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PROFIT LIMITATIONS AND RENEGOTIATION

Brigadier General Maurice Hirsch

29 October 1946

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THE INDUSTRIAL COLLEGE OF THE ARMED FORCES

WASHINGTON, D. C.

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GENERAL MCKINLEY: Gentlemen, this morning I think we are very fortunate because our speaker has the kind of background that I believe in. While I am a professional Army officer and have spent a lot of time at it, I have a very keen appreciation for the desire to sprinkle all through the Service various grades of people who have had more of a business background than an Army officer has had an opportunity to develop, with a view to enlarging our ideas and getting a keener appreciation of both sides.

This morning our speaker is Brigadier General Maurice Hirsch. He is a graduate of the University of Virginia with an A.B. and M.A. in 1910; LL.B., Harvard Law School, 1913; he is an LL.M., University of Texas, 1914. From 1914 to 1942 his activities were devoted primarily to corporate matters with extensive experience in the oil industry. He was part owner with substantial participation in the direction of various enterprises, principally truck transportation, warehousing, beverage distribution, housing, land development and oil exploration. He entered the Army in June 1944 as a Colonel in the Army of the United States, and was promoted to Brigadier General in April 1946. He is now Chairman of the War Contracts Price Adjustment Board and Joint Price Adjustment Board; Chairman of the War Department Price Adjustment Board, and Chief, Renegotiation Branch, War Department General Staff. So he has twofold duties: that of the over-all Joint duty, you might say, and the War Department special duty.

His subject is "Profit Limitations and Renegotiation." I take great pleasure in presenting General Maurice Hirsch.

GENERAL HIRSCH: Without notes, I am going to speak very informally, if you don't mind. The subject, as I have said to the Commandant, is one on which I could spend ten minutes or I could spend ten days--a constant talk. I am not going to spend ten days. I am going to try to give you a little of the background of renegotiation and something of the problems that we are facing and the means taken in order to attempt to solve some of the problems that Government was facing and that industry was facing.

I know that one subjects himself, perhaps, to a little bit of strain in welcoming questions, but I don't mind questions during the course of what I am saying, and you have the privilege of interrupting at any time you want to if there is something that is not entirely clear to you. I am not trying to go along any prearranged track, so you can call on me any time you want; it is perfectly all right.

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I don't see many of you here in this group who are old enough to remember the very serious situation that existed after World War I. I recall very vividly the attacks that were made upon industry after World War I and during the final days of the war. That was a war that didn't require anything like the procurement that was required in this war, and yet they say we developed over 12,000 millionaires in the United States out of that war. I don't know whether that is the correct number or not, but I do know that there were a great many millionaires created out of World War I. The situation was so serious that the word "profiteer" became one of the hated words of the language, and stigmatized industry and likewise stigmatized those in the departments who had placed contracts on a basis which would create millionaires. When I talk about the creation of millionaires don't misunderstand me. I think there is something very fundamental in the entire approach of renegotiation. I don't know of a single person in any of the departments who has engaged in this business who is opposed to profit. I don't know of anyone in these operations who has not been glad to see profit and to encourage profit. Someone said to me "You don't like to see millionaires made do you?" I said "Oh, yes, I do, but I want to be sure that if there are a million dollars earned there that whoever got that earned it in the war," because if a contractor comes out with that after we get through with it the bigger has been his contribution toward the winning of the war, and the idea that everything has an incentive is something that is very fundamental in the whole subject of renegotiation. Also don't misunderstand that I am trying to press down a concept of patriotism for I know of men who have come through without profit, but we don't encourage that as something that must be done in order to show that a person is patriotic and not a profiteer. There have been many who have participated without profit, and yet believing in the profit system they are convinced that profit gives an incentive. Somebody said--and I am going to find out some day who it was--that the sale of the stock of the Bank of England many years ago helped to finance the wars of England against France; that they sold the stock with great success due to a combination of patriotism plus 8 percent. There is a whole lot to that. We need both and we had both; the result has been a production that has gone far toward the winning of the war. When Congress began thinking about what ought to be done during World War I there were many suggestions. The American Legion made one that all profits should be taken out of war. A lot of people believed that, and I think if that were made universal it would be all right. Each person ought to know--everybody--capital and labor--that no matter what he got it is all necessary to the winning of the war, and if it is made universal there would be little complaint about it; but when there are differentiations as to whether this group or that group should have a profit without adhering to the wartime concept of profit, as to what is the best means of holding profit to the proper levels, I think it is subject not only to criticism but to absolute condemnation. We have had all kinds of suggestions. We have had the suggestion that there should be a percentage of cost as the profit. That was tried out during

