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THE ROLE OF SMALL BUSINESS IN THE ECONOMY—TAX AND FINANCIAL PROBLEMS

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JOINT HEARING

BEFORE THE

SELECT COMMITTEE ON SMALL BUSINESS

AND THE

JOINT ECONOMIC COMMITTEE

UNITED STATES SENATE

NINETY-FOURTH CONGRESS

FIRST SESSION

ON

THE ROLE OF SMALL BUSINESS IN THE ECONOMY—TAX AND FINANCIAL PROBLEMS

NOVEMBER 21, 1975

Printed for the use of the Select Committee on Small Business and the Joint Economic Committee

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U.S. GOVERNMENT PRINTING OFFICE

64-507 O WASHINGTON : 1976

For sale by the Superintendent of Documents, U.S. Government Printing Office Washington, D.C. 20402 - Price $3.80

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November 21, 1975:	
Morning session	1

THE ROLE OF SMALL BUSINESS IN THE ECONOMY—TAX AND FINANCIAL PROBLEMS

FRIDAY, NOVEMBER 21, 1975

U.S. SENATE,
SELECT COMMITTEE ON SMALL BUSINESS
AND THE JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The committees met, pursuant to notice, at 10 a.m., in room 1202, Dirksen Senate Office Building, Hon. Hubert H. Humphrey and Hon. Gaylord Nelson presiding.

Present: Senators Humphrey, Nelson, Javits, and Packwood.

Also present: William B. Cherkasky, executive director and Herbert L. Spira, tax counsel, Select Committee on Small Business; and Larry Yuspeh, economist, Joint Economic Committee.

Senator HUMPHREY. Secretary Simon, we want to welcome you again. You have been very considerate of our needs here in this committee, and as you know, this is a meeting of the Joint Economic Committee and the Small Business Committee of the U.S. Senate, a small joint meeting. Senator Nelson is chairman of the Small Business Committee.

I am privileged to serve in the chairmanship of the Joint Economic Committee.

We each have an opening statement. I will run through mine very quickly and then I will yield to Senator Nelson.

STATEMENT OF HON. HUBERT H. HUMPHREY, A U.S. SENATOR FROM THE STATE OF MINNESOTA

Senator HUMPHREY. As we indicated, the small business person has been suffering from a most insidious form of neglect by the Federal Government. The Government remembers him if tax payments are due or some Government regulation is possibly being violated.

But when it comes to helping him survive financially, most of the talk concerns his large competitors and regretably, none concerns him.

The small business person is most surely our Nation's new forgotten man. Irving Kristol, noted writer and scholar, points out in his excellent November 13, Wall Street Journal article, which I am now placing in this hearing's record, that, "Big business is in the spotlight to such a degree, and is the focus for such passionate concerns (pro or con), that the small businessman is an invisible figure, offstage somewhere."

I might add, the Government through the Small Business Administration, has given some attention to the needs of our smaller entrepreneurs.

This neglect, however, has had many debilitating effects on small business. But none has been so crippling as the capital formation crisis that now plagues small firms. Small business people must face tight money, rising costs, depressed markets, uncertain supply sources, and in addition to that, a Federal Government that pays too little attention to their specific problems.

Let's take a closer look at the financial environment of our economy's small business sector.

Small business does not have the access to capital funds as big business does. The financial vice president of a large corporation receives special treatment and interest rates from banks, and if he prefers not to raise his employer's debt position, he can turn to bond or equity markets to raise capital.

Small business, however, must pay extremely high interest rates. Short-term rates for small borrowers ran between 16 percent and 18 percent last year. And equity financing is all but nonexistent for small firms. There have only been 10 stock issues for small- and medium-sized firms in the past 20 months.

In addition, while $1.4 billion was raised in equity markets for firms with less than $5 million in sales in the boom year of 1969, such capital has all but disappeared in 1975.

These severe conditions have created an environment in which the formation of new ventures is more difficult than ever before.

Necessarily, therefore, small business must rely heavily on retained earnings to provide the capital it needs to operate and expand. But even here Federal policy does not give small business an even chance.

When I mention Federal policy, I am not speaking of the executive branch. I am speaking of the total Government, the executive as well as the legislative.

Tax rates tend to discriminate against small firms. While our Nation's largest businesses have an effective tax rate of only about 25 percent, small business must pay at a tax rate in excess of 50 percent.

Considering the apparent dismal financial condition of small business, one would think that the Federal Reserve System would at least have several people responsible for analyzing the general condition of the small business sector. But I am told that they do not have even one.

Today, we have as one of our witnesses, Mr. Wallich, who is here, and he will give us some information on this.

Because of this shocking condition, I introduced a Senate resolution yesterday, cosponsored by Senator Nelson, which directs the Chairman of the Federal Reserve Board to make sure that analysis of economic and financial data relevant to the U.S. economy's small business sector will be made and taken into account by the Board of Governors in making any of its decisions.

It also directs the Board of Governors to determine the impact on small business of any of its decisions before they are finally made. I am placing the full text of that resolution in the hearing record.

Today, then, we will hear from distinguished witnesses from both the public and private sectors. They will help us assess in some detail the extent of small businesses' capital formation problems, and they will discuss policy suggestions that they feel will help solve them.

Our first witness will be Hon. William Simon, Secretary of the Treasury. He will be followed by a panel, which is composed of Mr. Henry Wallich, a Governor on the Federal Reserve Board; Mr. James Needham, the president of the New York Stock Exchange; and Mr. Louis Laun, the acting Administrator of the Small Business Administration.

Senator Nelson, I believe you have a statement. After that, Mr. Simon, we will proceed with your statement.

STATEMENT OF HON. GAYLORD NELSON, A U.S. SENATOR FROM THE STATE OF WISCONSIN

Senator NELSON. This morning's hearing of the Select Committee on Small Business and the Joint Economic Committee is a milestone in the efforts to draw the attention of high officials of the Federal Government to the serious problems of the 97 percent of the U.S. business community, which is classified as "small business."

There is increasing recognition among the Congress and the public, that our Nation has been neglecting this vital segment of the economy which accounts for over half of private employment, 43 percent of business output, one-third of the gross national product, and over half of all invention and innovation.

This was summarized this month in the Wall Street Journal by Professor Irving Kristol of New York University.

He stated: "The small businessmen are being bankrupt by a political process that takes them for granted and is utterly indifferent to—their—problematic condition."

The use of the word "bankruptcy" is not an exaggeration. Business bankruptcies rose a startling 45 percent in the year ending June 30, 1975; and included 5 of the 10 largest business failures in U.S. history.

The worst recession since the 1930's was a major blow for the firms that failed. Beyond this, however, our committee has found, as a result of 50 days of hearings this year, that small businesses have become more vulnerable to such a collapse over the past 25 years because of an inequitable tax system, imbalance in the methods of raising capital, a proliferation of Federal regulation, and a blizzard of paperwork.

For example, the corporate income tax structure dates from 1950, and the estate tax structure from 1942. Meanwhile, inflation has increased the price of goods and services 224.1 percent from 1942 to mid-1975.

Moreover, the individual income tax exemption for 10½ million sole proprietors has risen only 50 percent, and the corporate surtax exemption remained at $25,000 from 1950 to 1975 when it was raised 100 percent for 1 year only.

As one result, the profit shares of the largest corporations have consistently increased. A pattern of mergers has been reducing competition and placing economic and political power in fewer and fewer hands.

Our committee has received testimony that it has become almost impossible to begin a significant, new business in this country in the past few years.

This is evidenced by the fact that there have been only 10 stock issues of companies with net worth at less than $5 million in the past 22 months.

The deterioration of conditions for small business is dimming hopes for economic recovery in the short run. However, over the long run, we are most concerned about the permanent damage being done to the U.S. economy and the private free enterprise system.

In my view, the starting point for changing this perilous course is a recognition that the present tax system is inequitable and obsolete as applied to existing small- and medium-sized, independent business, and to the potential new enterprise generation.

For this reason, we are particularly pleased to have the distinguished high officials of the executive branch as witnesses to discuss the vital questions of taxation and financing of this segment of the economy.

But, we must move quickly from recognition of the problems to meaningful relief and reform of tax structure and the means for raising capital. To do this, we will need some institutional reform.

We are looking forward to testimony this morning with the hope that the promise of this hearing can be fulfilled, and that it will help to usher in a third American century where the free private enterprise is renewed and preserved and can contribute strength and dynamism to our economy and society.

(The prepared statement of Senator Haskell follows:)

Statement of Hon. Floyd K. Haskell, a U.S. Senator From the State of Colorado

I am pleased to see that senior economic and monetary policymakers of the Ford administration have joined us today to discuss the problems of small business.

In 1970 the Nixon administration, in an attempt to dampen inflation created a significant economic downturn. Inflation was not dampened by decreasing demand. Arthur Burns recognized that its source was a combination of cost push and sectoral bottlenecks and not excessive demand. Monetary policy was eased and wage-price controls were instituted.

In late 1974 the Ford administration resorted to the same recession inducing monetary policy. The results have been devestating to the small business community.

I maintain that deliberate recession inducing policies are adopted at the expense of the working man (especially the nonunionized worker) and the small businessman. By hurting them least these policies benefit large corporations.

Today, I would suggest we consider the way in which our tax policies favor large corporations and thereby contribute to their competitive edge vis-a-vis small business.

How many small businesses benefit from DISC? Very few I'd suggest. Who benefits most from the investment tax credit? Mr. William Goldstein, Deputy Assistant Secretary for Tax Policy at Treasury has said it is the big corporation not the small businessman who really benefits from the credit. Small businesses don't generally have the concentration of fixed assets that a large corporation has and therefore does not enjoy the benefits of accelerated depreciation to the extent of the large corporation. They also don't have the resources to

employ sophisticated accountants and tax lawyers. Our tax laws encourage concentration and conglomeration.

I suggest that while we consider the tax needs of the small businessman we recognize that the first change must be to the provisions of the code which encourage concentration and benefit large corporations disproportionately to their benefit to small business.

Senator NELSON. Secretary Simon, do you have a prepared statement? I see you have.

Secretary SIMON. Yes, I do, which I would like to not summarize, because I think I have made some important points. But I will skip through it as freely as I can.

Senator NELSON. Feel free to present it as you desire. And will you for the purpose of accurateness of the record, identify your associates.

Secretary SIMON. Thank you. Mr. Chairman, gentlemen, on my left is Sid Jones, the Assistant Secretary for Economic Policy.

On my right, Bill Goldstein, Deputy Assistant Secretary for Tax Policy.

STATEMENT OF HON. WILLIAM E. SIMON, SECRETARY, U.S. DEPARTMENT OF THE TREASURY, ACCOMPANIED BY WILLIAM GOLDSTEIN, DEPUTY ASSISTANT SECRETARY FOR TAX POLICY, U.S. DEPARTMENT OF THE TREASURY; AND SIDNEY JONES, ASSISTANT SECRETARY FOR ECONOMIC POLICY, U.S. DEPARTMENT OF THE TREASURY

Secretary SIMON. I am delighted to be here this morning to discuss capital formation. The continued vitality of small businesses is fundamental to the development of the entire economy and we need a better understanding of the specific problems faced by these firms as a basis for preparing constructive policies.

Senator Humphrey mentioned the effective tax rate, and this is one of these issues that, of course, we have so many economic myths around the country today believed about all of the wealthy people are going to pay taxes, and all of the corporations that pay 2 percent or 3 percent, and all of the numbers given to illustrate this.

The fact of the matter is the official effective tax rates are presented in official form, and what confuses the situation is that companies which operate abroad pay a foreign tax and we have tax treaties which eliminate double taxation, one of the major purposes of the tax treaty with the other country.

This double taxation would render any company from any country unable to effectively operate if they were paying effective tax rates, 75 or 80 percent being taxed there and being taxed back here as well.

They would just say, "Well, I cannot operate. I will just concentrate here domestically." So, if you take that portion of foreign income out of these operations, these operations overseas, the effective tax rates of all these corporations, most of them large ones that operate worldwide; the effective tax rate, with the exception of timber and petroleum operations because as you know, they have special taxes that have been enacted by Congress; the effective tax rate is 45 percent. And if you put timber and petroleum back in, it is 40 percent. So, that is still a pretty high effective tax rate.

Senator NELSON. Are you saying that the figure of an effective rate of 25 percent for larger corporations, is at the domestic tax rate alone; and that these companies are paying additional taxes on foreign income?

Secretary SIMON. You know what they do? They aggregate apples and oranges and sometimes lots of people attempt to do that to make a point.

Senator NELSON. We try not to be guilty of that.

Secretary SIMON. No, but you take all of the income and not allow for the fact that foreign taxes were paid on foreign income. That is an incorrect, an invalid comparison. So you have to compare the U.S. tax to U.S. income.

Senator HUMPHREY. So, you are saying the effective tax rate is 45 percent?

Secretary SIMON. Yes, excluding timber and petroleum. If you put them back in, it is 40 percent.

Senator HUMPHREY. I don't want to be guilty of being misleading, but it is our understanding that the effective tax rate is 25 percent?

Secretary SIMON. Bill Goldstein testified before Senator Nelson and one of the things he had in his testimony was the alternative measures of effective tax rates for the largest corporations, by industry, and it computes the tax rates by industry, and so it may be I could submit that for the record.

Senator HUMPHREY. We will be pleased to receive it for the record.

[Subsequent information was received and follows:]

Table C-3

Alternative Measures of Average Effective Tax Rate (percent) for 82 Corporations Among 100 Largest U.S. Corporations, by Industry, 1970*

Industry type	No. of companies (Excludes corps. w/o taxable income)	Effective tax rates, percent — Measures of tax liability: U.S. income tax after credits — Measures of income: Taxable income, per Internal Revenue Code (1)	U.S. income tax after credits — Presumptive world-wide economic income (2)	U.S. income tax after credits — Presumptive domestic economic income (3)	U.S. & foreign income tax paid or accrued — Presumptive world-wide economic income (4)	U.S. tax before investment credit — Presumptive dom. economic income + invest. credit (5)	U.S. and foreign tax before investment credit — Presumptive world-wide econ. income + invest. credit (6)
01 - Computers & business machines	5	26.5	25.9	46.9	47.2	47.1	47.3
02 - Motor vehicles	3	31.1	30.5	45.1	45.6	46.6	46.6
03 - Aero-space	5	38.4	36.7	43.4	40.5	46.3	43.1
04 - Metal fabrication	4	33.4	29.7	38.3	38.7	40.6	40.5
05 - Food and related products	11	41.6	40.5	46.6	46.0	46.9	46.4
06 - Drugs, Chemicals, & related products	13	36.5	34.4	44.3	42.8	45.7	43.9
07 - Electrical & electronic products	7	39.3	35.8	48.2	41.6	50.1	43.2
08 - Conglomerates	7	29.9	27.0	42.7	41.8	43.2	42.1
09 - Miscellaneous	4	38.1	36.6	42.9	42.0	43.9	42.9
10 - Petroleum	16	12.8	8.9	13.6	33.9	15.8	35.0
11 - Paper and Lumber	7	21.3	20.6	26.4	25.3	30.1	28.3
All industries	82	28.0	24.4	35.2	40.4	36.7	41.4
All industries except petroleum and paper and lumber	59	33.5	32.0	45.1	44.1	46.3	44.9

Office of the Secretary of the Treasury
Office of Tax Analysis

October 31, 1975

*See accompanying text for definition of tax and income measures.

Secretary SIMON. For some time I have been concerned about the role of small- and medium-sized businesses. We need an environment in which existing small business can thrive as long as they provide an economically valuable produce or service.

It is also necessary to have a dynamic economy in which new enterprises can be formed. Without the continual search for new ideas and better ways of doing things, our competitive system would become complacent and progressively less efficient.

New enterprises are a basic source of innovative ideas and they serve to continually push the entire economic system to become more efficient.

While many think of a small business as the exciting "new idea" company which will evolve into the IBM or Xerox of tomorrow, the vast majority of small firms are not in that category.

Instead, they serve basic needs in the community and are likely to remain small. For many communities the small businessman really represents "business" in an economic, political, and sociological sense.

In addition to fulfilling an economic need, such businesses provide important outlets for self-expression by the individuals involved. The opportunity to create a new business is one of our most important freedoms, for in many parts of the world it does not exist.

