University of Chicago Law School

Chicago Unbound

Journal Articles

Faculty Scholarship

1944

Renegotiation--An Answer and Its Problems

George F. James

Follow this and additional works at: https://chicagounbound.uchicago.edu/journal_articles

Part of the [Law Commons](#)

Recommended Citation

George F. James, "Renegotiation--An Answer and Its Problems," 11 University of Chicago Law Review 204 (1944).

This Article is brought to you for free and open access by the Faculty Scholarship at Chicago Unbound. It has been accepted for inclusion in Journal Articles by an authorized administrator of Chicago Unbound. For more information, please contact unbound@law.uchicago.edu.

RENEGOTIATION—AN ANSWER AND ITS PROBLEMS

GEORGE F. JAMES*

PURPOSES OF RENEGOTIATION

STATUTORY renegotiation rests upon one foundation: the demand of the public conscience that no man shall gain from the common calamity of war. That this was its historical and political basis is clear. The sequence of specific legislative attempts to limit profits from war contracts, culminating in Section 403 of the Sixth Supplemental National Defense Appropriation Act, 1942, leaves no doubt as to the motivating force behind the enactment.¹ Consideration of subsidiary policies of the act and of its administration reveals a second truth, less obvious but equally important. No basis other than profit limitation for its own sake will adequately explain statutory renegotiation. Careful, intelligent, and well-informed administration can prevent renegotiation from operating to defeat or unduly to impair competing objectives. Some additional purposes may even be served almost as well as by means primarily designed for them. But there is no understandable and defensible end, except control of war profits for its own sake, which is better served by renegotiation than it would be by other means and methods.

The foregoing remarks are intended in definition of renegotiation and not in criticism. The objective of limiting war profits is a legitimate one. More than that, it is of such importance as to justify extreme measures and substantial expense in man hours, so long as other and more vital requirements are not sacrificed in the process and other essential ends are adequately served.

In the first place, the morale of the fighting forces and of the general civilian public, whether suffering extreme privation or merely undergoing minor annoyance and inconvenience, is sure to be impaired by the spectacle of great fortunes acquired in time of war. This is especially true if the fortunes are earned by those who produce matériel of war and are paid directly or indirectly from the common treasury. All should recognize the necessity in a democracy of preserving the belief that the enor-

* Chief, Price Adjustment Section, Chicago Ordnance District. The opinions expressed herein are those of the author. They are not to be taken as representing War Department policy.

¹ The statutory history is developed in some detail in an article by Senator Walsh in this issue and, therefore, is not included at this point.

mous cost of total war will be fairly distributed, with no useless sacrifice required but with no needless special privilege permitted. This belief might require the support of publicity devices, but the more it rests upon fact the more secure it will be.

There is also a second factor, the importance of which will be more apparent after the war and on which a majority will agree. If a system of industrial production financed and controlled by private capital is to continue in the United States after the war, there must be a reasonable degree of mutual confidence, understanding, and respect among industrial management and finance, labor, and the general public—consumer and voter. Nothing would more surely undermine that confidence than notorious evidence of widespread profiteering on war production. This danger to industry itself, inherent in large war profits, was the burden of early addresses by Mr. Maurice Karker,² first chairman of the War Department Price Adjustment Board, and undoubtedly motivated a number of the businessmen, bankers, and lawyers, who, in uniform and out, have been active in administering the Renegotiation Act for its two years of existence.

These two chief objectives—the preservation of public morale in time of war and the elimination or limitation of a dangerous occasion for economic dispute in the postwar period through a direct attack on war profits as such—explain the actual historical basis of renegotiation and must largely justify it, if it is to be justified. Other commonly stated purposes—checking inflation, rewarding and promoting efficient production at minimum actual cost, and reducing the dollar cost of war—are ends which must be served. Devices must be found to serve them, and if statutory renegotiation is part of our government contracting program, it must be so administered as not to defeat them. But no reasonable person having a clear understanding of the problem would advance overall statutory renegotiation primarily as a device for attaining these objectives in preference to obvious, easily devised competing devices. Some discussion of the procedures of renegotiation and their operation may be necessary to make this fact clear.

PROCEDURES AND OPERATION OF RENEGOTIATION

Section 403 of the Sixth Supplemental National Defense Appropriation Act as originally enacted on April 28, 1942, provided in its effective clause as follows:

² See, for example, the speech delivered by Mr. Karker to the Economic Club of Chicago, Chicago, Illinois, November 23, 1942.

Whenever, in the opinion of the Secretary of a Department, the profits realized or likely to be realized from any contract with such Department, or from any subcontract thereunder whether or not made by the contractor, may be excessive, the Secretary is authorized and directed to require the contractor or subcontractor to renegotiate the contract price.