World War I, and that is where there was a lot of condemnation heard. Not only did the dollars mount up but the contractor was subject to the proper criticism that in many instances he increased his costs for the purpose of creating profit, and in wartime that is critical because one of the primary objectives in wartime is to save every production unit that can be saved. Every production unit so saved can likewise go to war. But during World War I the contractor who could spend the most money, who could throw away dollars, was the fellow who got the most business when it came to profit; therefore, there was this outcry against a contract on a percentage of profit basis. As a matter of fact, neither the Congress nor the public has ever gotten away from the old idea of a cost-plus; even though under many circumstances a cost-plus-a-fixed-fee is in my opinion and in the opinion of many in the Services and the departments the best kind of procurement, if properly directed, nevertheless Congress and the public have never been able to get away from a cost-plus-a-percentage-of-cost--not a cost-plus-a-fixed-fee, so the idea of getting a profit on the basis of a percentage of cost went out the window. Frankly, we have had a lot of struggles with the Navy, the Army, the R.F.C., the Treasury, and the Maritime Commission to get them away from the concept of giving a contractor some extra fees because of the fact that he has expended more money. Our conception is that it can't be true that the more dollars a contractor spends on production the fewer dollars he should retain as profit. Our interpretation has been in the very opposite direction to that, cost-plus-a-percentage-of-cost.

How about percentage of sales? If you say to a contractor "I am going to pay you a profit based upon percentage of sales," what have you done then? You have encouraged him to charge you the highest prices he can charge, because the more he charges to the Government the more dollars he is going to keep on the basis of the percentage of his sales, and therefore when you do make a profit on the basis of the percentage of sales the result is to force up and up and up the number of dollars the contractor will charge for what he produces. And remember I am talking not only about the prime contractor. The cost goes all the way down the line. The cost to the subcontractor becomes cost to the next fellow, and all the time that thing is more and more and more, and when it comes through several tiers of subcontractors to the prime contractor you have forced up the cost of the contractor because you haven't had the proper control all the way down the line; therefore a profit on the percentage of sales means an inflation of cost and causes higher prices all the way up the line of the subcontractors.

What other means are there for determining what a profit should be? Should we say that a contractor should have a percentage on his net worth? If you do that you discourage production. If I have earned a million dollars on net worth what is the use of my taking any further risks? There are tremendous operations where the percentage of net worth in no sense reflects the contribution the contractor has made. I will give you some illustrations:

I know of one kind of industry where a dollar of investment in the course of a year might turn out something like a net of 126 dollars in sales. The net worth will be turned over in sales 126-plus times. I know of other industries like some of the elements of the chemical industry or the plate-glass industry where it takes a dollar of investment extremely well handled during the course of the year to turn out 80 cents in sales in the course of the year. How can you come to a basis of percentage of sales in relation to net worth? If you give that first fellow one percent on his sales he gets unduly rich. If you give the second fellow 10 percent on his sales you break him. In other words, you must have your basis of profit related to the various things that the contractor has had to risk; that is, to the contributions that he makes; what he has had to risk; and one of the things he has had to risk, only one of the things, is his net worth. Reputation can be risked.

There are types of risk that are not normal to a production line--the creation of a competitor, for instance. We have seen in many cases during the war where one concern over a period of twenty, thirty, or forty years developed certain kinds of profit on the output of that particular plant; the contractor as one of a dozen competitors has given to those competitors the know-how, and when the war is over that first contractor may go out of business because of that contribution to the war. He has created real competition from the standpoint of the manufacturer; the competitor probably in many instances manufacturing that product in new plants and with right up-to-the-minute machinery which can turn out the product a whole lot cheaper than could the first contractor. When the war is over the first contractor goes out of business because of his contribution to the war. That is a contribution that we have to look to in connection with what comprises the profit that a contractor has a right to charge and to retain.