For all of these reasons, I have a strong interest in the current state of small business.

Your letter of November 6 states that it is very difficult to find a widely accepted definition of small business. I share this concern.

In trying to define a small business on the basis of such widely varying statistics as asset size, number of employees, sales, net income, net worth, dominance in the field, and taxable income there are many arbitrary assumptions that tend to confuse the economic significance of the differences identified. There does not appear to be any universal definition which can be used.

Earlier this year, Frederic W. Hickman, then Assistant Secretary of the Treasury for Tax Policy, testified at length on this subject before the Select Committee on Small Business.

He recommended a procedure for defining small businesses which would rely upon an arbitrary cutoff point at the level where 90 percent of the firms classified by some statistic such as value added, sales, or assets would be categorized as a "small business."

A common definition of this sort would allow different analysts to make generalizations on the basis of the same set of companies rather than by using overlapping definitions as is now the case. Such consistency would be helpful to all who are concerned with the affairs of small business and about how to evaluate data pertaining to their performance.

The problems of capital formation, about which I have testified and talked on repeated occasions in the past, are a matter of concern for companies of all sizes. The plant and equipment requirements of large companies are obvious but the capital investment needs of small businesses are equally important to their success.

Therefore, the importance of capital formation must be recognized in evaluating the prospects for small businesses. Economic problems which restrict capital formation will have a serious negative impact on small businesses.

It is interesting to note from surveys of small businesses contained in the Quarterly Economic Report for Small Business, published by the National Federation of Independent Business, that inflation is cited as the single most important problem facing them today.

Equally interesting is the reported negative impact of inflation on the expansion plans of the small businesses surveyed. The greater the degree to which inflation was regarded as problem by the reporting small business firms, the less they expected to expand their inventories and capital assets.

As inflationary concerns have declined somewhat in the last two quarters, the sentiment for expansion has improved and the pace of business spending on plant and equipment increased slightly in the third quarter after declining during the first 6 months of 1975.

I believe that inflation has been a pervasive problem in our economy and that it was the basic disruptive force which caused the severe recession from which we now are recovering.

I am particularly concerned about the restrictive effects of inflation on capital investment. Indeed, inflation should be recognized as the major threat to savings and investment.

Inflation first reduces the incentives to save by eroding the purchasing power of financial assets and then distorts investment decisions.

In my May 7, 1975 testimony before the Senate Finance Committee, I endeavored to summarize the record on capital formation and to discuss the dimensions of the problem.

Briefly, the record shows that:

1. During the 1960's, the United States had the lowest proportion of capital investment to real national output of the major industrial countries.

2. Over this same time frame, our record of productivity growth was among the lowest of the major industrial countries.

In fact, productivity has been a major concern throughout the postwar period. I think it is interesting to note what our productivity has been since the end of the World War II in the United States, because it is remarkable.

From 1948 and 1954, output per manhour in the private economy rose by 4 percent per year; from 1955 to 1964, it rose by 3.1 percent; from 1965 to 1974, it rose by 2.1 percent; and from 1970 to 1974, it rose by 1.6 percent per year.

Capital investment is a key factor in increasing productivity, economic growth, and the real standards of living enjoyed by Americans.

This is not to imply that capital investment is the only factor affecting productivity. Other factors—new technology, shifts in the composition of output, the level of capital assets, the skills and growth of the labor force, the availability of transportation, communication and other facilities, access to raw materials, and the stage of the business cycle—affect productivity and economic growth.

However, the rate of capital investment is basic to the positive development of the other growth variables.

Our own analysis in the Treasury, together with analyses contained in a number of other studies—Brookings, Data Resources, Inc., General Electric, Chase Econometrics, Professor Friedman, and the

New York Stock Exchange, all of which are summarized in the appendix table of this testimony—are remarkably consistent in pointing to the need for a higher level of capital investment in the decade ahead. The most immediate capital requirement is to create more jobs for our rapidly growing labor force.

Between now and 1985, the labor force will expand by approximately 16 million persons. When we add to this the 3 to 4 million unemployed people in the current labor force who must be reemployed to return to reasonably high levels of employment, the challenge of creating the necessary number of new jobs becomes even more impressive.

A second problem arising from inadequate capital investment involves the capacity limitations that hold down economic growth.

During periods of economic expansion, specific bottlenecks develop which restrict growth and result in inflation as the supply of goods and services falls below the rising demand. Inadequate capital formation clearly contributed to the serious inflation problems experienced during the past decade.

I am sure you Senators remember the debate during the early 1970's inflationary period when they talked about the capacity and slackening of the economy which would take years before we would get back to full capacity.

And, yet, the bottlenecks we experienced during the 1973 and 1974 expansion totally refuted those predictions. And I suggest that today while the slump has been far more severe, we indeed might get back to effective 100 percent capacity in certain basic industries sooner than most people recognize and create some very fundamental problems.

Another requirement is for replacement and modernization of the existing stock of capital. In the 1960's, the United States used 62 percent of its investment capital for the replacement of existing facilities compared with only 52 to 54 percent for Canada, France, and West Germany, and only 31 percent for Japan.

Still another category of investment needs relates to specific policy objectives: Projects involving new energy sources and conservation; requirements for environmental control; safer working conditions; and the provision of more and better housing. And other capital investment needs will become apparent in the future as our economy continues to develop.

The rapid increase in capital investment in environmental control and safety-oriented projects reflects the concerns of society about the total quality of life; however, such investments usually do not add to the productive capacity of the economy even though they contribute to the achievement of other national goals.

In such a dynamic economy, it is impossible to estimate our future capital requirements exactly but it appears that private domestic fixed investment for new plants, equipment, and housing will total $4 to $4½ trillion from 1974 through 1985.

But most studies agree it is between $4 and $4½ trillion between now and 1985; roughly three times the total of the past decade.

Some analysts conclude it is not possible to meet these goals. I disagree. I firmly believe that we are capable of achieving our basic investment goals if we will follow responsible fiscal and monetary policies.

I have repeatedly emphasized the importance of a balanced Federal budget over time as a beginning point for achieving these capital formation goals.

Unfortunately, the Federal Government has reported a deficit in 14 of the past 15 years and a massive deficit is occurring in fiscal year 1976. The near-term prospects for balancing Federal budget are also discouraging.

The key point is this: Unless strong action is taken to bring Federal spending under better control, the chronic deficits of the past will continue and the achievement of our basic capital formation goals will be impossible. This basic contradiction is widely recognized but corrective action has not occurred.

If the Federal Government fails to provide the proper investment environment, the negative results of higher unemployment, continued inflation pressures, and inadequate productivity will occur.

This is not a choice between short- and long-term goals. If we do not have adequate capital investment we will continue to experience higher unemployment and inflation than we want. Small businesses will suffer over the longer run if the future growth of jobs is inadequate and inflation remains excessive.

On the basis of the available data, we are unable to say that the relative capital formation needs of small businesses are significantly different from those of other businesses.

There is some indication, based on data published by the Federal Trade Commission, that larger companies have a higher proportion of fixed assets and a lower proportion of cash, marketable securities and receivables than do small firms.

The fact that larger companies have a higher proportion of fixed assets than do smaller companies does not necessarily imply that there is any fundamental difference in the need for capital.

One would expect capital intensive types of businesses to be larger on the average than less capital-intensive types in order to take advantage of economies of scale and the figures in table 1 substantiate this view.

I have quite a few tables in back to support these statements that I am making.

If there were no costs associated with obtaining additional financing and if such financing were always readily available, most companies would want more in the way of capital assets.

The relevant question is whether there is a gap between the actual desired availability of capital given the costs of financing, and the actual amount of capital formation, and whether there is a systematic bias which favors large companies compared to smaller firms.

One of the factors which is currently restricting the rate of capital formation is the financial condition of American corporations—both large and small.

Analysis of debt to equity ratios indicates that corporate balance sheets have shown signs of deterioration over the past decade, which is a break from the pattern which persisted in earlier periods.

Debt has increased dramatically, both in absolute terms and relative to assets and income. Interest costs have risen appreciably, roughly doubling over the past 10 years.

The combination of increased debt financing and higher interest rates has resulted in a decline in the coverage ratios reported by

American corporations—that is, the ratio of earnings to interest charges.

The ratio of liquid assets to debt has shrunk. Profits, after allowing for more realistic accounting procedures, have declined in both real and nominal terms.

As a result of these developments, there is a serious question about the potential capability of companies to be able to finance the capital investment that will be required to achieve our basic economic goals of reducing unemployment and inflation.

For many years there has been a discernible trend toward growing dependence by business, both large and small, on outside funds to finance their growth.

As indicated in chart 2, the percent of business financing needs raised externally by nonfinancial corporations declined from 1958 to 1964 and averaged about 30 percent of total needs during that period.

However, that trend was reversed beginning in the mid-1960's and the proportion of external financing rose to over 60 percent in 1974. The growing dependence on external financing really began in the mid-1960's and has risen steadily since then.

This shift in financing methods from reliance on internal to external sources of funds follows the pattern of inflation pressures which also began to accelerate in the mid-1960's.

Inflation rapidly increases the costs of new investments and erodes corporate profits which are a major internal source of capital for financing new projects.

The distorting effects of inflation force companies to rely more heavily on external sources of funds.

Another, and perhaps more important, change appearing on corporate balance sheets is that the increased emphasis on external financing has been dependent on debt rather than equity sources of refunds.

There are several fundamental reasons for the shift toward debt: (1) Corporate treasurers have been reluctant to raise new equity capital because the sale of additional shares of ownership dilutes the earnings per share and ownership rights of existing stockholders; (2) in the 1950's and throughout most of the 1960's, the cost of debt was low relative to the cost of equity; (3) because of the depressed level of stock prices, the shares of many companies have had historically low price earnings ratios—indeed many stocks are selling at prices below their book values which discourages new equity financing; (4) the financing costs of arranging new debt issues or loans are usually much less than the costs of selling new shares of stock and there is less uncertainty about placement of the securities; and (5) the use of debt enables the borrower to deduct the interest payments from earnings before determining the amount of taxes to be paid.

The tax deductibility of interest payments creates a major advantage in favor of debt financing and has encouraged the sharp shift in the debt-equity relationship.

Unfortunately, the emphasis on debt commitments has made our financial system more rigid and more vulnerable to economic shocks.

From 1965 to 1974, nonfinancial corporations raised a total of $267.4 billion of long-term funds. Long-term debt accounted for 83 percent of that total. The balance sheet impact of this change was to cause long-term debt outstanding to rise from $141.4 billion to $362.3 billion over the same time span—a 2½-fold increase in just 10 years time.

What this means, of course, is that there has been a significant rise in debt-equity ratios over the past 10 years. These have roughly doubled—on the traditional measure—for manufacturing firms as indicated in chart 2.

The ratios for smaller-size manufacturing firms—those with assets of less than $1 million—have shown an even more pronounced rising trend, particularly in recent years.

The corporate balance sheet is not only more highly leveraged and at a higher interest cost, but the average maturity of the debt is also becoming shorter.

Corporate treasurers will have to make more frequent trips to the financial markets, but at the same time fewer companies are finding their securities welcome.

The emphasis on quality by lenders has increased dramatically in recent months so that today only top-rated companies are welcome in capital markets for all practical purposes. This sharp shift in investor preferences started with the financial difficulties of the Penn-Central Railroad in 1970 and has accelerated further following the well-published financial difficulties of New York City, the Real Estate Investment Trusts (REIT's) and several large companies.

Furthermore, record Federal budget deficits, which will total over $150 billion in just 3 fiscal years—fiscal year 1975, 1976, and 1977—will absorb a large part of the available savings.

This is a clear illustration of the "crowding out" phenomenon I have been discussing for many months now. Less than prime-rated firms are facing more difficulty in raising funds as seen in table 2.

The implication of these fundamental shifts in the patterns of financing is that the structure of corporate balance sheets is much more brittle and less liquid than it was 10 years ago.

Furthermore, with heavy demands on credit markets, especially over the years ahead, there will unquestionably be less room for some firms, the lower rated and smaller ones in particular, to get all the funds they need for expansion.

Obviously, there is no simple level where the corporate financial structure suddenly becomes too illiquid and inflexible, but at the same time an ever higher burden of debt commitments relative both to financial assets and to income is a matter for some concern.

Coverage ratios have dropped sharply over the past decade and operating breakeven points have risen. This makes companies less able to withstand even modest-sized recessions.

Accordingly, the potential for bankruptcy has greatly increased across the entire spectrum of U.S. business. This potential in and of itself will discourage future investment as lenders become more reluctant to make long-term commitments and companies become more reluctant to take on fixed payments of interest and repayment of debt obligations. Some investments which would have been undertaken in earlier periods will be passed over in the future.

With respect to the issue of small business financing, smaller companies appear to rely more heavily on external debt financing than do larger companies.

In the past, development capital was available from venture capital firms which were willing to lend money to growing firms despite the risks involved.

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Unfortunately, the supply of venture capital for small growth-oriented has largely disappeared. If venture capital is provided, lenders often demand a large—frequently a controlling share—of the ownership position in the company financed.

The future vitality of the entire economy will be unfortunately restricted if the availability of venture capital is not restored. This problem is another negative result of the excessive rates of inflation experienced in recent years.

Data from the Federal Trade Commission and from our own Treasury Office of Tax Analysis are shown in tables 3 and 4 respectively. A comparison on table 3 of the ratio of debt to equity with the ratio of long-term debt to equity suggests that the higher overall debt to equity ratios for smaller companies are occasioned primarily by the more extensive use of short-term financing.

In particular, these companies rely more heavily on trade credit and, to a lesser extent, on short-term loans.

With respect to sources of internal financing, we have run some studies of earnings by size of company. Two tables are provided: One where the compensation of officers is included and one where it is excluded.

For a smaller company controlled by the principals, often part of the compensation of officers really represents a return on investment as opposed to a return on human capital.

In part, this occurs in order to avoid the double taxation associated with a dividend payment. It is impossible to speculate on the exact mix of the two components.

Table 5, which includes the compensation of officers, shows that earnings per dollar of assets decline as the size of the company increases. This occurs for all industry classes.

When compensation is excluded, in table 6, earnings per dollar of asset increase for manufacturing companies up to about the $1 million size, after which they fluctuate about essentially the same level.

For other industry classes, the steady state level is reached much earlier. If one views part of the compensation of officers as a return on investment, it is not clear that smaller companies earn less on a relative basis than do larger companies.

Therefore, there is little indication of a systematic bias with respect to this important component of internal financing.

The related problems of growing capital investment needs and the deterioration of corporate balance sheets are not unique to small-sized business but rather are a difficulty confronting all U.S. business firms.

Under these circumstances, the appropriate policy steps should not focus just on the needs of small business but instead should attempt to help bring about and sustain an environment which will foster greater savings in our economy so that there will be adequate funds to finance the capital growth ahead; will encourage businesses to make long-term investment commitments; and will help reverse the growing trend toward greater corporate illiquidity and debt leverage.

First and foremost, we must have a much greater understanding on the part of the public on the basic concept of capital.

Capital is the cornerstone of increased productivity, of higher real wages, of greater job opportunities, of a stronger competitive position internationally, and of holding down the rate of inflation.

High levels of inflation raise interest rates, raise the dollar cost of new capital, discourage investment, and weaken our entire financial structure.

Unfortunately, the close relationship between capital formation and the vitality of the financial markets is not recognized by many analysts.

If we are to have the kind of sustained economic recovery we desire, including an increased rate of capital investment, the disruptive impact of chronic Federal budget deficits must be eliminated.

Second, the Government itself must follow policies that will help eliminate some of the economic and financial distortions created over the past decade and permit the free market system to function closer to its potential. Specifically, the Federal Government must get its own financial house in order.

The spiraling growth in Federal Government spending must be moderated. The excessive fiscal policies of the last decade can continue only at the expense of price stability and economic vitality.

This in turn works to the detriment of capital formation by small and large businesses alike. More and more, economic decisionmaking is being taken out of private hands, where within limits we believe it is most efficiently and responsively handled, and placed in the hands of the Government.