The emphasis is on profits realized or likely to be realized from contracts, and the operation is the renegotiation of contract prices, presumably to reduce the price on deliveries to be made in the future under existing contracts and perhaps also on deliveries already made under contracts in existence on that date. The act was evidently modeled, at least in part, on procedures already in use on an experimental basis and limited scale in the War Department. In these procedures certain contractors had, in fact, been called in and evidence presented to them showing that unreasonable profits had accrued and were accruing on their War Department contracts. They had then been urged to prevent the continuance of the situation by revision of their price structure and policies from that day forward. Immediately on enactment of the statute, a price adjustment board was set up in the War Department and, in a few early cases, this practice continued with primary emphasis on prices and the prospective operation of price renegotiation. There was apparently some thinking at that time that best results could be reached by a rather rapid review of the contractor's profits accruing in the fiscal year in which the renegotiation took place, the fixing of a firm price schedule not subject to further review for the balance of that year, and, to the extent necessary, the recapture of profits already accrued under the old price schedule, as an incident to the major repricing operation.

Almost immediately, however, practical difficulties arose which, within a few months, resulted in a complete change of emphasis and later in a change in the statutory plan itself. In the first place, any intelligent repricing has to be based upon prices applicable and costs being incurred under individual contracts, or at least for particular products. If a certain contractor producing a number of different products is earning a high profit on some and a low profit or loss on others but the result overall is too high a total profit margin, it would be quite unsatisfactory to require him to make a horizontal slash of all prices. It might be that production on his less profitable items would continue for a substantial time in the future while the contracts under which he was producing the more profitable items might be completed or, through changes in the war program, might be terminated in the near future, leaving the contractor operating at no profit or at a loss under his revised schedule. Or the opposite might occur, so that a redesigned price schedule which was expected to eliminate

all excessive profits for the balance of the year might, in fact, result in substantial excessive profits, due not to the increasing efficiency of the contractor but simply to a change in the distribution of his production among products. On the other hand, actual analysis of prices and costs on a variety of products in connection with renegotiation hearings would be an extremely time-consuming operation which might not prove feasible in the first, wholesale attack on war profits.

Once it was decided that the great majority of all contractors and sub-contractors must be reviewed and renegotiated under the statute, the size of the total operation was so great as to require decentralization. This raised a further difficulty from the point of view of the contractor. If his Ordnance contracts were to be renegotiated by Ordnance, Air Corps contracts by the Air Corps, Navy contracts by the Navy, and so on, there would be the danger that the prices of profitable contracts would be cut down to a level regarded as reasonable by the renegotiating agency while the prices of unprofitable contracts might be left undisturbed, resulting in a total profit picture entirely unsatisfactory to the producer. This possible inequity resulted in the assignment of contractors to the particular service or office having the major procurement interest, which office was granted authority to "renegotiate on an overall basis" for all services, further divorcing the pricing and renegotiation functions. All factors together impelled a mode of renegotiation in which the particular emphasis was on the determination of a lump-sum recovery, which, with any prospective price adjustment the contractor might be willing to make, would be adequate to eliminate excessive profits for the year to be reviewed.

Originally the attempt was made to start this overall review on estimated operating statements for the year. Naturally, such estimated statements could be prepared only by the contractor and no contractor would be willing to prepare such estimates without reasonable protection against contingencies which might result in higher costs and lower profits in the unexpired portion of the year. On the other hand, being largely at the mercy of contractor-prepared estimates and recognizing the inevitability of such contingency cushions, the renegotiating departments were not willing to enter into final contracts on such estimated figures without providing for a further review at the year-end to catch profits which might result from errors or undue caution in the original estimates. The final factor which produced the standard pattern of renegotiation of 1942 fiscal years was the time lag in setting up operating machinery and obtaining assignments for renegotiation. Although the act was passed in April, 1942, thus covering the larger part of 1942 sales and profits, few renegotiating agencies were actually in operation before the last quarter

of 1942 and the majority of all companies assigned for renegotiation were assigned in the latter half of 1943. Thus almost all renegotiation of prices for 1942 fiscal years took place after the end of the year, and more than half took place after a lapse of a number of months. Naturally, emphasis in such renegotiations was on the recapture of profits already earned.

The general procedure of statutory renegotiation in 1943 may be summarized as follows: Lists of war contractors and subcontractors, carefully compiled from a number of different sources, were assembled in the assignment section of the War Department price adjustment board. After an initial screening to eliminate cases in which it was quite apparent that excessive profits did not exist, the companies thus assembled were distributed among the renegotiating agencies, principally the War Department, Navy Department, and Maritime Commission, although certain other renegotiating agencies were later brought in by statute. Within the War Department a few major cases were held for renegotiation by the central Washington board, but the balance were then distributed among the various Army services, such as Ordnance, Air Forces, Signal Corps, Quartermaster, and Engineers. These services in turn decentralized their operations with offices in various principal cities. As a result a company might be assigned, for example, to the price adjustment section in the Chicago Ordnance District. By cross-delegation among the departments and services the local price adjustment section would have authority to conduct renegotiation on behalf of all interested Government procurement groups.