At the beginning of the war the problem of excessive profits was uppermost in the minds of those at the head of the departments, principally the War and Navy Departments. One day Mr. Forrestal, the then Under Secretary of the Navy, and Mr. Patterson, the then Under Secretary of War, woke up to the fact that there had been presented in Congress what was known as the Case Amendment. This amendment provided a top limit of six percent on sales for anything that went into war production, and that amendment had passed the House with only eight dissenting votes. They went pretty quickly up to the Hill, got a hold of Mr. Case, and told him "We can't conceive of anything that will be more destructive to procurement in the war than the passage of such an act as this." They pointed out that in some instances it would absolutely prevent a concern from producing and in other instances it would make the concern rich beyond any justification. Mr. Case said "O.K. What do you suggest?" Prior to that time in the War and Navy Departments they had attempted to reduce some of the profits by voluntary agreement with certain contractors that where the profits had gone up so high they voluntarily give you

back a hundred million dollars. It looked like something pretty serious, so overnight the first renegotiation statute was drafted. It was felt that it was inadequate, but it was a pretty good statute to be prepared overnight with the very brief experience the departments had had in voluntary agreements. It was felt that "If you make that much money there is going to be a public outcry, What do you think you ought to do?" Congress was much impressed with the point of view that you shouldn't just take back dollars from those who were willing to be right; that you ought to take back dollars from all of those who were wrong when it came to the amount of profit they were getting out of the thing.

When they passed that first act there was lots of opposition to it. There was a great deal of opposition to renegotiation up to about a year and a half ago. The first statute didn't set forth any of the factors that should be considered by those who were going to administer the law. When I read it the first time I must say frankly it frightened me. Here was a statute that didn't give much guidance. Here was a law that placed in the hands of men a tremendous responsibility for conclusions, without guidance, to be based upon their judgment.

Now there was one little sentence in the law that was highly criticized, and yet I think it was the best sentence in the whole act. It is this: "Excessive profits are those profits which are determined to be excessive." It sounds like excessive profits are excessive profits, but it doesn't say that. "Excessive profits are those profits which are determined to be excessive." At that time they had at the head of renegotiation men like Morris Coker, who was Chairman of the Board, and other men in the Army and Navy with the highest qualifications from business and from the professions. There never has been any criticism of the men engaged in renegotiation in any hearing that has ever been held on the Hill, and we have had eight of them. On the contrary, there has been commendation, and I am frank to say this law never would have worked if it hadn't been for the kind of men who were really doing the job. I am not trying to take any acclaim for those of us right here. My commendation and admiration go mostly to those men who are right out in the field and who are working with the contractors out in the field. They are the ones who are really doing the job in renegotiation.

Well, the various departments were faced with this first act. There was no over-all board. I recall the time in 1942 when after one of the departments would come to a conclusion as to what were excessive profits sometimes it would take three or four months to get a contract signed by the Government, and sometimes departments that had no interest in the particular contractor's production had to agree to the amount of excessive profits to be eliminated. We had a man who did nothing else except to go from one department to another explaining each case and trying to get an agreement with the heads of the departments on these various renegotiations and refund agreements. It was a terrible job. We finally eliminated

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a whole lot of that by what was known as the Joint Price Adjustment Board. That was a board created by agreement of the various departments. It was a group that proceeded purely on this agreement and it did a pretty good job, but there were certain elements, and some substantial elements, both in and out of Congress, that felt there ought to be two things at least: one, a crystallization of at least the factors which were to be considered in connection with renegotiation; and second, an over-all board to have absolute authority with reference to renegotiation, so that at least there would be that direction to be given to each of the departments.

So the Renegotiation Act of 1943 was passed. There was a great deal of trouble in connection with that act. I think some of the elements in industry were very short-sighted in their thoughts about it, and if it hadn't been for the Christmas recess of the Senate in 1943 I don't believe we would have anything like a Renegotiation Act. It was completely emasculated by the report of the majority of the Senate Finance Committee, but during that recess the minority report got more publicity. The newspapers and editorial writers came to the rescue of renegotiation and pointed out what would happen if there was a virtual destruction of the opportunity to eliminate excessive profits; by the time Congress came back to Washington something very unusual in Congressional history occurred. The chairman of the committee who had himself presented the majority report on the floor of the Senate moved that that report be not adopted, so renegotiation was saved. Lots of opposition was met with when it came to the extension of the act; however, we had a very different feeling about it.

I want to give you the previous background because I think it is important for you to know the evolution of the thinking, the governmental and Congressional thinking, the departmental thinking, and then the thinking of the industrialists about this job. The extension of the act after reintroducing it was approved unanimously from 30 June 1945 to the end of 1945 by the Senate Finance Committee; it was approved unanimously by the House Ways and Means Committee. It was approved by voice vote for a single adjustment on the floor of the Senate. In the House, however, it had a very close call--the vote was 301 in favor of and one lone vote against. That is how it passed in the House. There was one vote in all of Congress still opposed to the Renegotiation Act as amended.