The President's recommendations for controlling Federal expenditures and for personal and business tax relief is a positive step toward bringing the spiraling growth of Government spending under control.

The inflationary psychology is a key part of the forces behind inflation, and I do not believe we can change that psychology until the Government begins to moderate the rapid growth of spending.

The longer run implications of this program for inflation cannot help but improve capital formation.

Part of the President's program involves tax policy changes which are designed to provide more incentives for capital formation. Specific tax cuts contained in the President's program going to business would include: A reduction in the maximum corporate tax rate from 48 to 46 percent; a continuation of the 1975 act increase in the surtax exemption—which determines the amount taxable at rates below 48 percent—from $25,000 to $50,000 of taxable income; a continuation of the 1975 act in the 20 percent rate on the first $25,000 of taxable income—the second $25,000 of taxable income will be taxable at a 22-percent rate, with the balance of income taxed at a 46-percent rate; to make permanent the 1975 act increase in the investment credit from 7 percent—4 percent in the case of public utilities—to 10 percent; to enact a six-point program to provide tax relief to electric utilities.

As you requested, we have analyzed the corporation's income tax and investment credit proposals as they relate to the size of business.

As the program for electric utilities involves essentially large companies, we did not make such an analysis.

The results for increasing the surtax exemption to $50,000 and lowering the tax rate applied to the first $25,000 from 22 to 20 percent are shown in table 7, as is the effect of the 2 percent reduction in the surtax. In both cases, the estimated tax effect is projected for 1976.

For the surtax exemption proposals, the table shows that approximately 38 percent of the total tax benefits will be realized by businesses with $500,000 or less in assets.

As expected, the bulk of the tax benefits associated with the reduction in the maximum rate from 48 to 46 percent go to larger corporations. This is due to the fact that corporate income is a function of the total assets employed in the enterprise.

The distribution of the investment tax credit for 1972 by size of enterprise is shown in table 8. Most of the tax benefits associated with the investment tax credit are also concentrated in larger corporations.

Small businesses tend to use less machinery and equipment per dollar of assets employed than do larger businesses.

For one thing most small businesses are involved in trade and services, where fewer fixed assets are used than is the case in manufacturing.

Even in these industries, small companies tend to use relatively less machinery and equipment than do larger companies. This may be due to economies of sale.

In addition, small business investment in qualifying machinery and equipment often tends to be short-lived in nature, thereby qualifying for less than a full investment tax credit.

Finally, small enterprises more frequently make investments that are large relative to their taxable income. This is due to the "lumpy" nature of capital investments by the small business.

As a result, they less frequently are able to fully utilize the tax credit in the year the asset is placed in service.

For all of these reasons, smaller businesses realize less relative tax benefit from the investment tax credit than do larger businesses.

In addition to these tax measures for stimulating capital formation, the administration has proposed the elimination of the withholding of taxes on interest and dividends paid to foreign investors. We believe that this will greatly improve the atmosphere for foreign investment in the United States. In turn this should work to enhance capital formation.

For long-term savings and capital investment incentives, the administration still is actively seeking adoption of a plan presented in my testimony of July 31, 1975 before the House Ways and Means Committee for the integration of personal and corporate income taxes.

This proposal is specifically designed to encourage greater savings and investment. The proposal's major recommendation would eliminate the inequity and inefficiency which arises from first taxing corporate income and then taxing individuals who receive corporate dividends.

This double taxation is an onerous restraint on economic expansion which already has been eliminated by most major industrial countries. I believe it is time for the United States to act. I believe it is time for the United States to do the same.

The Treasury proposal is the only major recommendation that seeks to correct the imbalance between corporate debt and equity by encouraging greater reliance on equity financing.

By redressing this imbalance, the financial markets would be able to perform more efficiently their task of channeling the savings of society to the most promising investment opportunities. Small firms in particular would benefit by improving their access to the financial markets.

In order to provide a stable environment in which rational capital spending decisions can be made, Government wage-price control and/or guidelines should be strongly resisted.

While such steps may work for a short period of time, they ultimately end up causing shortages, distortions, and misallocations of resources in our economic system.

More importantly for capital formation purposes, they introduce a much greater element of uncertainty regarding the future return from current investment. The small businessman has to cope with added problems of whether he will have sufficient pricing discretion in the future to assure a fair rate of return on his investment.

The small businessman also has to contend with the possibility of supply shortages, even if he is willing to pay a higher price for the items in question.

Finally, unnecessary rules and Government reports should be eliminated and careful consideration should be given to deregulation efforts to remove existing barriers to economic efficiency.

Government regulations impose costs on business which ultimately are reflected in higher prices to the consumer.

Furthermore, these costs are usually more burdensome for smaller-sized business, since they tend to be relatively fixed in nature.

For example, in a company with only a few employees—and there are literally millions of such small firms in our economy today—this often means taking the time of the owner whose efforts are more properly focused on the immediate needs of his business.

The small businessman needs to devote his time to increasing his sales and controlling costs rather than complying with seemingly endless bureaucratic requirements enforced by distant Government officials who somehow seem to believe that the country's millions of small companies can afford staffs of technical experts to fill out the forms and figures out how to comply with all of the regulations imposed.

All of these policy measures would contribute to improving the climate for financing by American business and for capital formation in this country.

In the end, we must slightly tilt our preferences away from personal consumption and Government spending toward somewhat greater savings and investment.

We estimate that our capital formation needs in the decade ahead can be met if savings and investment increase moderately from about 15 percent of gross national product to almost 16 percent.

I might add that these views are shared by most others who have analyzed the problem. In terms of business fixed investment, this implies going from about 10½ percent of GNP to 11½ percent.

By improving the prospects for capital formation, the current economic recovery will be sustained and long-term prospects for higher productivity, economic growth, and rising standards of living will be improved.

Most important, increased capital investment will create more jobs and expand our productive capability to moderate inflation.

It is not a matter of reslicing the economic pie, but rather the need to expand the pie so as to benefit everyone.

For the reasons cited earlier, I feel that a major beneficiary will be small business, particularly when it comes to the problem of financing.

Thank you, Mr. Chairman, for this opportunity to share my views with you and the members of these two distinguished committees.

Senator HUMPHREY. You have a very extensive statement and it has been all incorporated in the record including the chart and information you have.

[The chart and information follow:]

STATEMENT OF THE HONORABLE WILLIAM E. SIMON
SECRETARY OF THE TREASURY
BEFORE THE JOINT ECONOMIC COMMITTEE AND
THE SENATE SELECT COMMITTEE ON SMALL BUSINESS
FRIDAY, NOVEMBER 21, 1975, 10:00 A.M.

Mr. Chairman, and members of the Committees:

I am pleased to appear before you this morning to discuss the capital formation and financing problems of small business firms. The continued vitality of small businesses is fundamental to the development of the entire economy and we need a better understanding of the specific problems faced by these firms as a basis for preparing constructive policies.

For some time I have been concerned about the role of small- and medium-sized businesses. We need an environment in which existing small businesses can thrive as long as they provide an economically valuable product or service. It is also necessary to have a dynamic economy in which new enterprises can be formed. Without the continual search for new ideas and better ways of doing things our competitive system would become complacent and progressively less efficient. New enterprises are a basic source of innovative ideas and they serve to continually push the entire economic system to become more efficient.

While many think of a small business as the exciting "new idea" company which will evolve into the IBM or Xerox of tomorrow, the vast majority of small firms are not in that category. Instead, they serve basic needs in the community and are likely to remain small. For many communities the small businessman really represents "business" in an economic, political and sociological sense. In addition to fulfilling an economic need, such businesses provide important outlets for self expression by the individuals involved. The opportunity to create a new business is one of our most

important freedoms, for in many parts of the world it does not exist. For all of these reasons, I have a strong interest in the current state of small business.

DEFINITION OF A SMALL BUSINESS

Your letter of November 6 states that it is very difficult to find a widely accepted definition of small business. I share this concern. In trying to define a small business on the basis of such widely varying statistics as asset size, number of employees, sales, net income, net worth, dominance in the field, and taxable income there are many arbitrary assumptions that tend to confuse the economic significance of the differences identified. There does not appear to be any universal definition which can be used.

Earlier this year, Frederic W. Hickman, then Assistant Secretary of the Treasury for Tax Policy, testified at length on this subject before the Select Committee on Small Business. He recommended a procedure for defining small businesses which would rely upon an arbitrary cutoff point at the level where 90 percent of the firms classified by some statistic such as value added, sales, or assets would be categorized as a "small business". A common definition of this sort would allow different analysts to make generalizations on the basis of the same set of companies rather than by using overlapping definitions as is now the case. Such consistency would be helpful to all who are concerned with the affairs of small business and about how to evaluate data pertaining to their performance.

CAPITAL FORMATION

The problems of capital formation, about which I have testified and talked on repeated occasions in the past, are a matter of concern for companies of all sizes. The plant and equipment requirements of large companies are obvious but the capital investment needs of small businesses are equally important to their success. Therefore, the importance of capital formation must be recognized in evaluating the prospects for small businesses. Economic problems which restrict capital formation will have a serious negative impact on small businesses. It is interesting to note from surveys of small businesses contained in the *Quarterly Economic Report for Small Business*, (published by the National Federation of Independent Business), that inflation is cited as the single most important problem facing them today. Equally interesting is the reported negative impact

of inflation on the expansion plans of the small businesses surveyed. The greater the degree to which inflation was regarded as a problem by the reporting small business firms, the less they expected to expand their inventories and capital assets. As inflationary concerns have declined somewhat in the last two quarters, the sentiment for expansion has improved and the pace of business spending on plant and equipment increased slightly in the third quarter after declining during the first six months of 1975.

I believe that inflation has been a pervasive problem in our economy and that it was the basic disruptive force which caused the severe recession from which we now are recovering. I am particularly concerned about the restrictive effects of inflation on capital investment. Indeed, inflation should be recognized as the major threat to savings and investment. Inflation first reduces the incentives to save by eroding the purchasing power of financial assets and then distorts investment decisions. In my May 7, 1975 testimony before the Senate Finance Committee, I endeavored to summarize the record on capital formation and to discuss the dimensions of the problem.

Briefly, the record shows that:

1. During the 1960's the United States had the lowest proportion of capital investment to real national output of the major industrial countries.

2. Over this same time frame, our record of productivity growth was among the lowest of the major industrial countries. In fact, productivity has been a major concern throughout the postwar period: from 1948 and 1954 output per manhour in the private economy rose by 4.0 percent per year; from 1955 to 1964 it rose by 3.1 percent; from 1965 to 1974 it rose by 2.1 percent; and from 1970 to 1974 it rose by 1.6 percent per year.

Capital investment is a key factor in increasing productivity, economic growth, and the real standards of living enjoyed by Americans. This is not to imply that capital investment is the only factor affecting productivity. Other factors -- new technology, shifts in the composition of output, the level of capital assets, the skills and growth of the labor force, the availability of transportation, communication and other facilities, access to raw materials, and the stage of the business cycle -- affect productivity

and economic growth. However, the rate of capital investment is basic to the positive development of the other growth variables.

Our own analysis in the Treasury, together with analyses contained in a number of other studies (Brookings, Data Resources, Inc., General Electric, Chase Econometrics, Professor Friedman, and the New York Stock Exchange, all of which are summarized in the Appendix table of this testimony), are remarkably consistent in pointing to the need for a higher level of capital investment in the decade ahead. The most immediate capital requirement is to create more jobs for our rapidly growing labor force. Between now and 1985, the labor force will expand by approximately 16 million persons. When we add to this the 3 to 4 million unemployed people in the current labor force who must be reemployed to return to reasonably high levels of employment the challenge of creating the necessary number of new jobs becomes even more impressive.

A second problem arising from inadequate capital investment involves the capacity limitations that hold down economic growth. During periods of economic expansion specific bottlenecks develop which restrict growth and result in inflation as the supply of goods and services falls below the rising demand. Inadequate capital formation clearly contributed to the serious inflation problems experienced during the past decade.

Another requirement is for replacement and modernization of the existing stock of capital. In the 1960's, the United States used 62 percent of its investment capital for the replacement of existing facilities compared with only 52 to 54 percent for Canada, France and West Germany, and only 31 percent for Japan. Still another category of investment needs relates to specific policy objectives: projects involving new energy sources and conservation; requirements for environmental control; safer working conditions; and the provision of more and better housing. And other capital investment needs will become apparent in the future as our economy continues to develop. The rapid increase in capital investment in environmental control and safety oriented projects reflects the concerns of society about the total quality of life; however, such investments usually do not add to the productive capacity of the economy even though they contribute to the achievement of other national goals.

In such a dynamic economy it is impossible to estimate our future capital requirements exactly but it appears

that private domestic fixed investment for new plants, equipment and housing will total $4 to $4-1/2 trillion from 1974 through 1985. This is roughly three times the total of $1.5 trillion invested between 1962 and 1973. Some analysts have concluded that it will not be possible to meet these capital formation requirements. I disagree. I firmly believe that we are capable of achieving our basic investment goals if we will follow responsible fiscal and monetary policies. I have repeatedly emphasized the importance of a balanced Federal budget over time as a beginning point for achieving these capital formation goals. Unfortunately, the Federal Government has reported a deficit in fourteen of the past fifteen years and a massive deficit is occurring in FY 1976. The near-term prospects for balancing the Federal budget are also discouraging. The key point is this: unless strong action is taken to bring Federal spending under better control the chronic deficits of the past will continue and the achievement of our basic capital formation goals will be impossible. This basic contradiction is widely recognized but corrective action has not occurred. If the Federal government fails to provide the proper investment environment the negative results of higher unemployment, continued inflation pressures and inadequate productivity will occur. This is not a choice between current consumption or investment. It is a choice between short- and long-term goals. If we do not have adequate capital investment we will continue to experience higher unemployment and inflation than we want. Small businesses will suffer over the longer run if the future growth of jobs is inadequate and inflation remains excessive.

On the basis of available data, we are unable to say that the relative capital formation needs of small businesses are significantly different from those of other businesses. There is some indication, based on data published by the Federal Trade Commission, that larger companies have a higher proportion of fixed assets and a lower proportion of cash, marketable securities and receivables than do small firms. (See Table 1) The fact that larger companies have a higher proportion of fixed assets than do smaller companies does not necessarily imply that there is any fundamental difference in the need for capital. One would expect capital intensive types of businesses to be larger on the average than less capital intensive types in order to take advantage of economies of scale and the figures in Table 1 substantiate this view.

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readily available, most companies would want more in the way of capital assets. The relevant question is whether there is a gap between the actual desired availability of capital given the costs of financing, and the actual amount of capital formation, and whether there is a systematic bias which favors large companies compared to smaller firms.

PROBLEMS OF FINANCE

One of the factors which is currently restricting the rate of capital formation is the financial condition of American corporations -- both large and small. Analysis of debt to equity ratios indicates that corporate balance sheets have shown signs of deterioration over the past decade, which is a break from the pattern which persisted in earlier periods. Debt has increased dramatically, both in absolute terms and relative to assets and income. Interest costs have risen appreciably, roughly doubling over the past ten years (see Chart 1). The combination of increased debt financing and higher interest rates has resulted in a decline in the coverage ratios reported by American corporations -- that is, the ratio of earnings to interest charges. The ratio of liquid assets to debt has shrunk. Profits, after allowing for more realistic accounting procedures, have declined in both real and nominal terms. As a result of these developments, there is a serious question about the potential capability of companies to be able to finance the capital investment that will be required to achieve our basic economic goals of reducing unemployment and inflation.

For many years there has been a discernible trend toward growing dependence by business, both large and small, on outside funds to finance their growth. As indicated in Chart 2, the percent of business financing needs raised externally by nonfinancial corporations declined from 1958 to 1964 and averaged about 30 percent of total needs during that period. However, that trend was reversed beginning in the mid-1960's and the proportion of external financing rose to over 60 percent in 1974. The growing dependence on external financing really began in the mid-1960's and has risen steadily since then. This shift in financing methods from reliance on internal to external sources of funds follows the pattern of inflation pressures which also began to accelerate in the mid-1960's. Inflation rapidly increases the costs of new investments and erodes corporate profits which are a major internal source of capital for financing new projects. The distorting effects of inflation force companies to rely more heavily on external sources of

funds.