On the receipt of such assignment, which on the average might have been as late as August or September, 1943, the section would establish contact with the contractor and request data relating to the volume of war business and the profits earned thereunder in the company's 1942 fiscal year. Proceedings would ordinarily commence with a conference, either in the office of the price adjustment section or in the contractor's office, at which time the aims and operation of the Renegotiation Act would be explained. Further discussion would then develop the nature of the information required or useful in renegotiation. The basic accounting data required would include balance sheets and profit and loss statements for the year under review and for a number of prior years. For the year under review it would be necessary to segregate income and expense between business subject and business not subject to renegotiation. The problems arising in connection with such segregation are discussed elsewhere in this issue. In addition, the contractor would be expected to furnish information concerning the character of his operations in years of peace, the character of his war production, and his special problems, ex-

penses, and risks, if any, involved in conversion from peace to war. In addition, he would develop evidence of any extraordinary contributions which he might have made to the war effort and any other arguments which he would consider relevant in support of the maximum profit allowance.

While the contractor was preparing accounting statements and assembling other data and arguments, the renegotiating agency would turn to other sources of information within the Government, and particularly to such comparative price, cost, and production data as could be developed in the purchasing and production branches of the procuring services. Information as to Government assistance by way of loans, advance payments, Government-owned plant and productive equipment, and the like might be obtained from the contractor, from Government sources, or both. After all available information had been assembled and reduced to a report, the renegotiating agency would call the contractor in for a conference.

At this conference the data and information appearing in the files of the agency would first be reviewed with the contractor, either to determine that there was no dispute as to the facts or to isolate and minimize any such dispute. Thereafter, either at the same conference or at a later conference, the Government representatives would either indicate that no refund was deemed necessary or would present a request for the refund considered adequate in view of all of the factors of the particular case. While the refund first named would not constitute a final determination, but would continue subject to discussion, the effort was of course made not to name a figure until it was believed that all of the factors were known and understood, and then not to depart from that figure, except on a rather clear indication that the facts had not been properly understood or that the value or importance of some factor had been misjudged. In the great majority of cases—probably 95 per cent or more of all companies assigned—agreement would eventually be reached and the case reported either for refund or clearance. For a number of months final action on all cases was by the several top Washington boards. Later, however, authority to act by agreement was delegated to the several services in cases involving total sales of not more than \$10,000,000 and, in many instances, to field offices in cases involving total sales of not more than \$5,000,000. All impasse cases, however, went to Washington for action, the authority to issue unilateral determinations not being delegated below the special representative of the Under Secretary of War.

The procedure described above had several advantages. It permitted the assigned contractor to average out losses or low profits on certain

Government contacts against high profits on other more successful operations. It subjected the contractor to review by only one agency, thus reducing the administrative burden both on the agencies and on the administrative and accounting offices of the contractor. It permitted examination of profits after the fact, thus eliminating the problems of estimated figures, and minimized the problems of risks and reserves against contingencies. On the other hand, it resulted in practice in almost complete focus on recapture of past profits and the elimination of repricing of existing contracts as an important factor. The result largely justifies the recent statement of Mr. William L. Marbury that "renegotiation under Section 403 as practiced during the early months of its operation was merely a discretionary excess profits tax of one hundred per cent."³

This development of renegotiation from repricing to recapture was later embodied in the statute. The Revenue Act of 1943, which became law on February 25, 1944, contains in Title VII, under the heading "Renegotiation of War Contracts," a complete revision of what had been Section 403 of the Sixth Supplemental National Defense Appropriation Act of 1942. This Title VII creates a statutory War Contracts Price Adjustment Board handling renegotiation for the several Government procurement agencies to which the act applies. This board is given authority to enter into agreements "with respect to the elimination of excessive profits received or accrued. . . ." It further provides: "If the Board does not make an agreement with respect to the elimination of excessive profits received or accrued, it shall issue and enter an order determining the amount, if any, of such excessive profits. . . ." The act then provides a limited review of such orders in the tax court of the United States. It should be noted that under this title the basic responsibility of the price adjustment board is the elimination of excessive profits *received or accrued*. The only authority directly to adjust contract prices is contained in the sentence which follows the directions of the board to endeavor to reach an agreement with the contractor with respect to the elimination of excessive profits and provides: "Any such agreement, if made, may, with the consent of the contractor or subcontractor, also include provisions with respect to the elimination of excessive profits likely to be received or accrued." The price adjustment board has no authority prospectively to adjust contract prices in default of agreement. This authority is vested by Title VIII of the same statute in the secretaries of the several departments.