How about inside of the Government? I recall in the War Department in 1942 six of our top procurement generals were voicing opposition to renegotiation, and one of them went to the extreme about it. He said it was destroying the opportunity for contractor procurement; taking away the opportunity of the contracting officers of getting contractors to get into work for the Government, work that was critically needed. I have within the past eight months heard from the lips of each and every one of those generals the expression that they were a hundred percent in favor of renegotiation; and from the lips of the one who was the most extreme

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on the public platform I heard the pronouncement that in his opinion nothing could have been conceived of which would have been of greater aid to war procurement than renegotiation.

Now let me give you again the change in opinion of another group, and that is the men in industry. The first public talk I ever made on renegotiation was before the Advisory Committee to the United States Department of Commerce, a group of men drawn from all phases of industry in America, and I know that in that group--and that was in the latter part of 1942--conservatively over 80 percent were opposed to renegotiation. Each year that group has had a meeting about renegotiation. A year and a half ago we found that they were no longer in opposition to renegotiation, and at the last meeting, which was something like five months ago, each and every one of the men who had expressed opposition to renegotiation in the earlier day got up on his feet and said that if it hadn't been for renegotiation--first, there would not have been any successful procurement for war and second, that they would fear for the continuance of free enterprise in America. I am saying, gentlemen, that that was unanimously said by the men of that group to show the change of opinions.

With regard to procurement I know what the gentlemen have said, and I might summarize it by telling what one of those men out of the ranks of industry said to me, Mr. Polly, the President of the Continental Canning Company. He said "Maurice, you will never know what renegotiation has meant," speaking of procurement and production. He said "I can speak for my 26 plants. I can speak for each and every man who is here at this meeting and for industry at large." He said "Initially we were very hesitant about giving the price. We didn't want to have advances. We were representing our stockholders and we wanted to get enough money for them but we didn't want to be profiteers, so we meticulously worked out what a proper cost would be and what a proper price would be. On the other hand the contracting officer didn't want to be profiteer either. He didn't want to make big profits which would later be subject to severe criticism when perhaps the amount of profit would get mountain high, so he attempted to work at cost." He said "You will never be able to compute all those weeks and months that were saved when the Renegotiation Act was passed." He said "From that time forward, oh yes, we tried to get together and do some reasonable thinking about what the cost might be. We knew we could get together. We had counsel and we were not afraid any more. We knew we were looking at it in the over-all. We knew we were not going to be profiteers." The contracting officer wasn't dependent upon them. "He still tried to work out something that was within reason. The Government told us they wanted something and we started our production lines moving." He said "That brings you pretty close to all on the front line because literally months of time were saved in many fields because of the fact that we could get together without the fear that was haunting us before." He knew they couldn't get to

any guide to cost or price. I had to listen to him when I attended a State convention of steel contractors in New York about two and a half years ago. They had their whole crowd there and they were very proud because at that convention they were presenting a cost analysis in connection with the items that they had been producing for upwards of fifty years. They told us then that they had a committee working at things that we never heard about and on something that the Secretary of War had never dreamed of--the cost of angle irons and the various things that had been produced over there--and that the committee would work out something that would show approximate cost. They told me there was going to be a statement of the cost in less than six months. The contracting officer under those circumstances would work out what the proper cost was going to be, and the men had been looking to the specifications on which the contractor was going forward with his production. If you can't look forward with sufficient vision to know what the proper profits should be, then what is the way to take care of that? You must have selected men who understand finance, business, production lines, and who are well versed in accounting and in the law to get around a table and do just exactly as men do out in business life. For instance, Vice President John Smith is sent by his Board of Directors to a different city and they tell him "There is a plant over there that is for sale. Find out what we can pay for it; what is the right price for us to pay." The Vice President goes into that city and finds out there is a very fine plant there and is assuming that the depreciation has been normal. He finds out that this particular city is finely located from the standpoint of supplies, and that it is strategically located from the standpoint of sales. He finds that the public relations have been splendid, that the labor relations have been outstanding, that there are four railroads in the city, and a siding alongside of the plant. He comes back and says "I think we can pay two and a half million dollars for that plant. I have looked at all the various things but I have enumerated only a few of the things you would probably look at." His directors say "How did you come to that conclusion? How did you work it out? How much did you allow for the site? How much did you allow for the siding? How many dollars did you allow because of the good labor relations? How many dollars did you allow because of the fact that the public are all in favor of you down there and like you?" He couldn't give a guess answer to those questions and we can't either, gentlemen. We know various factors in renegotiation but we can't give you an answer as to how many dollars for this, that, and the other thing; but when we see what the contractor has done and when we relate everything that he has done to the business there is a real relationship there, forgetting completely all about percentages. That is fine I think in peacetime and wartime procurement. Forgetting about percentages we try to find out how many dollars will fully repay the contractor for what he has done.