Another, and perhaps more important, change appearing on corporate balance sheets is that the increased emphasis on external financing has been dependent on debt rather than equity sources of funds. There are several fundamental reasons for the shift toward debt: (1) corporate treasurers have been reluctant to raise new equity capital because the sale of additional shares of ownership dilutes the earnings per share and ownership rights of existing stockholders; (2) In the 1950's and throughout most of the 1960's, the cost of debt was low relative to the cost of equity; (3) because of the depressed level of stock prices, the shares of many companies have had historically low price earnings ratios -- indeed many stocks are selling at prices below their book values which discourages new equity financing; (4) the financing costs of arranging new debt issues or loans are usually much less than the costs of selling new shares of stock and there is less uncertainty about placement of the securities; and (5) the use of debt enables the borrower to deduct the interest payments from earnings before determining the amount of taxes to be paid. The tax deductibility of interest payments creates a major advantage in favor of debt financing and has encouraged the sharp shift in the debt-equity relationship. Unfortunately, the emphasis on debt commitments has made our financial system more rigid and more vulnerable to economic shocks.

From 1965 to 1974 nonfinancial corporations raised a total of $267.4 billion of long-term funds. Long-term debt accounted for 83 percent of that total. The balance sheet impact of this change was to cause long-term debt outstanding to rise from $141.4 billion to $362.3 billion over the same time span -- a two and one-half fold increase in just 10 years time. What this means, of course, is that there has been a significant rise in debt-equity ratios over the past 10 years. These have roughly doubled (on the traditional measure) for manufacturing firms as indicated in Chart 2. The ratios for smaller-sized manufacturing firms (those with assets of less than $1 million) have shown an even more pronounced rising trend, particularly in recent years.

The corporate balance sheet is not only more highly leveraged and at a higher interest cost, but the average maturity of the debt is also becoming shorter. Corporate treasurers will have to make more frequent trips to the financial markets, but at the same time fewer companies are finding their securities welcome. The emphasis on quality by lenders has increased dramatically in recent months so

that today only top-rated companies are welcome in capital markets for all practical purposes. This sharp shift in investor preferences started with the financial difficulties of the Penn-Central Railroad in 1970 and has accelerated further following the well-published financial difficulties of New York City, the Real Estate Investment Trusts (REIT's) and several large companies. Furthermore, record federal budget deficits, which will total over $150 billion in just three fiscal years -- FY 1975, 1976 and 1977 -- will absorb a large part of the available savings. This is a clear illustration of the "crowding out" phenomenon I have been discussing for many months now. Less than prime-rated firms are facing more difficulty in raising funds as seen in Table 2.

The implication of these fundamental shifts in the patterns of financing is that the structure of corporate balance sheets is much more brittle and less liquid than it was 10 years ago. Furthermore, with heavy demands on credit markets, especially over the years ahead, there will unquestionably be less room for some firms, the lower rated and smaller ones in particular, to get all the funds they need for expansion.

Obviously there is no simple level where the corporate financial structure suddenly becomes too illiquid and inflexible, but at the same time an ever higher burden of debt commitments relative both to financial assets and to income is a matter for some concern. Coverage ratios have dropped sharply over the past decade and operating breakeven points have risen. This makes companies less able to withstand even modest-sized recessions. Accordingly, the potential for bankruptcy has greatly increased across the entire spectrum of U.S. business. This potential in and of itself will discourage future investment as lenders become more reluctant to make long-term commitments and companies become more reluctant to take on fixed payments of interest and repayment of debt obligations. Some investments which would have been undertaken in earlier periods will be passed over in the future.

With respect to the issue of small business financing, smaller companies appear to rely more heavily on external debt financing than do larger companies. In the past, development capital was available from venture capital firms which were willing to lend money to growing firms despite the risks involved. Unfortunately, the supply of venture capital for small growth-oriented has largely disappeared.

If venture capital is provided lenders often demand a large -- frequently a controlling share -- of the ownership position in the company financed. The future vitality of the entire economy will be unfortunately restricted if the availability of venture capital is not restored. This problem is another negative result of the excessive rates of inflation experienced in recent years.

Data from the Federal Trade Commission and from our own Treasury Office of Tax Analysis are shown in Tables 3 and 4 respectively. A comparison on Table 3 of the ratio of debt-to-equity with the ratio of long-term debt to equity suggests that the higher overall debt-to-equity ratios for smaller companies are occassioned primarily by the more extensive use of short-term financing. In particular, these companies rely more heavily on trade credit and, to a lesser extent, on short-term loans.

With respect to sources of internal financing, we have run some studies of earnings by size of company. Two tables are provided: one where the compensation of officers is included and one where it is excluded. For a smaller company controlled by the principals, often part of the compensation of officers really represents a return on investment as opposed to a return on human capital. In part, this occurs in order to avoid the double taxation associated with a dividend payment. It is impossible to speculate on the exact mix of the two components.

Table 5, which includes the compensation of officers, shows that earnings per dollar of assets decline as the size of the company increases. This occurs for all industry classes. When compensation is excluded, in Table 6, earnings per dollar of asset increase for manufacturing companies up to about the $1 million size, after which they fluctuate about essentially the same level. For other industry classes, the steady state level is reached much earlier. If one views part of the compensation of officers as a return on investment, it is not clear that smaller companies earn less on a relative basis than do larger companies. Therefore, there is little indication of a systematic bias with respect to this important component of internal financing.

SOME POLICY NEEDS

The related problems of growing capital investment needs and the deterioration of corporate balance sheets are not unique to small-sized business but rather are a difficulty

confronting all U.S. business firms. Under these circumstances, the appropriate policy steps should not focus just on the needs of small business but instead should attempt to help bring about and sustain an environment which

-- will foster greater savings in our economy so that there will be adequate funds to finance the capital growth ahead;

-- will encourage businesses to make long-term investment commitments; and

-- will help reverse the growing trend toward greater corporate illiquidty and debt leverage.

First and foremost, we must have a much greater understanding on the part of the public on the basic concept of capital. Capital is the cornerstone of increased productivity, of higher real wages, of greater job opportunities, of a stronger competitive position internationally, and of holding down the rate of inflation. High levels of inflation raise interest rates, raise the dollar cost of new capital, discourage investment and weaken our entire financial structure. Unfortunately, the close relationship between capital formation and the vitality of the financial markets is not recognized by many analysts. If we are to have the kind of sustained economic recovery we desire, including an increased rate of capital investment, the disruptive impact of chronic Federal budget deficits must be eliminated.

Second, the government itself must follow policies that will help eliminate some of the economic and financial distortions created over the past decade and permit the free market system to function closer to its potential. Specifically the federal government must get its own financial house in order.

The spiraling growth in Federal government spending must be moderated. The excessive fiscal policies of the last decade can continue only at the expense of price stability and economic vitality. This in turn works to the detriment of capital formation by small and large businesses alike. More and more, economic decision making is being taken out of private hands, where within limits we believe it is most efficiently and responsively handled, and placed in the hands of the government.

The President's recommendations for controlling Federal expenditures and for personal and business tax relief is a

positive step toward bringing the spiraling growth of government spending under control. The inflationary psychology is a key part of the forces behind inflation, and I do not believe we can change that psychology until the government begins to moderate the rapid growth of spending. The longer run implications of this program for inflation cannot help but improve capital formation.

Part of the President's program involves tax policy changes which are designed to provide more incentives for capital formation. Specific tax cuts contained in the President's program going to business would include:

-- Reduction in the maximum corporate tax rate from 48 percent to 46 percent.

-- Continue the 1975 Act increase in the surtax exemption (which determines the amount taxable at rates below 48 percent) from $25,000 to $50,000 of taxable income.

-- Continue the 1975 Act in the 20 percent rate on the first $25,000 of taxable income (the second $25,000 of taxable income will be taxable at 22 percent rate, with the balance of income taxed at a 46 percent rate).

-- Make permanent the 1975 Act increase in the investment credit from 7 percent (4 percent in the case of public utilities) to 10 percent.

-- Enact a six-point program to provide tax relief to electric utilities.

As you requested, we have analyzed the corporation's income tax and investment credit proposals as they relate to the size of business. As the program for electric utilities involves essentially large companies, we did not make such an analysis. The results for increasing the surtax exemption to $50,000 and lowering the tax rate applied to the first $25,000 from 22 to 20 percent are shown in Table 7, as is the effect of the 2 percent reduction in the surtax. In both cases, the estimated tax effect is projected for 1976.

For the surtax exemption proposal, the Table shows that approximately 38 percent of the total tax benefits will be realized by businesses with $500,000 or less in assets.

64-507 O - 76 - 3

As expected, the bulk of the tax benefits associated with the reduction in the maximum rate from 48 to 46 percent go to larger corporations. This is due to the fact that corporate income is a function of the total assets employed in the enterprise.

The distribution of the investment tax credit for 1972 by size of enterprise is shown in Table 8. Most of the tax benefits associated with the investment tax credit are also concentrated in larger corporations. Small businesses tend to use less machinery and equipment per dollar of assets employed than do larger businesses. For one thing, most small businesses are involved in trade and services, where fewer fixed assets are used than is the case in manufacturing. Even in these industries, small companies tend to use relatively less machinery and equipment than do larger companies. This may be due to economies of scale.

In addition, small business investment in qualifying machinery and equipment often tends to be short-lived in nature, thereby qualifying for less than a full investment tax credit. Finally, small enterprises more frequently make investments that are large relative to their taxable income. This is due to the "lumpy" nature of capital investments by the small business. As a result, they less frequently are able to fully utilize the tax credit in the year the asset is placed in service. For all of these reasons, smaller businesses realize less relative tax benefit from the investment tax credit than do larger businesses.

In addition to these tax measures for stimulating capital formation, the Administration has proposed the elimination of the withholding of taxes on interest and dividends paid to foreign investors. We believe that this will greatly improve the atmosphere for foreign investment in the United States. In turn this should work to enhance capital formation.

For long term savings and capital investment incentives, the Administration still is actively seeking adoption of a plan presented in my testimony of July 31, 1975 before the House Ways and Means Committee for the integration of personal and corporate income taxes. This proposal is specifically designed to encourage greater savings and investment. The proposal's major recommendation would eliminate the inequity and inefficiency which arises from first taxing corporate income and then taxing individuals who receive corporate dividends. This double taxation is an

onerous restraint on economic expansion which already has been eliminated by most major industrial countries. I believe it is time for the United States to act.

The Treasury proposal is the only major recommendation that seeks to correct the imbalance between corporate debt and equity by encouraging greater reliance on equity financing. By redressing this imbalance the financial markets would be able to perform more efficiently their task of channeling the savings of society to the most promising investment opportunities. Small firms in particular would benefit by improving their access to the financial markets.

In order to provide a stable environment in which rational capital spending decisions can be made, government wage-price control and/or guidelines should be strongly resisted. While such steps may work for a short period of time, they ultimately end up causing shortages, distortions and misallocations of resources in our economic system. More importantly for capital formation purposes, they introduce a much greater element of uncertainty regarding the future return from current investment. The small businessman has to cope with added problems of whether he will have sufficient pricing discretion in the future to assure a fair rate of return on his investment. The small businessman also has to contend with the possibility of supply shortages, even if he is willing to pay a higher price for the items in question.

Finally, unnecessary rules and government reports should be eliminated and careful consideration should be given to deregulation efforts to remove existing barriers to economic efficiency. Government regulations impose costs on business which ultimately are reflected in higher prices to the consumer. Furthermore, these costs are usually more burdensome for smaller-sized business, since they tend to be relatively fixed in nature. For example, in a company with only a few employees (and there are literally millions of such small firms in our economy today) this often means taking the time of the owner whose efforts are more properly focussed on the immediate needs of his business. The small businessman needs to devote his time to increasing his sales and controlling costs rather than complying with seemingly endless bureaucratic requirements enforced by distant government officials who somehow seem to believe that the country's millions of small companies can afford staffs of technical experts to fill out the forms and figure out how to comply with all of the regulations imposed.

All of these policy measures would contribute to improving the climate for financing by American business and for capital formation in this country. In the end we must slightly tilt our preferences away from personal consumption and government spending toward somewhat greater savings and investment. We estimate that our capital formation needs in the decade ahead can be met if savings and investment increase moderately from about 15 percent of Gross National Product to almost 16 percent. I might add that these views are shared by most others who have analyzed the problem. (See the Appendix Table for a summary of these studies.) In terms of business fixed investment, this implies going from about 10-1/2 percent of GNP to 11-1/2 percent.

CONCLUDING COMMENTS

By improving the prospects for capital formation the current economic recovery will be sustained and long-term prospects for higher productivity, economic growth, and rising standards of living will be improved. Most important, increased capital investment will create more jobs and expand our productive capability to moderate inflation. It is not a matter of reslicing the economic pie, but rather the need to expand the pie so as to benefit everyone. For the reasons cited earlier, I feel that a major beneficiary will be small business, particularly when it comes to the problem of financing.

Thank you, Mr. Chairman, for this opportunity to share my views with you and the members of these two distinguished Committees.

# # #

CHART 1

INTEREST PAID AS A PERCENT OF TOTAL NET RETURN TO CAPITAL, NON FINANCIAL CORPORATIONS 1946-74

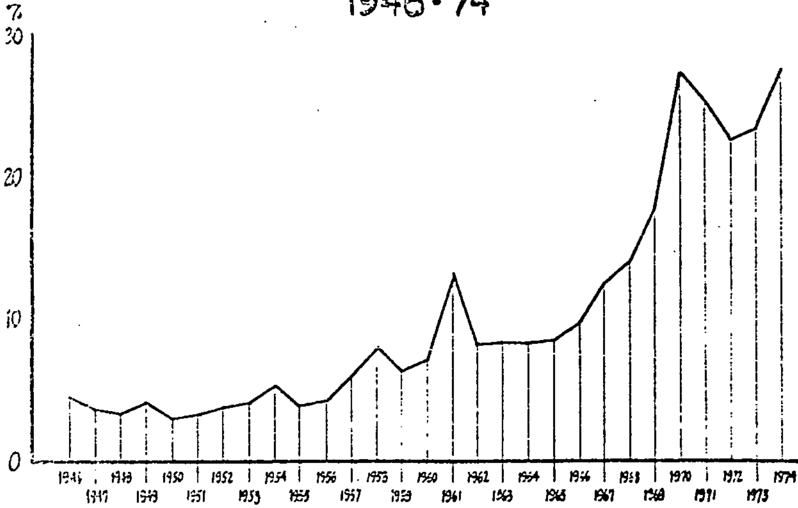
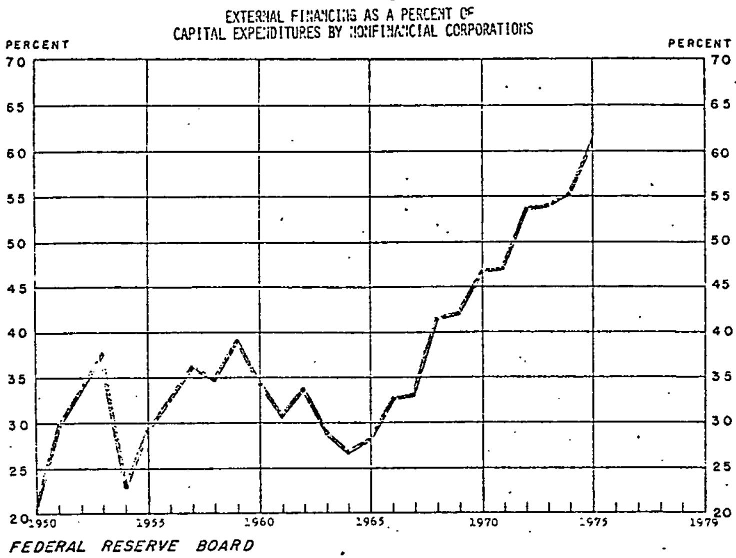


CHART 2



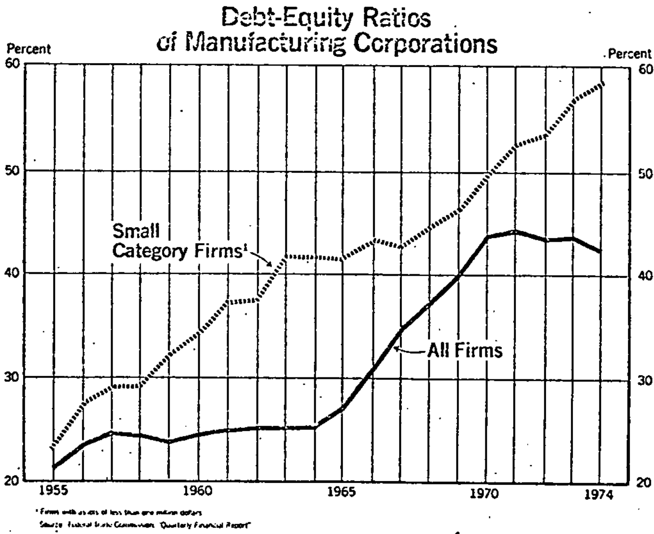


TABLE 1
BALANCE SHEET PERCENTAGES
of SELECTED ASSETS
to TOTAL ASSETS
2nd QUARTER, 1975
MANUFACTURING COMPANIES

	ASSET (In percent of total assets)				
SIZE OF COMPANY	CASH	MARKETABLE SECURITIES	RECEIVABLES	INVENTORIES	NET FIXED ASSETS
Under $1 million	11.0	1.0	26.5	23.8	28.6
$1-5 million	7.4	1.3	25.5	29.2	27.9
$5-10 million	6.5	2.2	23.0	30.5	28.2
$10-25 million	5.7	1.8	21.6	29.5	30.7
$25-50 million	4.3	1.7	20.9	29.8	30.5
$50-100 million	4.0	2.5	20.7	27.6	31.1
$100-250 million	3.8	1.7	18.8	27.1	32.6
$250-1,000 million	3.1	1.8	16.8	25.0	33.9
Over $1 billion	2.3	3.2	12.3	17.9	38.3
All sizes	3.6	2.5	16.2	22.3	35.0

Source: Federal Trade Commission Quarterly Financial Report.