The recapture or taxlike emphasis of renegotiation has formed the

³ "Renegotiation and Procurement" by William L. Marbury and Robert R. Bowie, 10 *Law and Contemporary Problems* 225 (1943).

major basis for much of the more temperate and better-reasoned criticism of Section 403. It is, therefore, of value at this point to indicate certain respects in which this procedure, however much it may differ from the original repricing theory, is still justified as a satisfactory technique—a technique superior to others which might be used for the purpose of eliminating excessive war profits. It is often objected that the Renegotiation Act contains no definition of excessive profits. It is argued that the act provides a one hundred per cent tax on profits above a point, which point is not fixed by statute but is left open for administrative determination. In this it contrasts sharply with the technique of the Vinson-Trammell Act or the Case Amendment passed by the House of Representatives in April, 1942, each of which fixed maximum percentages of operating profit to sales⁴ and provided for recapture of all profits accrued in excess of the rate allowed. Such definite and inflexible profit margins may, perhaps, be justified if applied by statute to a single field, such as shipbuilding in the original Vinson-Trammell Act. If applied to all war production, they would achieve actual discrimination of a glaring sort under the guise of uniformity. A single profit margin applicable to the needle trades, to a single manufacturing operation (such as a grey iron foundry or a forge shop), and to a most highly integrated manufacture in which basic raw materials are processed through a number of steps into the amazingly intricate and accurate end products of modern ordnance matériel, would necessarily be far too liberal at one extreme, far too severe at the other, or, in seeking to strike an average, would be unsatisfactory at both ends of the scale. On the other hand, it would be impossible for Congress, within the limits of time available, to study all of the industries the products of which flow directly or indirectly into the procurement branches of Government, and work out separate standards for each such industry and operation. Even if it were possible effectively to classify all Government contractors and subcontractors by industry and operation, the task could only be performed through the more flexible administrative procedure and could only be performed in the first instance on a case by case approach, and through the accumulation of precedents, each based on the informed judgment of reasonable men dealing with the detailed problems of the contractor, forced to negotiate with experts in each field and exchanging information among themselves as the task for the first year proceeded toward completion. On this ground alone and even assuming that standard formulae for treatment of various industries and operations would be

⁴ It was clear in the Vinson-Trammell Act that the maximum statutory profit percentage referred to the percentage of operating profit to sales. The same was quite evidently the intent of the Case Amendment, although the language is not so clear.

desirable, the actual operation of renegotiation in 1943 is abundantly justified.

It is, however, extremely questionable whether even this character of uniformity by industry and operation is desirable and should be achieved. Within an industry there will always be a variation in normal earning power, operating efficiency, competitive position, volume of production, and risk among the various units, which may justify rather wide departure in particular cases from any norm established for the group. Before considering the manner and the extent to which such factors should be considered and permitted to create apparent discrepancies, it will be well to consider the criteria which have in fact influenced the results reached and profit margins allowed in renegotiation settlements.

For a few months renegotiating agencies early in the field operated almost entirely without instructions as to the criteria for determining excessive profits. To the extent that uniformity of approach was attained, it resulted from the hundred per cent review of all settlements in the War Department, Navy Department, and other central Washington boards. Before long, however, directives and statements of policy and procedure were issued, binding at least on the consciences of all field offices. Substantially these criteria were later embodied in the revised Renegotiation Act of February, 1944. Thus, the following statutory provisions⁵ state, in effect, the policies which were in effect during 1943.

In determining excessive profits there shall be taken into consideration the following factors:

(i) efficiency of contractor, with particular regard to attainment of quantity and quality production, reduction of costs and economy in the use of materials, facilities, and manpower;

(ii) reasonableness of costs and profits, with particular regard to volume of production, normal pre-war earnings, and comparison of war and peacetime products;

(iii) amount and source of public and private capital employed and net worth;

(iv) extent of risk assumed, including the risk incident to reasonable pricing policies;

(v) nature and extent of contribution to the war effort, including inventive and developmental contribution and cooperation with the Government and other contractors in supplying technical assistance;

(vi) character of business, including complexity of manufacturing technique, character and extent of subcontracting, and rate of turnover.

One of the most important factors in the early cases was the prewar earnings record of the contractor, suggested in the phrases "reasonableness of costs and profits with particular regard to volume of production, normal prewar earnings, and comparison of war and peacetime products."

⁵ Revenue Act of 1943, Title VII, Sec. 701 (a).

The theory was that the actual record of each contractor in a normal peacetime era (ordinarily taken as the years 1936/1939) constituted a starting point in determining a reasonable profit for the same contractor in time of war. This profit was taken in terms of the relation between average prewar operating profit and average prewar sales, in dollars. It was, however, early determined that this ratio should not necessarily hold in cases in which the contractor was enjoying an extraordinary volume of sales as a result of the war effort. To take the simplest case, if a contractor ordinarily earned \$1,500,000 on a normal sales volume of \$10,000,000 and in 1942 he was enjoying a sales volume of \$100,000,000 in the same product, without comparable increase in plant and invested capital, it did not follow that he was entitled to a profit of \$15,000,000 before taxes from these operations. A possible alternative computation would have been to "freeze" the contractor's normal ratio of operating profit to invested capital. The difficulty of this approach would be that the contractor would have no incentive whatsoever to increase his output in relation to plant and investment since he might show no profit on his additional or "incremental" sales volume. The sliding scale technique by which the contractor would receive some additional profit on each increment of additional volume but a smaller percentage profit as volume increased, afforded in effect a compromise between a normal return on sales and a normal return on capital, designed to leave an incentive for increased volume while preventing dollar profits so great as to offend public conscience and to support a charge of profiteering.