A little fellow out in California who was employed by the Telephone Company for twelve or fifteen years had a little place in the back of

his house where he devised the means of creating crystals, and with less than 30,000 dollars he made a profit of about five or six thousand dollars on it. He had to because he had a salary of 7,500 dollars from the Telephone Company. Then came the war, and crystals as you may well remember in the early days of the war were a critical item. That fellow knew how to get them out. He produced 1.7 million dollars worth of crystals in a year and he made something like 750,000 dollars profit, with a net worth of 5,000 dollars. Now work that out. If you are afraid we are going to give somebody 10 percent on net worth that fellow worked a year and made a magnificent contribution, and he told a lot of those other crystal makers how to do that, and that is one of the reasons we won the war. And you are going to give him 10 percent on his net worth--500 dollars--for what he did. You should give him a hundred percent on his net worth. A hundred percent on his net worth? Oh no. You are not going to confine yourself to any percentage on anything. What are you going to do? Are you going to be bound by that concept that anybody ought to be able to make six percent on sales? You give that fellow six percent on his sales and he has so much money he doesn't know what to do. Here is something that has a new meaning at night at such a time, this rock crystal. Who would attempt to evaluate that in any percentage of anything? What would that fellow's contribution to the war be worth? We find every day creative contribution. Let's say, for instance, Mr. X has a plant. It is antiquated. It is not well adapted to the manufacture of a particular type of thing that is urgently and vitally needed for the war. He doesn't want to take a contract he knows he can't do well, and the contracting officer examines it and says "O.K." At the same time the Government finances another plant for Mr. Y across the street and it makes plans for the building for all-out production lines. Mr. X is a patriotic citizen. He tells the Government and tells Mr. Y "You better avoid this or this or there will be serious defects in your production line." It happens that Mr. Y comes through and has a wonderful production line, making the same thing that Mr. X is manufacturing. Is not Y's cost not going to be way under X's cost? X might be doing a much finer production job in the plant than Y is doing with this new plant, so the cost per unit is not going to control my judgment in connection with profit, and in addition, there is no history of creative genius behind Mr. Y, so you can't give him dollars on the same basis that you can give dollars to Mr. X. I am just throwing these things out at random to show the complications in connection with cost in appraising profit. I could give you a thousand instances, but I am showing you very briefly why we have come to the conclusion that we have no formula to go by, why it is a matter of judgment, and why it is a matter of judgment that can still be exercised before and after. We have tried it out. I sat for something like two years on a committee we called the Formula Committee. We had on the committee men with various backgrounds. I recall one of them was Mr. Taylor, the President of the Globe Aluminum Company, an outstanding man in industry, and there were several people connected with the renegotiation activity all over the country. There were something like over 250 of those suggested

formulas that were to give us the answer but we never found a single one that would give you the answer correctly across the board; we were not able to find a formula that would even take care of the problems as to any segment of our country, of our work. You may say, gentlemen, "If it is just a matter of individual judgment, how is it that you can fearlessly keep in mind the conclusion of the Los Angeles Air Forces Board, the New York Navy Board, and the Chicago R.F.C. Board?" This is just really a different one. You know that in each of the departments there is a Price Adjustment Board composed of several members. For each department they have operational responsibility. Those men come together every week. There is a discussion of the fundamentals; there is a discussion of important cases. There is an analysis of what has been done in the various industries, and many times there are discussions of the individual cases. I am not going to take the time to tell you of the internal operational setup, but there is one thing you can be assured of, and that is that the contractor has not one but several opportunities to present his case. We don't conduct our hearings like they would in a court. It is a very informal procedure.

I am a lawyer and therefore I don't like to discourage the use of lawyers, but I say here a lawyer is not necessary in a renegotiation hearing on account of the fact that we are representing the contractor just as much as we are representing the Government.

