiced wherever practicable. Again, however, we find that lack of time and accounting personnel make it impossible to audit all contracts periodically and, in this way, to prevent excessive profits.

Here again we find that the administrative problem is especially great in connection with cost analysis for the large number of subcontracts.

6. What about cost-plus-percentage-of-costs contracts? These, of course, actually encourage inflation of costs and profits and were made illegal during World War II by the First War Powers Act of 1940.

7. Well, let us look at GPF contracts. Here also we find that there is a failure to encourage efficiency and cost control unless special incentive provisions are included. Furthermore, after actual rather than estimated costs are known the fee or profit received may prove to be far higher in relation to costs than was originally anticipated.

8. We have seen why all of the six indirect methods of limiting war profits may be inadequate in one or more respects. Let us next look at three direct methods of profit limitation. The first of these is excess profits taxes. Such taxes have proven very valuable in limiting war profits of businesses not selling directly or indirectly to government agencies. They are, therefore indispensable during wartime for this purpose. However, they are considered inadequate by many responsible persons in the procurement agencies to control profits received by prime or subcontractors of these war procurement agencies. This is because they apply too late to provide an incentive for avoiding waste and promoting efficiency in use of materials, labor and facilities. Furthermore, since the performance and the individual situations of contractors vary greatly such taxes cannot be equally fair to all contractors. If the tax rates are high enough to recover so-called "excessive" profits of all contractors, they will discourage efficiency, risk-taking, inventive and developmental contributions, etc., on the part of many contractors. If they are not

high enough they do not achieve the purpose of limiting war profits. It should be stressed that during all the Congressional hearings on renegotiation no one was able to suggest a form of excess profits taxation which would limit profits, encourage efficiency and be fair to all contractors.

9. The same criticisms may be made of statutory limitation of profits to fixed or inflexible percentages as have just been made of excess profits taxes. To limit all contractors to the same percentage of profit on either sales or cost is similar to requiring all consumers of shoes to wear size 9B. A shoe of this size would pinch many feet, but others would rattle around inside them. Any comfort derived from such shoes would be, in the words of the movie producers, "purely coincidental."

10. a. And so we come to the final direct method of limitation, namely, statutory renegotiation. This method has certain undesirable aspects, as we shall see, but also the advantage of flexibility in attempting to treat each contractor on his merits.

b. In other words, by varying the rates of profit allowed, renegotiation can encourage, reward, or consider such important factors as:

- (1) Efficiency in the use of manpower, materials and facilities and in meeting quality standards and delivery schedules.
- (2) Risk-taking in the form of price and cost reductions at the time of negotiation or during the life of

contracts, and use of private rather than Government capital.

- (3) Inventive and developmental contributions.
- (4) General cooperation with the Government.
- (5) Character of business, complexity of operations, subcontracting, rate of turnover.

Each of these factors will be considered in more detail during the period beginning at 10:40 this morning.

c. Of course, as we have already stated, emphasis should be placed upon close pricing of contracts through cost analysis because this gives contractors incentives for efficiency in use of materials, labor and facilities during production. Nevertheless, as we have seen, such close pricing or "forward pricing" cannot always be effective or practicable. This conclusion is borne out by the fact that continuation of both renegotiation and "forward pricing" was considered necessary by both War and Navy Departments even in the later years of World War II. The fact that renegotiation was continued long after forward pricing became widespread was not accidental, and it should be emphasized that the cost-and-price analysts found it useful to point out to contractors that price reduction would improve their status in renegotiation.

d. Since renegotiation normally covers a contractor's government business for an entire fiscal year, for which he already has financial statements, it generally requires less accounting and auditing than cost analysis involved in forward pricing, readjustment or redetermination for each contract. This practical consideration is extremely important and sometimes outweighs philosophical considerations.

e. It has been said that renegotiation applies after contractors have incurred costs and expenses and that it, therefore, does not encourage efficiency and economy. As we have seen, this is not true since renegotiation allows differences in rates of profit on the basis of efficiency and other factors. In other words, renegotiation provides the advantages as well as the disadvantages of hindsight. After their first experience with renegotiation, contractors become deeply impressed with the fact that efficiency of operations is the factor often given greatest weight by the price adjustment personnel in determining profit rates to be allowed.

f. For all these reasons the advocates of renegotiation consider it a useful "backstop" and helpmeet for the various indirect methods of profit limitation already discussed and for such a direct method as excess profits taxation. As baseball players you know the importance of a backstop, human or material.

V. Summary.

A. Let us take a quick look backward at what we have found. The brief history which we have covered indicates that any future American war would probably bring popular demands for limitation of war profits. World War II is unique in the fact that, not since its earliest stages, has there been an outcry against profiteering. The American people are not likely to forget this fact.

B. While greater emphasis should be placed on close pricing and/or repricing of fixed-price contracts after careful cost analysis, practical considerations often prevent application of this method of avoiding excessive profits and of encouraging efficiency and economy in use of

materials, labor and facilities. We may anticipate that in any future emergency it will still be difficult to estimate in advance the cost of new or even old materiel produced at greater volume. Whether there will be adequate accounting personnel in procurement offices and contractors' plants depends upon our planning and policies regarding key personnel.

C. For these reasons, reliance on some form of "backstop" not only for recovery of "excessive" profits after they are received, but which will also encourage efficiency and risk-taking, through price reductions on future deliveries, seems unavoidable.

D. The disadvantages or inadequacies of excess profits taxation and fixed-percentage limitations on profits, previously explained, make renegotiation the "backstop" which seems most-nearly to "fill the bill."