No contemporary discussion explains in detail why it was generally conceded that a contractor with high prewar earnings should be permitted a higher profit on war business than a contractor with a low prewar profit. Two reasonable explanations suggest themselves. In most cases high prewar profits indicate one or both of two conditions: (a) an industry the characteristics of which are such that a relatively high profit on sales is normal and necessary; (b) efficient management and operations resulting in a profit margin above that normal for the industry. In any particular case high or low profits might have resulted independently of the normal operation of these factors. For example, a particular industry which ought to show a high profit in normal periods might chance to have been depressed during the period 1936/1939, or a particular company by virtue of monopoly position might have enjoyed profits not justified by the nature of its business or by its own efficiency. In general, however, the base period approach would tend to give favorable treatment to industries requiring a high profit and to efficient operators. Since the base period approach was used as a guide and not as a formula, individual cases in

which it produced an unjustified result could be eliminated by adequate analysis.⁶

From the start it was apparent that the base period approach has little validity where the war production of the contractor is not substantially similar to its peacetime business. If a washing machine company, a stove manufacturer, a radio assembler, and a producer and merchandiser of gasoline pumps are all engaged in manufacturing armor-piercing shot there is no particular reason why the prewar earnings of these various companies should be relied upon as a test for what each should earn in its war production. In such cases it becomes necessary more directly to attack the problems of the "efficiency of contractor, with particular regard to attainment of quantity and quality production, reduction of costs, and economy in the use of materials, facilities and manpower" and the "character of business, including complexity of manufacturing technique, character and extent of subcontracting, and rate of turnover." The factors of the character of the business would be more or less uniform among producers of the same military item, or at least to the extent that they were not uniform the differences would be comparatively simple to evaluate. Such problems could, after a year of operation under renegotiation, be reduced fairly effectively to a set of administrative standards permitting a reasonable degree of comparative equality of treatment. Factors of efficiency, however, are those peculiar to each contractor and the ones which present the greatest difficulties in the fair and constructive administration of the statute, once the negotiator departs from base

⁶ A typical case in which base period averages would constitute too harsh a starting point in determining excessive profits would be that of a company engaged in a normally highly cyclical industry in which the years 1936/1939 represented a relatively low point in the cycle. It is characteristic of such businesses that they must earn fairly high profits in their good years in order to carry them through recurrent periods of low earnings or losses. For example, a company producing heavy steel forgings, largely for the railroads and rail equipment industry, showed an average rate of earnings from 1936 to 1939 of less than 6 per cent on a normal sales volume of less than \$5,000,000. It is common knowledge that these years were not a period of generally satisfactory earnings in the industry. The inadequacy of this company's level of operations and profit was demonstrated by the fact that its net income after taxes expressed as a percentage of net worth varied from 2 per cent to 10 per cent during the period, with an average between 5 per cent and 6 per cent. It was apparent that this was not a level at which permanently successful operations could be looked for. The company was allowed approximately 10 per cent on sales before taxes on the renegotiable portion of approximately a \$15,000,000 sales volume, which permitted the company to retain a profit equal to about 13 per cent of net worth after taxes. On the other hand, another company showed average prewar earnings of about 23 per cent before taxes on a normal sales volume in excess of \$1,000,000. Analysis of the business situation showed that the 1936/1939 period was abnormally good for this company which happened to have a trade position permitting it to take the fullest advantage of an abrupt and drastic increase in the demand for its product. Despite close similarity between the war and peace product, the company was cut down to a return of about 12½ per cent before taxes on the renegotiable portion of its 1942 volume.

period earnings as a test assumed approximately to reflect efficiency in management.

The simplest approach to the problem of efficiency would be to take all producers of a particular item, and compare their respective unit prices and their respective profit margins. If four competing firms were all manufacturing 75-mm. armor-piercing shot at the same unit price and one contractor came in with a 5 per cent profit margin, the second with 10 per cent, the third with 20 per cent, and the fourth with 40 per cent, it would appear that the relative efficiency of the producers was thus demonstrated. The most efficient producer would be entitled to the highest profit margin not only in percentage but in dollars. If the 10 per cent producer were taken as the norm, on a \$1.00 unit price he would receive and retain 10¢ in profit. The 5 per cent operator would present no problem. As long as his production was necessary for the war effort he would be entitled to keep his nickel, but no more. And certainly the 20 per cent and 40 per cent producers would be entitled at least to 10¢ a shot, even though the result was to give the 40 per cent producer a profit of 16.7 per cent on costs or 14.3 per cent of "adjusted sales."⁷ This would be the minimum. Perhaps the most efficient producer should receive at least 15¢, although this would show him a profit margin of 20 per cent on adjusted sales, a level of profit which, without the supporting data, would appear to be excessive.⁸

Even if data as accurate as those assumed in the foregoing paragraph could normally be obtained, the problem is not so simple as that and the answer is not so obvious. In private business with no Government control and no Government interference, the efficient producer with low average costs would receive 40 per cent profit on his \$1.00 shot as long as the demand was such that shot could be sold for \$1.00 and the 95¢ producer retained in production. In cutting the 40¢ profit producer down to a 15¢