TABLE 2

QUALITY DISTRIBUTION OF PUBLIC STRAIGHT CORPORATE BOND ISSUANCE (MONTHLY AVERAGES; $ MILLIONS)

Moody's	1971		1972		1973		1974		1975—1st Half	
	$	%	$	%	$	%	$	%	$	%
TOTAL ISSUANCE										
Aaa	$ 492	27.7%	$ 441	33.7%	$ 308	30.0%	$ 659	31.9%	$ 996	29.6%
Aa	447	25.2	347	26.5	321	31.3	670	32.4	942	28.0
A	565	31.9	373	28.5	298	29.0	596	28.8	1161	34.5
Others (incl. non-rated)	269	15.2	149	11.3	99	9.6	144	7.0	267	7.9
TOTAL	$1773	100.0%	$1310	100.0%	$1026	100.0%	$2069	100.0%	$3366	100.0%
LONG-TERM ISSUANCE										
Aaa	$ 422	27.8%	$ 237	23.3%	$ 289	30.8%	$ 559	39.4%	$ 664	35.5%
Aa	413	27.2	327	32.2	302	32.2	392	27.7	572	30.6
A	472	31.1	325	32.0	268	28.5	385	27.2	584	31.2
Others (incl. non-rated)	213	14.0	126	12.4	80	8.5	81	5.7	51	2.7
TOTAL	$1520	100.0%	$1015	100.0%	$ 939	100.0%	$1417	100.0%	$1871	100.0%

SOURCE: <u>Salomon Brothers Comments on Credit</u>

TABLE 3
DEBT RATIOS FOR
ALL MANUFACTURING CORPORATIONS
AND FOR THOSE WITH $1 MILLION OF
ASSETS OR LESS

	Total Debt/Equity Ratio		Long-term Debt/Equity	
	All Manufacturing	Under $1 million	All Manufacturing	Under $1 million
1959	.24	.32	.18	.19
1960	.25	.34	.18	.21
1961	.25	.37	.19	.24
1962	.25	.38	.19	.24
1963	.25	.41	.19	.26
1964	.25	.41	.19	.26
1965	.27	.41	.21	.26
1966	.31	.43	.23	.27
1967	.34	.43	.26	.26
1968	.37	.45	.29	.27
1969	.40	.46	.30	.29
1970	.44	.50	.32	.32
1971	.44	.53	.33	.34
1972	.43	.53	.33	.33
1973	.44	.57	.33	.37
1974	.42	.58	.31	.35
1975 1st Half	.44	.59	.33	.36

Source: Federal Trade Commission Quarterly Financial Report.

TABLE 4*

Corporate Debt-Equity Ratios for Selected Industries for Firms with Net and Without Income by Asset Class, 1972

Asset class (thousands)	Under $25	$25-50	$50-100	$100-250	$250-500	$500-1,000	$1,000-2,500	$2,500-10,000	$10,000-25,000	$25,000-100,000	Over $100,000
Manufacturing	19.34	2.23	1.41	1.13	.91	.80	.81	.62	.58	.62	.69
Services	3.73	1.96	1.39	1.42	1.71	2.33	2.52	2.17	1.87	1.82	1.34
Construction	7.13	2.58	1.61	1.38	1.70	1.75	1.79	2.22	2.38	2.13	1.17
Transportation	3.98	2.06	1.52	1.41	1.20	1.43	1.40	1.36	1.36	1.46	1.19
Wholesale and retail trade	5.15	2.06	1.48	1.10	1.00	1.06	1.20	1.16	1.19	1.09	1.08

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*The debt/equity ratios in this table for 1972 is substantially higher than that in Table 3 for three reasons: (1) in this table, "debt" is the sum of net trade credit plus all other liabilities, which is more comprehensive than the measure used in Table 3; (2) in this table, the asset measure is total assets net of trade credit and this tends to cause a downward redistribution of enterprises as compared with that in Table 3; (3) the sample of manufacturing corporations filing tax returns in 1972 is not identical to the sample underlying Table 3.

TABLE 5

Earnings Including Compensation of Officers, per Dollar of Assets, for Corporations With and Without Net Income by Asset Class, 1972

Asset class (thousands)	Under $25	$25-50	$50-100	$100-250	$250-500	$500-1,000	$1,000-2,500	$2,500-10,000	$10,000-25,000	$25,000-100,000	Over $100,000
Manufacturing	.49	.39	.35	.28	.24	.22	.18	.16	.14	.12	.10
Services	2.42	1.03	.53	.29	.19	.13	.11	.09	.09	.09	.07
Construction	.85	.53	.40	.30	.23	.19	.16	.13	.09	.08	.05
Transportation	.42	.26	.26	.23	.18	.15	.13	.11	.10	.08	.05
Wholesale and retail trade	.49	.34	.29	.24	.21	.20	.17	.15	.12	.12	.09

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Income = total receipts - total deductions + interest + officers' compensation + charitable contributions

TABLE 6

Earnings, Excluding Compensation of Officers, per Dollar of Assets for Corporations With and Without Net Income by Asset Class, 1972

Asset class (thousands)	Under $25	$25-50	$50-100	$100-250	$250-500	$500-1,000	$1,000-2,500	$2,500-10,000	$10,000-25,000	$25,000-100,000	Over $100,000
Manufacturing	-.13	.00	.06	.07	.09	.11	.12	.13	.12	.11	.10
Services	2.12	.99	.10	.09	.08	.07	.07	.06	.07	.08	.06
Construction	-.04	.02	.09	.09	.08	.08	.09	.07	.06	.06	.05
Transportation	-.03	.05	.07	.09	.09	.09	.09	.09	.09	.07	.05
Wholesale and retail trade	-.07	.04	.07	.10	.11	.11	.12	.07	.11	.11	.09

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Income = total receipts - total deductions + interest + charitable contributions

TABLE 7

Distribution of Proposed Corporation Income Tax Reductions, for All Corporations and Selected Industry Categories; by Size of Total Assets

Industry/item	Estimated 1976 quantities	All sizes	Under $25	$25-100	$100-500	$500-2,500	$2,500-10,000	$10,000-100,000	$100,000 and over
		Asset size (thousands)							
					(percent)				
All industries: 1/									
Number of corporations 2/	2,085,000	100.0	24.8	30.4	31.5	9.9	2.1	1.1	0.2
Tax reduction provided by:									
H.R. 10612	$2.0 billion	100.0	3.0	10.3	24.5	23.6	13.3	20.9	4.4
Surtax reduced 2 points 3/	$2.5 billion	100.0	0.2	1.4	6.2	9.3	7.9	12.8	62.2
Wholesale and retail trade:									
Number of corporations 2/	639,000	100.0	19.8	33.2	35.3	10.2	1.2	0.3	*
Tax reduction provided by:									
H.R. 10612	$300 million	100.0	2.3	12.5	35.5	32.5	9.7	6.8	0.7
Surtax reduced 2 points 3/	$360 million	100.0	0.3	3.2	18.4	25.5	14.7	14.6	23.3
Services:									
Number of corporations 2/	402,000	100.0	46.1	29.6	18.9	4.5	0.7	0.1	*
Tax reduction provided by:									
H.R. 10612	$ 65 million	100.0	15.2	23.6	29.3	18.4	6.9	5.7	0.8
Surtax reduced 2 points 3/	$ 80 million	100.0	3.8	10.6	22.2	18.6	12.4	17.9	14.5
Manufacturing:									
Number of corporations 2/	229,000	100.0	16.8	26.5	34.1	16.6	4.0	1.5	0.4
Tax reduction provided by:									
H.R. 10612	$1.0 billion	100.0	0.9	5.3	18.0	28.2	21.9	20.1	5.7
Surtax reduced 2 points 3/	$1.3 billion	100.0	*	0.3	2.0	5.9	7.1	13.3	71.4

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*Less than 0.05 percent.

1/ Includes industries not displayed here.

2/ Includes corporations with and without taxable income as well as those electing not to be taxed as corporations under the provisions of Subchapter S.

3/ 2% reduction on all corporate income subject to corporation income tax above $50,000.

TABLE 8

Distribution of Investment Credit Data, for All Corporations and Selected Industry Categories, 1972

Industry/item	1972 Quantities	Asset size (thousands)							
		All sizes	Under $25	$25-100	$100-500	$500-2,500	$2,500-10,000	$10,000-100,000	$100,000 and over
	(millions)	(percent)							
All industries: 1/									
Number of corporations 2/	1.419	100.0	23.8	29.6	31.9	10.8	2.4	1.3	0.2
Investment in qualified property	71,466	100.0	0.3	1.5	5.4	7.8	5.5	9.5	70.0
Amount qualified for credit	62,073	100.0	0.3	1.3	4.8	7.1	5.2	9.4	72.0
Credit taken	3,013	100.0	0.1	0.8	4.6	7.7	5.7	10.3	70.8
Wholesale and retail trade:									
Number of corporations 2/	.442	100.0	18.9	32.3	35.9	11.4	0.7	0.1	*
Investment in qualified property	6,287	100.0	0.8	5.0	17.9	21.6	11.7	15.0	28.0
Amount qualified for credit	5,186	100.0	0.7	4.7	16.7	19.9	11.3	15.4	31.3
Credit taken	263	100.0	0.1	2.3	14.4	21.5	12.2	16.9	32.6
Services:									
Number of corporations 2/	.242	100.0	45.7	29.4	19.3	4.8	0.7	0.1	*
Investment in qualified property	3,756	100.0	2.7	7.6	16.5	19.5	14.1	16.8	22.9
Amount qualified for credit	2,722	100.0	2.6	7.5	16.1	19.8	13.1	16.8	24.1
Credit taken	106	100.0	1.0	6.1	18.0	23.0	13.9	14.3	23.8
Manufacturing:									
Number of corporations 2/	.166	100.0	15.2	25.0	34.7	18.3	4.7	1.7	0.4
Investment in qualified property	26,669	100.0	*	0.6	3.0	6.3	5.6	11.1	73.4
Amount qualified for credit	23,496	100.0	*	0.5	2.9	6.2	5.6	11.2	73.5
Credit taken	1,374	100.0	*	0.2	2.6	6.0	5.9	11.5	73.7

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*Less than 0.05 percent.

1/ Includes industries not displayed here.

2/ Includes only corporations subject to regular corporation income tax whether or not taxable in 1972. Does not include corporations electing to be taxed under provisions of Subchapter S.

APPENDIX TABLE

ACTUAL AND PROJECTED INVESTMENT AS A PERCENT OF GNP

	Average 1965-1974	NYSE 1/	Bosworth Duesenberry Carron 2/	Friedman 3/	G.E. 4/	DRI 5/	Chase Econometrics 6/
Gross private domestic investment	15.1	16.4	15.5	15.8	15.8	15.7	15.9
Non-residential fixed	10.4	12.1	11.3	11.5	11.4	11.0	11.8
Inventory	1.0	0.3	0.8	0.8	0.4	0.8	0.8
Residential	3.8	3.9	3.5	3.5	4.0	3.8	3.3

1/ The New York Stock Exchange, The Capital Needs and Savings Potential of the U.S. Economy: Projections Through 1985, September 1974. Figures shown are based on cumulative projections in current dollars, 1974-1985.

2/ Barry Bosworth, James S. Duesenberry, and Andrew S. Carron, Capital Needs in the Seventies, The Brookings Institution, 1975. Figures shown are based on estimates for 1980 in current dollars from Table 2-12, p. 39 (note the constant dollar 1980 figures in Table 2-11 project gross private domestic investment as 15.8 percent of GNP).

3/ Benjamin M. Friedman, "Financing the Next Five Years of Fixed Investment" in President's Authority to Adjust Imports of Petroleum, Public Debt Ceiling Increase; and Emergency Tax Proposals; Hearings before the Committee on Ways and Means, House of Representatives, January 1975, pp. 710-726. Figures shown are based on 1975-79 averages of current dollar projections.

4/ Reginald H. Jones, "Capital Requirements of Business, 1974-85," Testimony submitted to Subcommittee on Economic Growth, Joint Economic Committee, May 8, 1974. Figures shown are based on cumulative projections in current dollars, 1974-1985.

5/ Data Resources, Inc., Summer 1975, "Special Study: The Capital Shortage." Summary table on inside cover. 1985 data only, current dollars, standard forecast.

6/ Chase Econometrics August 1975. "The Next Ten Years: Inflation, Recession and Capital Shortage." 1984 data only, current dollars. Table, page #1 of 14. No recession run.

Senator HUMPHREY. I would very much appreciate some reconciliation of the effective tax rates. I do not like to have those figures so widely different—the ones that I use, and the ones that you use.

It is not a question of being argumentative, it is just a question of some meeting of the minds. What I would like to do, and Senator Nelson will perhaps concur, is to have some members of our respective staffs get together with your people and see if we can come up with a more definitive and accurate assessment.

Secretary SIMON. I would like to have Mr. Goldstein, my Deputy Assistant Secretary, who is certainly an expert in this area, work with your respective staffs.

I think it is important.

Senator HUMPHREY. I think it is important to arrive at least at some uniformity of statistical information.

We can draw our policy judgments after that, but this argument of the amount of the effective tax rate, I think lends itself to unnecessary arguments, particularly if you can come to some better understanding of the figure.

So, we will look into that, and better, I am going to ask you to present that to us at the Joint Economic Committee.

Secretary Simon, in one of your appearances here, before the Joint Economic Committee, I believe it was Senator Bentsen's Economic Subcommittee some time ago, you said inflation would reduce savings because consumers would be spending more to avoid future high prices.

That is, I think, a very natural observation.

Some people looking down the road will say; let us buy now, because it is obvious things will cost more later on.

We had quite an argument yesterday in the Senate on that in the purchase of wetlands, because the longer we delay the purchase, the less land you get for the amount of money you have available.

But a consensus of the six pollsters—we had Harris, Hart and others before us on October 30—establish that consumers are reacting to inflation by being very savings-minded, and savings are up, not down as you expected.

What effect has this had on business capital formation, generally, if it has had any effect at all?

Secretary SIMON. It will be helpful. I think history suggests, Mr. Chairman, indeed, as I said in my testimony before Senator Bentsen's committee.

One can say a lot of things are happening differently at this particular time than happened before because we have a different set of circumstances today.