Congress didn't give us any quota in dollars. Congress didn't tell us we had to get so many dollars. It is our job to try to come to a fair conclusion, and we have often gone this far in the exercise of that judgment: we have had cases where the contractor has been fit to give back certain dollars to the Government as a refund in the renegotiation, and when the cases have come up to us for a review they sent them in in some instances, giving us so many dollars and in other instances saying it was necessary as a refund representing excessive profits. I am frank to say that some of the contractors of the country have been rather startled at that. Here is an opportunity on the part of the Government to get dollars but the Government doesn't take them. We don't take them because that is not our job. We are not a collecting agency. We are an agency trying to come to a fair and decent conclusion as to what will be not a meager compensation but what will be a reasonable compensation, or what would have been arrived at if everything had been known at the time the contract was placed. Oh no. We tried to say to him that he was receiving the number of dollars that would properly pay him for everything that he had done as a contribution to the war. That means volume of production; it means risk of capital; it means invention and engineering; it means cooperation with the Government; it means each and every one of those many things which would go to make up the participation of the contractor in the war effort.

What are the results? I am very happy to say that the Secretaries of the Departments realize that while dollars are of great importance,

that the collection of dollars is the least of the accomplishments of renegotiation. But let me tell you something about the dollars first.

As of now refunds in renegotiation have been recovered just about on the dot of 10 million dollars. A lot of that would have come back in taxes. We have made a very careful survey and we estimate that 70 percent of that would have been captured in taxes. We don't know whether that is correct but that is our best estimate. That means a net of three billion dollars in the elimination of 10 billion dollars from the accounts in earnings, and those are the accounts that are looked at when a company or individual is subject to criticism. In addition to that every one of the contracting officers--sometimes other than lawyers--has an edge on renegotiation, but in most instances with the influence and in some instances with the cooperation and in other instances with action on the part of the renegotiation agencies there has been an over-all of something like an additional 10 billion dollars in reductions in prices on contracts after prices were already established in the contract. Those two elements do not take into consideration the effect on subsequent orders for new procurement. Nobody will ever be able to give you the whole case as to that. The prices in thousands of instances are the effect of influence; that influence is brought about by something I probably should have emphasized before, that is the emphasis we put on the risk inherent in close pricing. We told them "We are assuming that you have held your costs down as low as you can, because we are going to leave you less if you charge more," and when we found out that he maintained a high peak of production by a tremendous margin of profit we cut him down substantially below what we would have done if he had maintained what was a fair margin of profit. We have attempted to apply that whenever we could. I freely confess that was an instance where we didn't know enough about pricing. The pricing is based upon the conditions that you find in different plants and in the procurement in the background of production.

I know one striking instance where I was on the stand in an executive session of one of the committees and one of the Congressmen was very much interested in a constituent. We had required a very substantial refund for there was a competitor who had charged substantially more than others per unit. Without calling names the Congressman said "How can you justify taking away dollars from this contractor when his price is substantially under the price of a competitor per unit of production?" I said "Mr. Congressman, I can't answer your question. You don't give me enough facts upon which to base a reason, a conclusion. Let's assume, Mr. Congressman, that you are now to a particular type of production. On the other hand let's assume I have been producing a certain kind of unit for six or eight or ten or twelve years. There may be a little difference in detail but that is substantially what I have been producing through the years. Let's assume that in 1943 I manufacture a hundred thousand units; in 1944 I get a contract for another hundred thousand units. Now let's

assume that you in a contract in December of 1943 have a hundred thousand units to be produced in 1944. My production lines were set up and ready. I had thought about that in the prior years. My foremen know what to do. My labor knows what to do. My management knows what to do. I am all set to go and you are thrown into the production picture. Do you think, sir, that there is any fair comparison between my price and your price for a hundred thousand units? Your cost on the item might be around 3,000 dollars. Your cost may be 2,900 dollars a unit. It may be 3,100 dollars. You may lose money on it. My cost may be 2,500 or 2,000 dollars. But you may be doing a better job getting ready to utilize the labor facilities while I have had several years in which to learn. You may be doing a much better job than I am doing." There is no basis for appraising cost comparisons there, therefore we have to be very careful with those price comparisons, those cost comparisons. If we know, if we have a reasonable assurance that one contractor has priced lower than another we are going to assume that their cost has been right; that the one who prices lower is going to keep more dollars per unit of his production. That has had a tremendous effect. In the contracts that have been renegotiated we have seen them come down, down, down through the changes of renegotiation. There is a margin of something over five percent difference in the pricing, and that is after a tremendous number of changes in connection with the item that is being produced. That is after the absorption of many of those modifications in specifications and new contributions on the part of the contractor. We can see the result of it in lower pricing from year to year.