⁷ "Adjusted sales," an important concept in renegotiation computations, is actual net sales less the dollar amount of the refund obtained. Renegotiable profit after refund is always expressed in price adjustment statements as a percentage of renegotiable adjusted sales. Thus, if a company came into renegotiation with renegotiable sales in the amount of \$10,000,000 on which it showed an operating profit of 60 per cent and if a refund of \$5,000,000 were obtained, the remaining \$1,000,000 in profit would be described not as 10 per cent of sales but as 20 per cent of adjusted sales. This method of computation is necessary in comparing results, since a mode of expressing remaining profit after renegotiation as a per cent of unadjusted sales would tend to favor companies who entered renegotiation with greatly inflated sales figures resulting from extraordinarily high profits. In effect, the adjusted sales technique is a circumlocution for expressing profit as a percent of cost.

⁸ The hypothetical case discussed is by no means fanciful. A number of comparable instances could be presented from the files even of the single office with which the writer is connected.

profit we have already introduced an element of moral judgment. We have, in effect, decided that the low cost producer is not entitled in practice to the full difference between his average cost and a price which permits the highest cost producer whose product is required by the Government to remain in business. Following the same approach, we must next consider the cause of such startling differences in average cost of production. We may find that the 95¢ producer is operating with a relatively small volume of Government orders, using relatively inappropriate and inefficient machinery which he has acquired and converted to war production, while the lowest cost producer has been given a tremendous volume of orders and has acquired or has been furnished the most modern and best-equipped of plants to make his high level of production possible. In such a case the efficiency of the high cost producer, given the situation in which he is to operate and the facilities which he is using, may be as great as or greater than the minimum cost producer, and it becomes less obvious that the minimum cost producer is entitled to a higher profit margin.

The foregoing illustrations are based on the assumption that genuine comparisons can be made among various producers of novel war items. Even on this assumption it should be clear that the problem of determining proper profit margins for each such producer is not an easy one. In the majority of actual cases, moreover, the assigned contractor is producing several different war items and produced them during the year at various prices and with various modifications of design from time to time, some of which may be unimportant but some of which may be very important indeed. The attempt to compare him with other producers of the same and different items, likewise produced at various prices and subject to various design changes, is so complex as to fall in very many cases outside the limits of practical administration. We can only note that the efficient producer should receive preferential treatment in renegotiation—since uniform treatment in terms of per cent of profit to costs will otherwise actually reward inefficiency and put a premium on waste—that low prices or high profit margins at average prices are some evidence of efficiency, but that variations in labor market, plant, and equipment may render these guides of price and profit margin unreliable as a gauge of efficiency in any particular case.⁹

⁹ The discussion to this point has covered the factors which had the major influence on actual profit margins allowed in renegotiation of 1942 fiscal years. In certain cases the element of public and private capital employed and the net worth of the contractor have been important. The writer believes, however, that the question of capital employed is so closely related to the question of volume that it hardly merits independent discussion. In general, it may be said that to the extent that extraordinary volume is obtained by the use of Government equip-

At this point it may be well to introduce a competing objective of the retrospective pricing function exercised in statutory renegotiation. In Lieutenant Watt's article it is pointed out that the very existence of renegotiation as a backstop for their efforts has afforded a temptation to procurement officers to relax in their efforts to obtain the closest possible price from each producer and has given the producer an argument which he may present to the contracting officer and to his own conscience in support of bids which carry either a high profit margin or unreasonably large reserves against contingencies which will probably ripen into high profit margins in the normal course of production. It has been suggested that renegotiating groups must combat this tendency by rewarding the contractor who comes into renegotiation at the year end with relatively low profits, since these indicate that he has followed what is known as a "close pricing policy."¹⁰ But the question has aptly been asked "Close to what?" Relatively low profits at the year end may result from efficient, well-controlled operation under carefully considered low prices. It may equally result from relatively high prices followed by a relaxation of cost

ment, working capital, or both, through extraordinary reliance on subcontracting, or by any combination of these factors, the maximum discounting for volume (i.e., the most severe application of the descending sliding scale of profit) is indicated. On the contrary, where the extraordinary volume is obtained with the use of the contractors' own capital and plant, either by additional investment and physical expansion, or by bringing previously idle facilities into play, there is less justification for any volume discount. It will frequently be true where a large additional volume of actual manufacturing operations can be carried on with the capital and facilities already in use that the company was one subject to severe cyclical influences and was in an unfavorable stage of the cycle in the base period and, therefore, had large standby capacity. In such a case discounting from base period would have very questionable validity. (See in this connection note 6 *supra*.) Where the contractor has committed substantial amounts of additional capital to his venture and particularly if he has invested them in fixed assets, again it seems quite questionable whether there should be any substantial discounting for volume.