The people who have represented the traditional policies of economics, of stimulating an economy to fiscal and monetary measures, that does not work now, as we have seen in other countries.

Unfortunately, the very severe recession is also accompanied by an extraordinary phenomena of extraordinarily high inflation.

So, therefore, the stimulation will not cause the same results.

To demonstrate what it has done in other countries is counter productive, so we say there is a great recognition in the country today, and in the world that inflation causes recession and indeed higher unemployment.

So, there is an element of fear and a loss of confidence involved, when people fear inflation.

As a result, there is a natural tendency to save money when you are uncertain about whether or not there will be a resurgence of inflation, whether or not one is worried about losing his job, but I still believe this is a temporary phenomena.

As you know we react tremendously in this country to 1 or 2 month economic statistics. In May and June, inflation rates went up, and we said, let us not pay too much attention to the aberations on the low side or the high side.

I remember in August when Sid Jones made a speech out in the midwest somewhere, he commented that the economic statistics over the next few months were going to be turbulent.

This sent the stock market down. What Sid meant by that was any economic recovery is going to show statistics that are going to be contradictory, some statistics on the high side, and some on the low side, but he did not mean that we would have a return to a double-digit inflation problem.

We have a base rate inflation rate in the area of 7 percent. It will take a long time to work down to what you and I would call an unacceptable level, but we should not pay too much attention to the short-run statistics. With respect to the 3 months savings rates, indeed they have been high, and they do help capital formation if sustained.

The money that flows into the thrift institutions, that is a good signal for a very major sector of our economy. Money flowing into thrift institutions is good for housing.

Now, this is a viewpoint most economists would agree with. But there again we have a little phenomena going on, our higher interest rates due to inflation, and perhaps more restrictive monitary policies, that they do not help.

Does the fellow in the savings and loan company say, if I make a long term commitment for mortages today, do I have to worry about what will occur 6 months from now, and be darned sorry I made this commitment?

So instead, if he desires some liquidity he will make his decision now with the long term commitment in mortgages to the extent that he would have in former expansions. But he will also make it in the market in corporate securities where he can get an outstanding yield and in Government securities, and this affects small business.

I am going on too long. You did not ask that question.

Senator HUMPHREY. I do not disagree with the fact that things have changed, and despite our many arguments over the months, Mr. Secretary, there is not any doubt to what the reaction was, what we used to term conventional economic development that you could predict no longer pertains.

Secretary SIMON. We do not have any argument, Senator. We just have interesting discussions.

Senator HUMPHREY. What is your prediction as to when, if ever, the new issue market will return?

Secretary SIMON. Well, you look at periods when venture capital was plentiful, it was when we, of course, were not in the market to the extent that we are now, and there were more than enough savings to finance venture capital.

That is a matter of attitude, as well as the amount of money, and when people have confidence the economy will grow, at a noninfla-

tionary rate of growth, as far as one can see, then they are willing to take a chance, they are willing to take a chance in opening a new business, and there is more money available for them to finance this business, and at a reasonable level. But let us look at what is happening today.

Prime rate companies, the best, are yielding 9½ to 10 percent returns on their debt. Now, that is a rate of return that is absolutely extraordinary, not only in the better period of business cycle, it is more illustrative of the terminal stage for boom. But more importantly, on the return basis, which I think most investors look for, this is a tremendous rate of return.

This is for the prime. As we move down the ladder on the rate of companies to the nonrated, to the new ventures, they cannot finance in the debt market.

They could not afford to finance with the interest rate, that is assumed somebody who lends at the regular interest rate, because people are very happy to receive 10 percent interest on a prime rated company and sleep well at night, rather than worry about speculative venture. So they demand tremendous equity, or even controlling interest in a company, if they are willing to put the money up, which in many instances is unacceptable to these companies, because these entrepreneurs think they have a very good idea, and they do not wish to give away their total bowl of porridge for everything that they are going to be doing themselves. So when we can restore—and this gets right back to the basis of all of our discussions—when we can restore stability in the economy, where people will have the confidence their Government is running good policy, sound policies that will be durable and lasting, then you will see a return of the startup firms. And small business will be able to adequately finance their needs and not before.

Senator HUMPHREY. You are not making much of a specific prediction, Mr. Secretary.

Secretary SIMON. We are on the way to doing that right now.

If we can indeed convince the people that they can look 3 years down the road, and see a balanced budget, can see monetary and fiscal policies that are not of the variety that they have been in the last 10 years, then this confidence will be restored, but that is a very fragile thing, confidence.

Senator HUMPHREY. I know you have some time constraints, and I want to yield now to Senator Nelson.

Senator NELSON. You are probably familiar with the Canadian statute that was enacted, I think 3 years ago, to allow the writeoff of capital investment in equipment and in machinery, in 2 years. Are you familiar with that?

Secretary SIMON. No, but every country has a different investment for depreciation guidelines.

Senator NELSON. One of the problems raised constantly, especially under the very rapid inflation rate of the past few years, is that if a piece of equipment is bought today, and depreciated over a 10-year period, when the company gets around to replacing it, the costs will be three times as much. Many witnesses have argued, on behalf of something like the Canadian system. They will allow on any piece of equipment, they do not have a variety of schedules depending upon the industry, they just arbitrarily say you can write off 50 percent depre-

ciation the first year, and the remaining 50 in the second year, or whatever period you chose.

Do you have a viewpoint of that?

Secretary SIMON. We started to move toward that direction in the last tax reform exercise in the active depreciation range.

It is a matter of judgment and debate, as to how far and how fast this country wishes to move in that direction.

I have sympathy for moving in that direction, yes, No. 1, and No. 2, I also feel strongly, as I stated in my testimony before the Ways and Means Committee on the accounting practices, that do not take this into consideration as well. That is extremely important, so a combination of the two would be a very good idea.

Senator NELSON. Have you referred to DISC[1] in your statement?

Secretary SIMON. Not today.

Senator NELSON. As you know, there is lots of dispute and argument about it.

Do you have anything on that that you would consider fairly accurate that would demonstrate the increased foreign sales activities by U.S. corporations as a consequence of the enactment of DISC?

Secretary SIMON. We think so, and that is the best I can say.

Let me tell you why.

This program is only 2½ years old. There is a lot between the time the program is implemented, the startup, to increase the export activities on the part of our business people, and the time these figures come in, that we can evaluate over a period of time, because 1 year's figures in an operation like this, are not terribly conclusive.

The business community will be very persuasive to show you how they have increased all of their activities, our new firms have come into the business, as a result of DISC.

In conclusion, at Senator Long's request, we are starting, we have started, excuse me, a joint Commerce Department, Treasury Department study on DISC, to completely review developments to date. I will submit the report to this committee for the record, and to you, Senator.

Senator NELSON. That issue was raised on the House side, and it will be before the Finance Committee. I have in the past voted against this, however, in recent months, a number of small businesses and some individually from my State, have informed me by letter, that they went into the foreign trade fields specifically because of DISC. These companies never had been there; would never have been there without it. So in their tax returns, presumably, it would show that their exports were at zero, prior to DISC, and they now say that they have increased foreign sales to several million dollars.

It would be very valuable in this testimony on the Finance Committee side, if you could give some kind of indication to us, how widespread the involvement of small business has become in DISC. It would be helpful to have the overall figures on businesses of all sizes, but particularly small business—how widespread their involvement in export trade has become as a consequence of DISC.

Secretary SIMON. I want to do that.

Let me comment, it is not only DISC. DISC is 2½ years old, and I suggest, while the evidence is still sketchy at this point, we will

[1] Domestic International Sales Corporation.

have evidence as time goes on. So if we do not remove DISC, I believe it will prove conclusively just what you have said, that we have more people doing overseas business than ever before, and one can say that DISC was a contributor to this.

There is no doubt about that, and you must remember, I think it is pretty generally agreed that every billion dollars of exports from the United States, provides 75 thousand new jobs, and that is pretty important as well.

You know, there is a cost involved in setting up a DISC operation in a business and here DISC is 2½ years old, and all of a sudden we talk about removing it.

In other words, if there is one thing the business community, or anybody needs, it certainly is Government policies which relate to what I was talking about a few minutes ago. When you think that the business community response is to spend some money and some time to set up DISC programs, and then they have threatened to have removal within 2 years of setting it up, after a while, people do not really believe it.

The same thing with the ADR. We have to put in programs, and keep them in place long enough so that people believe this is certain. We also have to make certain the asset depreciation range remains at a level we can continue to defend, because just like the investment tax credit which we have juggled four times since 1962, put it on, taken it off, and then back on again, we believe the investment tax credit is a useful instrument for getting capital investment, stimulate productivity, and doing all of the things I talked about.

The more we ad hoc all of these policies, whether they are tax policies, depreciation range, the more the uncertainty in the business community, and then after a while they do not respond to the incentives that we put forward because they do not trust they will be semipermanent.

Senator NELSON. Mr. Secretary, we may have some more questions about that.

Maybe we will submit them in writing, because I know we have some time constraints. I think Senator Javits has some questions.

Secretary SIMON. We will be glad to answer them.

Senator NELSON. Whenever you have to leave to meet whatever schedule you have, go ahead.

Senator Javits?

Senator JAVITS. Mr. Secretary, can you give me 5 minutes, and in return, to be very refreshing, I will not ask you a single question about New York's financial crisis.

Secretary SIMON. I will stay 10 minutes.

Senator JAVITS. That is how to win friends.

Now, you be good to us, even though I am not asking you questions.

Senator HUMPHREY. This is a new Javits attack.

Senator JAVITS. This is what is known as a soft sell.

Senator HUMPHREY. We have tried everything else.

Senator JAVITS. That is true.

Mr. Secretary, in view of the problems of small business, and, by the way, this is such a remarkable statement, that with your permission, I would like it to a list of maybe 20 of the people that I would like to hear on finance, and business finance, and economics, and so

forth, and their comments, and, Mr. Chairman, it could also be very valuable, that I asked for the Secretary's permission, consent to insert into the record those comments and such sources as are agreeable to the Secretary, and No. 2, agreeable to the Chairman.

Senator NELSON. I think it will be very valuable for the record.

Senator JAVITS. I just thought as I said here, that this is the most thorough statement that I have seen.

Whatever architect you had to do this, we all owe a debt of thanks to, whether we agree or disagree, the analysis is absolutely priceless.

I would like to compliment whoever is, whoever constructed the framework of it.

Secretary SIMON. I want to thank you for that, Senator, because I have felt for a long time, that we never seem to pat anybody any more on the back. I think the Treasury Department, and the U.S. Government, and most importantly the people are blessed with the most dedicated professional staff in Government, for which I am personally grateful, and that is why I go to great pains to attempt to read a good portion of the testimony, because they are not just prepared somewhere down the bowels of the Treasury, but they are done by a group of professionals, they are rewritten, anywhere from 5 to 15 times, and a lot of hours and thought, good thought on the part of these people go into that, so I personally thank you for these remarks.

Senator JAVITS. This is a very professional and excellent job.

There is one figure here that puzzles me, and I want to move from it, so I will ask you about it.

At page 4, you say when we add to this a 3 to 4 million unemployed in the current labor force.

I thought it was 7 to 8 million.

Secretary SIMON. That is the total I was talking about as related to the full employment.

Senator JAVITS. I see.

All of us, you know, fight off this idea, we will accept forced unemployment, so I think it would be more accurate if we dealt with the whole thing, bearing in mind that we simply have got to accept a certain amount of unemployment. I just called that to your attention.

Secretary SIMON. Yes, sir.

Senator JAVITS. Now, the point I want to make, it is very tough to raise money for small business.

You can make a strong case, for the economic viability and importance of small business, and I think as you state here, of the individuals, the abilities and the talent, as being the red blood of dynamics democracy comes from small business.

Now, many of these things which you recommend are very good, but for the near term, very, very difficult to achieve.

In view of the historical and economic desirability of raising the level of the small business communities' ability to compete, and to have a place in American life, what is the basic objection to a domestic development bank to serve in the domestic world the same function that the Bank for Reconstruction and Development serves in the international world, with also the possibility of a soft blown window, like the IDA, and investment window, like the International Finance Corporation, as a supplementary means for achieving this high economic and social goods packaging principal, and the World Bank,

as you know, as I am sure the Secretary knows, whether he agrees or not, I don't know, based on a very enviable reputation in that regard, and the RFC, that made a remarkable record in that regard to, showing that we do not necessarily have to be full of polluted processes in our banking system, and to finance that domestic development bank, the same way the World Bank does, with a basic subscription, but with public investment capital, which could possibly come on a very safe basis, and bearing in mind that the satellite corporation, which we have as a moneymaker today, that is a Government operation, whose stock does quite well compared to many other stocks in the New York Stock Exchange, so this is a question that the Secretary was not thinking about when he wrote this paper.

We have bills in, and I have had a bill in for a long time.

What is half, including a very distinguished member of this body, Senator Sparkman, who is no economic radical, and I just wondered if the Secretary would give us some objective view on that, whether it could be explored further, whether we should ask the Treasury perhaps to give its ideas on such an institute might be constructive, by way of a definitive step forward in this bill.

Secretary SIMON. I would be delighted to work with you on this subject.

We have not done a substantial amount of work in this area, and indeed, it probably would be very useful to explore this in specific language, the idea of how we can finance small business in this country more efficiently and effectively.

I think your next witness here this morning, one of them, is Mr. Laun, from the Small Business Administration, who has had a very distinguished career in business, and he can therefore give you both sides, the effectiveness of the Small Business Administration, the SBIC's, which were also created to do exactly that, you know. I think about Government corporations, and Government development banks, to substitute for the private decisionmaking of the market place, and the venture capital firms, and other financial institutions, the insurance companies to a growing degree, which we are today providing moneys to small business, and today's substantial amount years ago, and to new entries. First, we are creating a new and undoubtedly growing bureaucracy in the Federal Government. Second, where you are substituting the judgment of the bureaucrat, which may or may not have any experience in business, as to whether a particular business is a good idea, or is not a good idea, I am skeptical.

Also, it needs to be financed, and as we look at the financing requirements of just the Federal Government, and the budget agencies, they are enormous by any comparison. As you all know, Senator, that by hurting these small businesses, and other businesses, it seems to me if the many things I discussed in my testimony, if we could move our sales out of the capital market to a greater degree, if we could get the inflation under control for a sustained period of time, and remove what is more important the inflationary expectations, that are so deeply ingrained in the economy, and get long-term interest rates back down to what you and I would call an acceptable level of 5 or 6 percent, which are high, but low by comparision to today, then there would be plenty of money available for small businesses that would indeed wish to finance. So my advice, which I am sure is no

surprise to you, Senator Javits, would, on that side of attacking what I see as the fundamental causes for problems, rather than the result.

Senator JAVITS. Mr. Secretary, I appreciate everything you say.

I appreciate your deep feeling about it, and yet we are selling the securities of these top mortgage finance corporations, which are again listed on the exchange, I think it is either Fannie Mae or Gennie Mae, which again has done very well, not withstanding the colossal amount of guarantees.

I think we are well in excess of $100 billion is where they are at.

You have a whole complex of home loan banks, and agricultural and credit organizations.

You understand, I am very sympathetic to the fact that business profits are too low, and I am not one of those liberals, and I am, as you know, not against business profits.

On the contrary, I consider it one of my jobs on the floor of the Senate to see that these businesses do have the opportunity for providing in the public interest their services, and that is the next point I would like to come to with you.

Is it not a contradiction, Mr. Chairman, may I have 2 minutes, I am sorry to take so much time, is it not a contradiction between the statement at the bottom of page 3, and the statement at the top of page 5, which, I am not trying to catch you on as a cross-examiner, but simply to highlight the two points of view, which you yourself present, showing the dichotomy in the mind of any thoughtful person acquainted with business finance?

Let me call to your attention what I mean, you say at the bottom of page 3, this is not to imply that capital investment is the only factor affecting productivity.

Other facts, new technology, shifts in the composition of the output, the level of capital assets, the skills and growth of the labor force, the availability of transportation communication, and other facilities, access to raw materials, and the stage of the business cycle affects productivity.

I would like to emphasize especially in this discussion with you, new technologies, and the skills and growth of the labor force, access to raw materials, and when you turn over the page, to page 5, this is what you say, the top of page 5, you say some analysts have concluded it will not be possible to meet these capital formation requirements.