In summation I would just like to say that these are some of the objectives and accomplishments of renegotiation. Probably the greatest accomplishment of all was our help to the boys in the front line and the protection of the system of free enterprise. Frankly, I don't believe there would have been any chance of saving the system of free enterprise in America when the war was over if it hadn't been for the operation of renegotiation. That is a pretty broad statement.

Let me just read from a letter that the Secretary of War sent to Senator McKellar sometime ago in response to an inquiry from the Senator as to what had been accomplished in renegotiation. The Secretary of War called attention to the days of recovery and to the net savings, the even greater savings than he thought had been occasioned in connection with subsequent ordering, and then he said:

"The cost of all of this on the over-all has been approximately a third of 1% of the gross recoveries, and about 1-1/3% of the net recovery, after deducting for taxes, so it has been a profitable venture from the standpoint of the cost, efficiency, and the dollars recovered by the Government."

I know that that has been concurred in by Secretary Forrestal, who wrote this:

"Although the monetary saving to the Government is impressive, it is perhaps the least important result of the Renegotiation Act. Through the Act and its efficient administration the procurement and production of war material has been enhanced, inflationary tendencies of the wartime period have been combatted, and the system of free enterprise has been protected against the accusations of excessive and unconscionable profits out of war."

Thank you, gentlemen.

GENERAL MCKINLEY: We are ready for a few questions now if you have any.

STUDENT: What were the bookkeeping methods of the companies under the recent Renegotiation Act?

GENERAL HIRSCH: We have, I think, adopted a practical approach. We have, in fact, attempted to continue the accounting methods that were used by a contractor. We have accepted any system of accounting that would reasonably give us a true picture of what the contractor's situation was. In the figures in the evaluation of what a contractor has done the various methods of accounting can give you very different results. Let me give you an illustration.

I know that some companies in one accounting method throw just about everything with the exception of certain overhead items, administrative items, into inventory in connection with their production. There are a few contractors who throw everything into inventory. They divide up every item of expenditure, and to the extent it goes into the production of a unit of production those things are evaluated into that unit and so declare his inventory accumulation. Others go to the other extreme and we find instances where one of those numerous crystal manufacturers put in raw material in bulk, and it is not all expensive stuff, and when he came to the Inventory Account even though he had on his shelves hundreds of thousands of dollars of the inventory articles he would weigh them and he would put them in his inventory on the basis of the initial cost of the raw materials. Those are two extremes, and when we know what method is used then we can properly evaluate what the contractor has done. The Navy has done that more often than has the Army or the other departments. Although all have worked consistently with the various contractors they have never imposed themselves upon the contractors. The Navy, the Army, and the other departments have almost always accepted the accounting of the contractor.

We have felt that this job could not be done if we didn't have the cooperation of industry. Let me read you just one paragraph from a letter that was signed by each of the members of the War Contracts Price Board to the Mcade Committee. It is in connection with accounting and has a bearing on your question:

"The procedures adopted in renegotiation we find very adequate. They admittedly are founded on the assumption that by and large the business men of America are honest. They don't contemplate an inquisitorial staff."

I think that will explain to you the approach we have taken; and I must say that we have found very few instances where, even when checks have been made based upon some suggestion that there may have been fraudulent acts on the part of the contractor in connection with his accounts, it has been indicated that the contractor has attempted to defraud the Government. I believe there is no group that has had a better opportunity to see what industry has done and to evaluate the contribution and cooperation of industry. They have been cooperative, they have been fair, and they have done an outstanding job.

STUDENT: Will you please elaborate concerning those members of industry who have opposed the administration of the act?

GENERAL HIRSCH: Yes. There is one outstanding opponent of renegotiation. He has fought us all the way through and he is still fighting us. It is Mr. Rockwell. He says that renegotiation has destroyed industry. As a matter of fact, if you will read his testimony you will see that almost every other word is to the effect that incentive is destroyed; it is just going to keep us from having incentive; we are not going to have any incentive. I have no regard for the fellow who comes in as one did before one of the Committees. Mr. Morris wasn't in favor of renegotiation. He said "I remember the time when I was in the South Pacific where the boys didn't have good planes and they knew they didn't have planes as good as the Jap Zeros; they wanted to get the reason." He turned to this witness and said "Do you mean to say that you wouldn't do everything that you could to get production out to those boys over there?" The fellow said "Well, it would take away my incentive if I was going to be limited on my price." That is the kind of fellow that maintains he is a hero, but thank God there haven't been very many of them here in America. That is one kind of opposition to renegotiation.