The special committee of the United States Senate investigating the National Defense Program presented a report March 30, 1943, showing profit margins after renegotiation in 70 cases in which the War Department had completed renegotiation and had obtained a refund. Three per cent of these companies were left with renegotiable operating profits less than 6 per cent of adjusted renegotiable sales. Thirteen per cent were left with a profit between 6 and 8 per cent, 22 per cent with a profit between 8 and 10 per cent, 24 per cent with a profit between 10 and 12 per cent, 17 per cent with a profit between 12 and 14 per cent, 14 per cent with a profit between 14 and 16 per cent, and 7 per cent of the companies with a profit in excess of 16 per cent of adjusted renegotiable sales. Thus approximately two thirds of the cases were settled between 8 and 14 per cent. The writer has seen later and more comprehensive figures which are generally consistent with those published in the Senate report. The variation indicates that some factor or factors were, in fact, taken into account as justifying a very considerable spread from a median of about 11 per cent. In the writer's opinion, the principal factors which produced this result were those discussed above and particularly base period earnings and the nature and complexity of the manufacturing operation.

¹⁰ Note statutory criterion: "(iv) extent of risk assumed, including the risk incident to reasonable pricing policies."

control when it became apparent that these high prices were resulting in high profits which taxes would largely eliminate and which renegotiation would not permit. In some instances this situation is easily discovered. If a contractor comes in with an abnormally high gross manufacturing profit and a net operating profit within a reasonable range, padding of such overhead items as advertising, branch office expense, and administrative salaries is a possibility to be considered. General and approximately uniform lack of control over costs, with high wage rates, inefficient use of labor, waste of raw materials, and excessive profits paid for pre-fabricated components, is much less easy to recognize. Despite their limitations, comparative price data supplemented by reports from Government plant engineers and inspectors on the nature of the operation, the modernity of plant, and the character and quality of equipment here give the best guide. It must be recognized, however, that within the limits of the administrative procedure such checks are not perfect. To the extent that emphasis in renegotiation is based on apparent "close pricing" in the sense of a reasonable profit margin at the year end, it may be at least a half truth that efficiency does not pay in renegotiation. This brings the discussion around to the stated objectives of the act, other than control of excessive profit, and to criticisms which have been leveled against the act and its administration.

MAJOR PROBLEMS OF POLICY—THE PROS AND CONS

As stated above, renegotiation has been credited with various subsidiary objectives among which were reduction of the total dollar cost of war, avoidance of inflation, and the promotion of efficient production at minimum actual cost. On the reduction of the dollar cost of war, renegotiation has made a definite contribution, small by comparison with total Government expenditures but still significant. The most commonly quoted estimate of the net savings from renegotiation—the amount recovered through renegotiation which would not have been recovered through taxes—is about \$1,500,000,000. Such a saving is by no means negligible. In normal times the sum would seem vast and even today it should justify its cost and even the political turmoil which it has occasioned. While obviously more money could be raised by an increase in the tax rate, renegotiation as an instrument of fiscal policy may be regarded as a flexible adjustment of maximum tax rates, designed to increase the burden on companies earning too much even despite taxes; in a sense is an offset to various relief provisions in the excess profits tax designed to aid companies on whom these taxes bear too heavily.¹¹

¹¹ The writer is indebted for this analogy to Mr. Herbert C. Hirschboeck of the Milwaukee Bar, formerly a member of the Chicago Ordnance District Price Adjustment Section, who

The extent to which renegotiation has been of value in combating inflation and in promoting industrial efficiency is more questionable. Taking the recapture operation alone and disregarding any indirect assistance which renegotiation may afford the pricing activities of procurement officers, there is some force to the argument that the effect of the statute is inflationary and tends to discourage efficiency. Mr. Baruch has pointed out the truism that such is the effect of high excess profits taxes. To the extent that renegotiation has operated as a one hundred per cent tax on certain profits determined by administrative procedure to be excessive, the same principle would seem applicable.¹² The preceding discussion should show that a sincere effort has been made in the administration of the act to reward efficiency and to favor the company which has not been guilty of charging prices so excessive in the first instance as to create a virtual guaranty of profit. In any case one year of renegotiation, coming in well after the event and not fully anticipated during the year reviewed, could have had no substantial effect one way or the other on the costs of that year. The problem today is the effect of continued renegotiation on industrial efficiency and morale and the extent to which good effects may be emphasized and bad effects minimized. At this point perhaps another word may be said on the twin policies of rewarding low cost and penalizing high profit. Each is designed to promote industrial efficiency. The theories behind them are different and their operation may to some extent be inconsistent.

The theory of rewarding low cost is the converse of the "cost-plus-per-cent-of-cost" criticism. If it were true, for example, that all steel foundries could expect to receive as a result of renegotiation a profit equal to 12 or 13 per cent of cost, the higher the cost of the operation the higher approved profit would be in dollars. To the extent, therefore, that it is possible in renegotiation to test comparative costs of competing producers and to insist upon the rule that the low cost producer must receive the

proposed it in an address to the Wisconsin State Bar Association on February 22, 1944. The following illustrations (based on actual cases, with the facts somewhat disguised) show that such a flexible correction of maximum tax rates is sometimes necessary. Company A had average annual net sales in the prewar period of less than \$300,000, with an average net profit before federal taxes of less than \$30,000 and net income after taxes of less than \$25,000 a year. In 1942 this company before renegotiation showed a total net profit before taxes of more than \$1,500,000 and a net income after taxes of more than \$400,000, or some three and one-half times the net worth of the company at the start of the war period. Company B had average prewar sales of less than \$1,000,000 a year with average profit before taxes of less than \$50,000. In 1942 this company's net profit before taxes was in excess of \$8,000,000 and its net profit after taxes in excess of \$2,000,000, or more than six times its net worth at the start of the war. These cases are extreme but scores of other instances almost as extreme could be adduced.