I firmly agree we are capable of achieving our basic investment goals, and if we will follow a responsible fiscal and monetary policy, and then later on the same.

You say, the point is this, unless strong action is taken, to bring Federal spending under better control, crime deficits of the past will continue, and the achievement of our basic capital formation goals will be impossible, and so I ask you the question, as what you say has not worked, I am not arguing on doctrine, it has not worked.

You yourself say we have had deficits for 14 of the last 15 years.

OK, that is this perverse animal called the American people. That is it.

Now, why don't we try the other route now?

Secretary SIMON. I agree with you. Let us balance the budget.

Senator JAVITS. No, I say, why don't we try the other route now, why we are trying the route of economy and expenditure, of budget committees, why not try to expand our production by some of these other means, which we have not given a fair show.

That is why I suggest to you the domestic development bank.

For example, you speak of the new technology.

Let me give you an example. For years, we have had an antitrust exemption in the Small Business Act. I wrote it in myself. I have been at this for a long time, as you know, so that small business firms could collaboratively do research and development.

They have hardly used it, because there has been nobody around to really simulate, develop, and organize.

Second, as we speak of the access of raw materials, the Paley Commission, 20 years ago or more called our attention to those, and yet when it came to doing an ERDA 20 years ago, which we finally did now, and even now, we are taking two steps backward as we take one forward to finance it, we really did not pile into to get the new technology, the very Small Business Committee headed by Senator Nelson says we are fast asleep at the switch on solar energy, as one example, and the third thing is the skills and growth of the labor force.

We pay bills and unemployment compensation, but we do not give people a high school education, and we do not give them training while they are drawing unemployment compensations, why, because it will cost $5 billion more than the $18 billion we are spending in unemployment compensation.

The final point, I have just had the inestimatable privilege, if I do nothing else, the rest of my life, I am content, of being the author of the great pension reform law, we also need a profit sharing law, and a stock ownership law, so the question I ask you, Mr. Secretary, don't we have to do, as the first line has failed, to work, effectuate by balancing the budget, economizing on expenditures, and so forth, don't we now have to put the national effort into increasing the aggregate of what we produce, so that you may create more credit, and so forth, because that is what this is all about?

Secretary SIMON. You know, you started and ended with that statement, that it has failed.

It has not failed. We failed. It is not the failure or the result, from balancing the budget, and doing all of these things.

It is our failure to balance the budget, failure to live up to the ideals and principals that we have had for so many years in this great country.

It is a fundamental difference I guess in an approach whether or not the individual, and the free enterprise system, that overused the term is more efficient than the Government, and we do set a lot of priorities, and you named a lot of them yourself, Federal home loan banks, the Fannie Maes, the Gennie Maes, Federal intermediate credit institutions, the land banks for the farmers, we have established all of these priorities to assist these special sectors, and they have grown and they have grown and they have grown.

Senator HUMPHREY. And they have made money and they have made money.

Secretary SIMON. They have made money.

Senator HUMPHREY. It is a wonderful thing. The Federal Land Bank is the most profitable organization, one of the best in the country.

Secretary SIMON. I am not sure on an orderly basis, indeed we could say it is profitable, and that depends on the institution, and I do not have any analysis on that at this time to make that comparison, but as I say, there is a fundamental difference. Should the Government, is the Government's role to step into a lot of these areas?

I think it should as far as stock ownership plans and profit sharing. I agree with you 100 percent, wherever we get the basic beliefs of strength in our free enterprise system, then everybody ought to have an opportunity to own a share of American business, when they work in it. Yes, that is important, and we have been working for some time. I suggest nothing is perfect, in my judgment, but in this area putting in something imperfect is better than not having anything at all. And then let the system finally work its way through.

The same way with profit sharing, whether the Government in its wisdom decides that a ERDA type proposal is needed for small businesses, categories, how big we have become, we would be the lender for most of all business in this country, again, I think Government clearly has a role in research and development, and we have provided the necessary funds to ERDA, belatedly, but we have it off the ground, and we are beginning to finance it.

What the scientists say, $2 billion a year, is the most we can efficiently spend on research in all of these areas.

Maybe we could spend a little bit more, but again, I contend that none of us have the expertise to decide that solar energy, or geothermal, or fission, or the rest of them demands more money in a particular year.

It seems to me that this approach makes a good deal bit of sense from my relative brief energy background. But I think it would be more than useful, Senator Javits, if you wanted to give us the assignment Senator Humphrey, or Senator Nelson, to conduct hearings on the entire subject of priorities in Government role, and how the Government has performed in many of these areas, because I have had experience with most of these.

I was a managing underwriter, and it was my responsibility while I was in industry to work with new issues by the Fannie Maes (FNMA), and in the Gennie Maes (GNMA), and major participants in the home loans, so I do have some experience in this area. I will find it extremely interesting to write on the efficiency and effectiveness of the Government role on these various areas, and indeed what the costs are there, because money that is taken out of the economy by the Federal Government, is money that would be used in the private sector, so you are to say, how much money are we taking out at this particular time, and what damage implicitly does that mean to the future of the system.

I think that that would be a very useful thing.

Senator JAVITS. Mr. Secretary, it would need to be structured, so I would suggest, Mr. Chairman, that the Joint Economic Committee would be the most suitable vehicle for this purpose, together with Senator Nelson, if he wishes to put his committee into it.

Secretary SIMON. Give us enough time between the time you write the letter, and the time that I have to come up and testify, because I want to be totally prepared.

Senator JAVITS. I would suggest more than that Secretary Simon, that our chairman is willing, the staffs sit together, it may take some

months to really structure a set of hearings, which would be the new economic policy for the United States.

Secretary SIMON. And the fine way the differences are in fundamental philosophies, and where indeed they can merge.

Senator JAVITS. And what are the options.

Secretary SIMON. Yes.

Senator HUMPHREY. We are looking forward to a set of hearings on capital formation, but I believe the broader perspective is needed.

Secretary SIMON. This is the other side of the equation.

Senator HUMPHREY. And, of course, this is a question in which there is hot arguments.

Secretary SIMON. Sure.

Senator HUMPHREY. I just wanted to summarize this very quickly, on my side of it, I, like Senator Javits, feel that the profit structure of course is vital to any kind of business expansion.

I have never been opposed to the profit system, or the adequate profits, indeed, much more generous profits as presently exist, which is one way you have capital for expansion.

I have long supported the investment tax credit, but I noticed today that your testimony indicates it is not as desirable an instrument for smaller businesses as it is for the larger one, and I think we need to take a look at that, and see what improvements we can make.

As a matter of fact, I have been very critical of administration policies on a lot of things along the line. You and I have had some dialog and discussion with that, but I think you have to give the policy a chance to run its course, to give some sets of continuity, and to stabilize it.

On depreciation, that Senator Nelson brought to your discussion, I wish you would look at the Canadian plan.

I have never felt the Government lost anything out of accelerated depreciation. It is just a question of which is the better way, for the company or the business firm, to take off its depreciation.

You can do it over a long period of time, because once you have depreciated the equipment, you have lost your tax benefit. With the high rates of inflation, the necessity for modernization, improving technology—which is one of the ways of improving productivity—I think that is a much more radical accelerated depreciation rate that can be justified.

I know the traditional liberal doctrine says you are not supposed to do that, but I think the traditional liberal doctrine in that area is off beam.

If we need to have modernization, we should promote a great deal of capital investment in durables and capital equipment. It is one of the ways that we can improve productivity.

Your figures on productivity, I think are very revealing, and I have no reason to dispute that, but this drop in productivity tells a sad story.

The drop in productivity contributes to inflation, No. 1.

No. 2, it indicates there has been a failure to have the kind of technology advancement, which requires heavy investment, which requires profit, or at least requires accessibility to money markets, which apparently has not been fully adequate, so there are lots of areas where we will find ourselves working together in considerable understanding.

Senator Javits, as you know, I have a bill in, and have had every year, since I have been back in 1970, on the National Domestic Development Bank.

I have never been able to see how we justify the World Bank and not have one for ourselves.

We have got all kinds of banking structures, Export-Import Banks, and the production credit administration for a short-term loan to farmers.

The Federal Land Bank is all borrower owned, made a whole tub full of money, paid off all of the Federal Government capital investment.

The whole farm credit system today, which is really one of the marvels of finance, is borrower owned.

With the exception of the farmer's home loan administration, which is for the small farmer, on emergency needs, it is a resounding financial success.

The bank for cooperatives does very well. They all make money. And the interesting thing to me is that they needed it for the agricultural sector, and by the way, all of it was initiated by Congress.

It did not come down from the higher echelons of the brain trust of the executive department.

CPA, the Federal Land Bank, the Bank for Cooperatives, have their initiation right here in the Congress of the United States. So I think what we need to do is examine what Senator Javits said, the alternatives, to take a look at what both you and I agree on. We have inflation and recession, which we have never had before, and conventional medical treatments, or financial treatments or economic treatments for these two plagues, these two diseases, this is not doing the job. We need to take a good look at what more needs to be done not necessarily more Government programs, I am not saying that, but what needs to be done structurally. Senator Nelson was primarily responsible, as I recall, in the last tax act that we passed.

I was in the Finance Committee the day he was proposing some moderation in the tax structure for small business, and I think that we need to take a look at it. I want to ask you, if you have had any ideas about a bill that could create a graduated capital tax structure, to allow savings increases, according to the length of time an investment is held, or a bill that would create a graduated corporate income tax, that would be graduated according to business size, again, I mean, the size would have to be in terms of dollar paid.

Have you any idea on that, Mr. Secretary.

Secretary SIMON. I have always favored the graduated, meaning declining, that is.

Senator HUMPHREY. That is correct.

Secretary SIMON. It is the tax on the length of the assets held, and I can remember shortly after coming to the Treasury, after 1972, visiting with the Chairman Wilbur Mills on this subject, and I found that he had indeed great favor with this type of proposal as well.

I claim, and the economists can argue about this 400 years, and I am sure will or longer, that there will be a ripple effect in the economy through doing this, it will give an incentive, if you will, for investment, and selling of assets.

Velocity of capital, it will have a very economic good effect.

The Ways and Means did not go as far as I would have liked to have gone the last time, but at least we are moving in that direction, the recognition of philosophy of lower rates of taxes, the longer the assets are held.

I must admit, we talked about simplification of the tax system, by any measure, it is without a doubt the most complex system the world has ever devised over the years.

If you wanted my real druthers, and wanted to really simplify the system, we will never really get into it, let us just abolish the corporate tax, because the tax that people pay anyway, and abolish all of the deductions that we have got in there, and just have a graduated tax, the Government will make more money, and the American people would be a lot better off.

Senator HUMPHREY. You would have a hard time selling that, Mr. Secretary.

I am not prepared to argue one way or another on it. That is a pretty complicated business.

There was a time that I would have argued, despite the fact I did not know too much about it, but not now.

You have frightened me into greater moderation. The only thing I wanted to say, Mr. Secretary, about the balanced budget, everyone of us worships a balanced budget. It is sort of like going to the religious exercise, and I hope we really believe in it, but does not the budget really reflect the state of the economy in a large measure?

What do you think would happen, if we balanced our $72 billion budget deficit.

Secretary SIMON. Let me talk for a minute about two things. When I talk about balancing the budget, I always have a critical few words, that is over time, over a cycle, if you will, that a deficit is unavoidable, and desirable during periods of economic slack.

Yes, it is unacceptable, because our revenue has declined in an economic activity, and, of course, then unemployment increases, and so your costs go up, but during periods of high economic activity, such as we experienced in mid-late 1960's, and indeed in the 1970's, that is a time when neither of those two factors are present, and, therefore, we can achieve a budget surplus.

Senator HUMPHREY. I agree with you on that.

Again, it is time for you to leave. We have had two agreements.

Secretary SIMON. I am sorry the television cameras are not here to put forward this historic event.

Senator HUMPHREY. Will one of you stay here in case we need you? We do not need you at the table. We just want you around.

We thank you very much.

Secretary SIMON. Thank you very much.

Senator HUMPHREY. We will now have a panel made of Henry C. Wallich, Governor, Federal Reserve Board, Washington, D.C.; James Needham, president, New York Stock Exchange, New York, N.Y.; and Louis F. Laun, Acting Administrator, Small Business Administration, Washington, D.C.

Gentlemen, we are pleased to have you here, and you can see that we had almost, I will not say a love test this morning, but we have had a very friendly discussion with the Secretary of the Treasury, Secretary

Simon, because we are in an area where we are probing for some answers, and looking for some advice.

Since this is small business we are discussing today, we will start with Mr. Laun, and then we will follow with Mr. Wallich and Mr. Needham.

Might I suggest, I notice your statements are somewhat extensive, thank goodness they are, we want them to be long, but would you be willing to paraphrase and to summarize, because we would like to hear from all of the panelists, and then Senator Nelson will be back here in a moment, and Senator Javits, and we will have a chance to question you.

Mr. Louis F. Laun, you are the Acting Administrator of the Small Business Administration, and you may proceed.

STATEMENT OF HON. LOUIS F. LAUN, ACTING ADMINISTRATOR, U.S. SMALL BUSINESS ADMINISTRATION

Mr. LAUN. Thank you very much, Mr. Chairman. I appreciate this opportunity to be here.

Over its first 100 years, this country has effectively combined an abundance of human and natural resources with the productive institution of free enterprise to produce the highest standard of living in the world.

Small business has been an integral part of that phenomenal record of productivity and growth. Historically, small business has been the essential backbone of our economy.

In 1953 the Congress formally recognized the importance of small business, declared it to be the policy of the Government to "aide, counsel, assist, and protect . . . the interests of small business concerns in order to preserve free competitive enterprise . . ." and created the Small Business Administration to carry out this mission.

Senator HUMPHREY. May I interrupt to say, my former associate here in the Senate, now deceased, but a very fine gentleman, by the name of Senator Edward Thye, was one of the original sponsors of the Small Business Administration.

He was a Republican, I was a Democrat, and we collaborated in that effort, it started out as a rather temporary organization, took on much more permanency, and we also established that Senate Small Business Committee, so there is no area of congressional endeavor in which there seeks to be more coming together than the desire to be of some help to this segment of our economy.

I wanted to put that in the record, because it was one of Mr. Thye's singular accomplishments, and I remember serving with him when I was a very young man, and I did want to give him some credit for what he did at that time.

Mr. LAUN. We certainly appreciate those carrying on that torch.

We think of ourselves as the Department of Defense for the free enterprise system, and we are glad you found us.

Since 1953, however, several disturbing trends have emerged which have clearly caused an erosion of small businesses' position in our economy.

First, available evidence indicates that the small business share of gross private domestic investment has been reduced by 50 percent since 1953.

Second, our indulgence in financing today's consumption with tomorrow's income has produced the inevitable result of severe inflation, shortages of real and financial capital, and a crisis of confidence—all of which impact disproportionately on the small business sector.

And now we have discovered the "capital crisis." It's interesting that the capital gap is now getting so much national attention, when SBA and its constituents have been trying to deal with it for over 20 years. Obviously, capital shortages have finally begun to impact on big business.

If there is one primary point I would like to make today, it is this—if there is a pending capital crisis for big business, then we are about to witness a capital disaster for small business.

The problem of capital shortage hit small business first because it is the most vulnerable sector of the economy.

Without corrective actions, increased capital shortages will hit small business harder and with more velocity.

We now have a small business constituency, which we believe is about 9.4 million of the 9.7 million small businesses in the United States.

They do about 48 percent of the gross business production, 55 percent of the nonagriculture workers in the private sector are employed in the small business sector of the economy.

There is a statement from the New York Stock Exchange that has concluded that there would be a $650 billion shortfall in meeting the capital demands of this segment over this next 10-year period.

If you try to apply how that will affect small business, you take that figure, then you look at our share. In 1953, the gross private investment of small business was about 21 percent of the total of $7.4 billion.

In 1973, small business investment was $16.5 billion, but shrinking to 10.9 percent of the total, so if you take that figure and apply it as the small business percent against the capital gap, we figure our capital gap is about $7 billion per year.

We figure we are going to be impacted more. Most experts agree there will be this shortage.