There has been another kind. There was a whole lot said about renegotiation; that it should be sufficient if we were to have a high tax; that taxes were something for all and we know how it is going to apply to everybody; therefore, let us have a very high tax, even a hundred percent tax if you please. I think that finally Congress saw our point of view about it, which was not the point of view of many here because

of the inefficiency. They saw the viciousness of that point of view, that as a matter of fact the higher the taxes, assuming there is anything over, the more the incentive to high prices, and we will drop it. If I keep five cents out of every dollar and if I make two dollars and keep 10 cents, the more dollars I would make the more I would keep. There is no pressure there to hold down the price, and when once these prices get into the stream of your economy you can see what it does to the inflationary tendency of the period; that is something that you are always faced with. There were cases in 1943 showing what the profits were after taxes and with renegotiation, and some of those cases were so utterly scandalous that there wasn't much more said about taxes alone being able to take away excessive profits in wartime. It is outrageous the profits that can accumulate.

Let's see what happens when you say "Let's make a one percent tax." Let's put it that way. Of course then you really do take away all incentive to add to production. There you have a complete elimination of just the additional spur to go ahead. We have seen the results of those things in England. England didn't take the time for our approach and it is obvious in the production of the plants of industry in England because they had a very high tax and an elimination of profit based on giving something back at some time in the future, which showed directly in the production rate of industry in England. You must have the background and know that those things can be effective. We will have to struggle plenty of times to maintain incentive, and so many times there is going to be the hue and cry that industry has participated in excessive profits due to the fact that everyone knows that life itself is at stake. The taxes I think have established that conclusively, and that was one of the attacks on renegotiation.

Another was the suggestion that we ought to work out some relationship of net after taxes in relation to sales; that we ought to work out what a contractor ought to have or industry at large ought to have. Let us fix something. Let us give them four or five or six or eight percent of sales but after taxes. Some of the results of that are literally terrible. Let's assume there is a contractor who made over 10 million dollars in sales out of the war. In the best period of peace all that he could ever have made was a million dollars in sales and he was very well satisfied to make that then. The old tax rate wasn't so much. He came out with a fine return--a million dollars in sales, so he had his 100,000 dollars. Comes the war and instead of running his plant eight hours a day or six hours a day that same plant runs 24 hours a day, like all similar textile plants. It runs constantly. Now he has 10 million dollars in sales but he hasn't put anything into the investment. I will take that back. A lot of them do put something into the investment. They have repairs and maintenance. One month it would be repair. Next month a wall over here or a roof, a new factory, new spindles---everything else. He has 10 million dollars on sales--six percent on sales after

taxes. How many dollars is he going to have? He has 600,000 dollars after taxes. He has that 600,000 dollars after taxes, and of course the big part of that is going to be the 80 percent over-all rate, which means that you are going to have to multiply that 600,000 dollars by five, which is three million dollars. Ten million dollars in sales before taxes is three million dollars profit, and do you think that the economy of America would stand for that? Do you think Congress would stand for that? Do you think the GI would, who doesn't look at the after taxes, which is plenty. He made a hundred thousand before the war. He looks at what he made before taxes, and if you let him keep 600,000 dollars, then you have taken away from him the burden of helping to carry the war. You have increased your prices so that the burden goes on everybody else. Congress is the taxing authority and the Congress said they should have so much before taxes, and the tax rate is so-and-so. Then we come in and say "We are going to see that what you have done has no effect. We are going to give them so much on the price, and give them a bonus because we have learned that in operating their shops they have stimulated operation more than they ever had in their experience before."

We could give you hundreds of illustrations to show that it was worth the attempt, on the basis that what was suggested was the basis of the opposition to the Renegotiation Act absolutely was not unreasonable from the standpoint of wartime procurement.

I think those were, by and large, the most serious objections urged to renegotiation.

GENERAL MCKINLEY: I am sorry our time seems to be running out. I imagine there are many more questions because they seem to be right in the middle of the subject. I feel that the class has enjoyed this meeting as much as I have, because I think the subject is most instructive and enlightening. I appreciate very much your coming down here and speaking to us.

(29 December 1947--250)S/jeh