¹² It should be noted, however, that the effect of renegotiation in improving public morale may have an important effect in minimizing inflationary demands for wage increases.

higher unit profit in dollars regardless of the result upon profit percentages, this criticism could be met and it could be demonstrated that even a continuation of renegotiation for successive years would not operate to put a premium on inefficiency and discourage cost reductions. The chief difficulties in the execution of this policy are two: (1) it is impossible in many cases and difficult in all cases to obtain accurate product costs on which any reliable comparison could be made among producers: (2) such figures even when obtained are unreliable and inconclusive as a test of efficiency, unless they are supported by reasonably comprehensive information as to the character of each producer's plant, equipment, manufacturing process, and available labor supply, since low dollar costs may result either from exceptional efficiency of management or from the exceptionally favorable situation within which the management is operating.¹³

The policy of penalizing high profits, on the other hand, ties in with the general procurement picture. Maximum industrial efficiency and the pressure on management to control costs result in the normal competitive market not only from the hope of profit but also from the fear of loss. A contractor who is able to sell his product at such a price that the fear of loss is eliminated is subject to only one of these pressures—the hope of gain, and the effectiveness of the hope of gain as a motive for controlling costs is sharply limited by the existence of effective tax rates at 80, 90, or 95 per cent. The philosophy behind penalizing the unreasonably high profit margin is to induce the producer to negotiate contracts with the Government and subcontracts thereunder at such prices that his maximum profit from careful and efficient production will be moderate and loss might result if costs got out of hand. The danger in this approach lies

¹³ The writer is indebted to Mr. Sharp, also a contributor to this issue, for a criticism pertinent at this juncture. Mr. Sharp points out that there may be a significant "cost-plus" factor even in procurement at firm prices not subject to subsequent review. Although the contractor in such a situation is entitled to retain his profit on any particular contract (subject to taxes) his actual costs on completed work and work in process are a necessary and proper factor for consideration in awarding him additional orders and continuation contracts. Hence, on a close question of control or relaxation of costs, a contractor might feel that what he loses in increased costs on contract A he would gain in an increased price on contract B, although he would always be limited by the danger that if his costs got far out of control, the elements of competition and selection which remain in the procurement program would result in his failing to obtain additional or continuation business. Mr. Sharp suggests that while it is extremely difficult to detect loss of control of manufacturing costs by comparison of one producer with another, it may prove easier to detect rising costs and, hence, to apply pressure for cost control through statutory renegotiation, when a given producer's costs for the second or later years subject to review can be compared with the costs of the same producer in years which have already come under scrutiny. It is to be hoped that this approach will prove fruitful, but evidence to support the thesis lies in the future.

in the difficulty of determining after the fact and particularly on an overall analysis of results, often without truly dependable bases of comparison, whether a high profit margin may not have resulted from extraordinary efficiency at a fairly reasonable price while a more moderate profit margin might have resulted from inefficient operations at a price under which the contractor should have been able to show far better results.

The foregoing discussions may support certain conclusions, or at least opinions. As a device for limiting profiteering and transferring back to the Treasury unreasonable gains from war production, the Renegotiation Act is and has been satisfactory. More flexible than any tax statute or arbitrary profit limitation, it can at the least equate allowable profit margin to the character of the operation reviewed. It can and does supplement excess profits taxes by eliminating those truly excessive profits which will always escape a uniform revenue-raising measure designed to cover the average case. Mr Karker once defined excessive profits as those profits which no conscientious man would care to defend in the forum of public opinion in a time of national calamity. In eliminating these profits renegotiation has performed a valuable service for public morale and for the reputation of decent business in the postwar period.

It is harder to make a case for overall, retrospective recapture of profits through statutory renegotiation as a measure designed to encourage and advance the most efficient operations of our economic system. There is no lack of good will to do it; there is no lack of understanding of the problems presented and, on principle, of the techniques to be applied. The practical difficulties are such that renegotiation is a very dubious instrument for economic control. Recognizing this fact, Congress has determined that the act should expire on December 31, 1944, plus or minus six months as the President may direct. In its short life the act has provided the occasion and the machinery for accumulating a tremendous amount of information concerning the overall operations of that portion of our economy directly devoted to the war effort. The next few months will decide whether the use made of this material, first in cooperation between the renegotiating and the purchasing agencies and then by the purchasing agencies in the exercise of their own unique responsibilities in shaping future pricing policies, will give a second and equally important justification for this noble experiment and will, at the same time, justify its termination.