Now, population changes, inflationary aspects, and personal income foretell a decline of personal savings.

Governmental income transfer assistance programs such as Social Security, welfare and pension plans reduce the incentive to save for the future.

Inflation has caused an overstatement of business profits and inadequate depreciation allowances, reducing retained earnings available for reinvestments.

Several studies tell us that savings flows would only be adequate in the coming decades if the Federal Government would eliminate deficits and operate at a surplus.

While the administration is making every effort to achieve this objective, it would seem realistic to expect the Federal deficit at least for the near term.

Capital market imperfections do affect small business. There are several of them: The cost of entry, the basic costs of floating securities and the cost of complying with the maze of disclosure requirements are considerably higher for the smaller issuer—so high as to be prohibitive.

We believe there is limited access to markets. We believe there is crowding out and investor flight from risks, because capital, being a

highly mobile quantity, flows out of the more risky investments into the safer variety.

At the same time, money managers are becoming less risk oriented in their choice of investments. Both of these trends impact negatively on small business.

Another capital-related problem is the declining share of assets.

We have compared information on manufacturing corporations with under $50 million of assets with those having over $50 million of assets, and we found the following results:

In 1963 the smaller business share was 28.8 percent. By 1968 it was only 20.4 percent, a decline of almost 30 percent.

Part of that is accounted for by inflation, but we think it was a net decline.

A great deal of this decline in manufacturing assets occurred from 1965 to 1970. This was the period during which a major merger movement was underway.

The asset growth in the large business sector was partially due to its external growth by acquisition of capital-short small firms.

Senator HUMPHREY. This is where we find our tax laws playing quite a role.

Mr. LAUN. Yes, sir.

Deteriorating measures of credit worthiness: It is also clear that the significant measures of credit worthiness have been deteriorating steadily over this period.

Liabilities as a percent of stockholders equity have increased 34.3 percent for small corporations. Liquidity ratios have deteriorated and interest coverage ratios have become thin. Internal financing, due to cash flow sparcity, has declined.

We see this every day in our small business portfolio. In the last 15 years business in general has experienced a deterioration in financial position and has increased its reliance on outside sources of capital.

Borrowings have been much greater than increases in equity and much of this borrowing has been short term.

The relationship of long-term debt of business to short-term debt declined from 1.7 to 1 in the 1960's to just over 1 to 1 today.

Liquid assets to short-term debts declined in the same period from 1.5 to 1 to only 0.5 to 1.

We had a 2-tier market for credit. We have a large range of financing alternatives, and in the second tier are those firms with weaker credit, plus higher financing costs.

This group now contains many larger firms which at one time had access to national financial markets but are now dependent on local suppliers of funds, primarily the banks. This crowding out has put further stress on the ability of small firms to obtain adequate financing.

The banking community has also had a deterioration in its own financial position. Banks can be expected to be cautious and limit their lending to better credits.

Where does all this leave the small businessman?

Obviously he has little or no access to national credit and equity markets and must continue to rely on traditional markets—the banks and trade credit.

Generation of internal capital through improvement of debt to equity ratios will prove difficult if not impossible. Those venture capital investors who are still in the market have become much more

conservative. They have joined the shift to safety and away from risk and will be highly selective in making investments.

I am going to talk a bit about the variety of programs that the Small Business Administration has in order to relieve some of these problems.

Senator HUMPHREY. If I may just interrupt, with one little note, the problems that small business is encountering now with rather strict regulations that we have on pollution abatement, and higher safety and health standards, keeping up with technological innovation, these are fantastic responsibilities and create high costs.

Mr. LAUN. That is correct.

While our original legislation permitted us only to help physical disaster victims and small business concerns needing long term business loans for plant construction, modification or expansion, to purchase equipment, supplies, inventory, or for working capital and debt payment, this has been broadened tremendously.

We now have 22 financial programs in the Small Business Administration. Nineteen are loan programs. Ten of them are to cushion small business from the effect of such things you mentioned: Pollution and other programs that impact, such as the result of energy shortages; those Federal standards and regulations enacted in recent years to preserve the environment in which we live; the sanitary conditions under which meat, poultry, and eggs are processed; and to assure that the working conditions of employees across the country are free from health mishaps.

Since 1958, we have been able to aid directly in the furnishings of risk or equity capital for small businesses through privately owned and operated small business investment companies, licensed and regulated by the Small Business Administration.

We provide loans to State and local development companies to aid in improving their economies, to create new jobs and to preserve existing jobs and industries.

We provide loans for sound business purposes to low-income and disadvantaged persons, many of them being minorities who might not otherwise have opportunities.

We have been able to give special loan assistance to those small businesses seriously and adversely affected by the energy crisis, and to those small concerns injured by the closing of major military installations. SBA has a lease-guaranty program permitting us to guarantee the rent for a small business, when it is unable to lease a good location without such assistance. This covers leases for shopping centers and we have a very fast growing surety bond program to enable small contractors unable to get surety bonds to get them with our guarantees.

Now, recognizing that the needs of small business can be served best through the combined efforts of public and private sectors, SBA has continued to emphasize private sector participation in our programs.

We believe very, very much that the $3 billion a year that we put out in our programs have got to be done with as much private sector investment as possible and we now have that up so that only 15 percent of it is Government money, other parts being guaranteed loans, by banks, and guaranteed surety bonds, so about $2.7 of that $3 billion average for the last couple of years, has been done with somebody else's money, and not SBA's.

In addition to that, we have offices in 91 cities, and we can have small businesses taken care of in 8,500 banks.

Under the surety bond program, begun in fiscal year 1971, the agency has assisted small firms, primarily construction contractors, by approving 52,477 surety bonds.

Of these, a total of 31,621 contracts were obtained, totalling $2.1 billion.

Our surety program is growing like a weed at this point, and we are quite proud of it.

The agency's loan programs aid small businesses which are denied access to business loans on reasonable term.

The agency has simulated competition by helping close the credit gap by making over $14 billion of business loans to small business firms since the program's inception in 1954. We believe this has helped create millions of jobs.

Senator NELSON. Mr. Laun, due to the constraints of time, as you know, the Small Business Committee has an oversight responsibility to the Small Business Administration, and we will be getting to some hearings later on these special agency programs, and how they are working. I think it would be helpful with regard to time, if we just put this part in the record, and you could answer a question which Senator Humphrey and I have raised, with two resolutions. Does SBA have the resources to advise the Joint Economic Committee, the Finance Committee, or any of the executive agencies of the government, for example, upon the impact of the tax structure on small business; or on alternate depreciation policies, tax exemptions, or capital accumulation strategies, and paperwork form problems. There is also the current pensions act, that is causing such problems to small businesses, and we will have some hearings on that. We will hear from accountants, and from small businesses, who handle the pension work of the small business employers. We have already received testimony that the new forms required from small businesses, may cost $300 to as high as $800 or $900 per employee just to fill out the forms, which is absolutely preposterous. It would be better under those circumstances to throw out the pension plan and to give the employee the $900.

Now, what happens in those cases, when a small firm has got a pension plan for 12, 15, 20, 25 people?

We will get to the oversight later, and call you again as a witness; but we are at 12:00.

Do you have the resources to address yourself to that kind of question?

Mr. LAUN. Yes; I do.

I have almost come to the end, and I just want to mention a few more things, and these things are in my last 3 minutes if I could hit on them.

Senator NELSON. Fine.

Mr. LAUN. Some recommendations that we have here: I have mentioned the reduced Federal deficit; the economic impact of legislation, is something that I think you are talking about, but I think we would like to participate and to give greater consideration to the potential impact that pending legislation could have on small businesses.

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We would recommend the Congress consider undertaking an economic impact analysis as an integral part of its legislative process. This is perhaps the sort of thing you are talking about.

Two or three of the things we are trying to do go to the thing Senator Humphrey and Senator Javits were talking about earlier, actions that the SBA was taking to try to get additional capital.

One of them is a secondary market for the SBA guarantee loans.

We are working toward an effective secondary market system. We now do about $100 million a year, but it is French cooking. It is done in only localities, and we do not have a Gennie Mae or Fannie Mae system. We are working within our own agency, and with the SEC, and we will be coming forward with some legislative requests to get small business paper handled in the same way a Gennie Mae or a Fannie Mae loan might be handled.

In addition to that, we are proposing something called a Small Business Lending Co., which will be set up in the private sector, entirely for the purpose of making loans with longer terms, loans to small business, and if we can tie that into the increasing secondary market, then we can pump billions of dollars into our system in this area during the course of the year.

The liquidity of the capital system frustrates us as it does you. We have studies going on, but we are utterly frustrated.

Our SBIC's are doing about $500 million invested in 6,400 small businesses.

It is not nearly enough, and we are hopeful we will find a way to do more.

ESOT's, we are looking into that, we think that is a new source of capital, and we have a whole task force looking at the employee stock ownership trust.

We think that would help here also.

In addition to that, we have major thinking going regarding one of the reasons that banks do not like to deal with Government agencies: That we overwhelm them with forms and redtape.

We have gotten rid of about two-thirds of redtape, but we still have too much, and we have an "Operation Streamline" to simplify the banking community's work with the SBA districts. We are trying to be more responsive to the problem, and we think that this will get us into a lot more banks, and do more loans with banks, if we can do that.

One of the most important things that we have to think about, and we will tell you about, is the increased management assistance and funding educational institutions programs.

Small business traditionally lacks the sophistication of large business in management, so that part of the capital gap is caused by inadequate management by small business.

The Service Corps of Retired Executives, which has over 7,800 people, and the Small Business Institute, in which 22,000 business school students and their professors are helping to counsel and to train small businesses.

With these people and through 5 million publications per year, we believe we aid right now about 2 million small businesses a year.

We are planning a massive program of university participation in setting up Business Development Centers. All of this activity costs the taxpayer very little.

We are working on a proposal in the private sector, with the universities, to set up business development centers, to get these individuals in universities, such as the University of Georgia which is setting up 12 of these right now, with Georgia State money, where small business can go in and get help from a wide spectrum of people from the University of Georgia. That includes people from the law school, people from the engineering school, the whole works.

Senator HUMPHREY. Could you send me a description of that, to my office, not to the Joint Economic Committee, but to my office. I want to see whether our State is doing that.

Mr. LAUN. That is brand new. We are planning a major presentation, to 1,700 deans of business schools who will meet with us in a few months to see the whole thing spread out. By that time, we will have a few of these pilot things going on.

We would love to work with you on it, sir.

Legislation, other than tax matters. We have several small business capital-related items that are now pending before Congress.

One is to increase the maximum amount of 7(a) and the development company guaranteed loans from $350,000 to $500,000, and another is to increase the economic opportunity loan ceiling from $50,000 to $100,000, and the other is to increase the maturity of 7(a) loans for construction by purchase of existing facilities to 15 years.

On tax legislation, I have to make a general statement. The constraints on small business capital formation and investment are reinforced by a tax system that weighs particularly heavily on investment benefits and wages of those actively involved in the small business sector.

In the enactment of any revisions to the Federal income and estate tax laws, special consideration should be given to the requirements of small business and the individuals investing in, and employed by, that sector of the economy.

We are happy to see the things that happened on the corporate income tax including the surtax exemption. We applaud those.

In compliance with regulatory requirements, this imposes a unique financial burden on small business. We suggest that consideration be given to providing some reasonable period of breathing space to adjust for costly improvements which do not help the capacity of small firms.

We are doing considerable work in promoting small business with the Government agencies, talking to people about the problems.

We have talked to OSHA people to FEA people, we talked to the Defense Department people, and we are getting heard.

Senator HUMPHREY. You are getting heard by OSHA.

Mr. LAUN. Yes, sir. It is quite a turnaround.

Senator HUMPHREY. That is refreshing.

Mr. LAUN. It certainly is.

I think Secretary Dunlop has had quite a change in attitude in the Department of Labor and we feel comfortable with it. We feel they are interested in small business, which they were not originally.

Senator HUMPHREY. We feel there is a constructive change as well.

Mr. LAUN. Yes, sir. And we are delighted.

We sponsored several SBA multiagency meetings. We have one in Los Angeles with 22 Government agencies, and the Under Secretary

of Labor talked at that, one on things he was doing to make OSHA regulations more acceptable to the small business community.

Thank you.

Senator NELSON. May I say, over the years in the statements I have seen from the Small Business Administration, your testimony has been most impressive and effective, and I want to congratulate you on that.

Mr. LAUN. Thank you very much.

Senator HUMPHREY. I join Senator Nelson in that.

Mr. LAUN. We have had a tremendous amount of help in preparation from the staff as Secretary Simon said and they will appreciate your comments.

[The prepared statement of Mr. Laun follows:]

SMALL BUSINESS ADMINISTRATION

Washington, D.C.

STATEMENT

OF

LOUIS F. LAUN

ACTING ADMINISTRATOR
UNITED STATES SMALL BUSINESS ADMINISTRATION

BEFORE THE

JOINT ECONOMIC COMMITTEE
AND THE
SENATE SELECT COMMITTEE ON SMALL BUSINESS

UNITED STATES CONGRESS

NOVEMBER 21, 1975

INTRODUCTION

During its first two hundred years, this country has passed through several phases of development which merit brief review in order to properly understand the context for our discussion of "The Capital Formation Problems of Small Business."

Originally, this Nation was endowed with an abundance of natural and human resources and a unique capacity of its citizens for hard work, thrift and ingenuity. When these characteristics were creatively combined with the productive institutions of free enterprise, they provided the basis for the bounty which we all now enjoy. The economy of the country has efficiently combined our natural and human resources, and with advancing technology, has been able to produce the highest standard of living in the world. Along the way we have been able to become a major world power and the defender of democracy and freedom around the world. Our technology has taken us to the moon literally and figuratively.

However, we have not reached our level of affluence without incurring some costs along the way.

While small business has played an important role in the development of our economy, it has had to wage a continuing battle to prevent its erosion.

The epoch between the founding of the Nation and the Civil War is most responsible for the traditional concept of the American economic system. During this period, almost all business in America was "small", the rights of the individual entrepreneur were extolled, and the American economy was fundamentally in balance with no one segment exercising

inordinate power over any other. There was little or no oligopoly or monopoly present to disrupt the laissez-faire system.

It was during the period commencing with the Civil War and lasting through World War I that the first indications of geometric growth of big business began to emerge, and with that growth, the problems of economic concentration associated with monopoly and oligopoly became apparent. It was also during this time period that Congress began to act to contain these forces; first, with the enactment of the Sherman Antitrust Act (1890), to curb cases of business combination in restraint of trade, and then in 1914, with the Clayton Act, to clarify the Sherman Act and strengthen the forces allied against big business.

Then, during the period from 1929 to 1940, the length of the Depression was as tragic for small business as its depth.

Yet this blow to enterprise generally, and small enterprise in particular, was quickly followed by the improved economic climate of the years immediately following World War II -a period of special relief to small businesses. It was during this period that the Congress acted to create the Small Business Administration in 1953, and determined that:

> "It is the declared policy of the Congress that the Government should aid, counsel, assist, and protect, insofar as is possible, the interests of small-business concerns in order to preserve free competitive enterprise, to insure that a fair proportion of the total purchases and contracts for property and services for the Government be placed with small-business enterprises, and to maintain and strengthen the overall economy of the Nation."

The Small Business Act of 1953, P.L. 163-83, Title II, Section 202.

Since 1953, a continuing struggle has been made to maintain a delicate balance between big business concentration and small business growth. But, the record clearly shows that small business has been losing the struggle.

Flow of funds data published by the Federal Reserve Board shows that in 1953, when the SBA was created, gross private domestic investment was $34.6 billion of which $5.1 billion (or 15%) was invested in small, non-farm, non-corporate business. In 1973, these investments were $182.1 and $11.4 billions respectively, with the non-farm, non-corporate business portion being reduced to 7.5% of the total. In short, while investments in small, independently owned non-corporate businesses have increased modestly over the past 20 years, these investments have declined by 50% in terms of their relative share of gross domestic investment. In addition, this trend has been further exacerbated by the tight-money episodes of 1966 and 1969 when many first-class small firms were apparently forced to merge with larger units.

Over this same recent time period, another set of influences has also manifested itself.

Consumption became the predominant emphasis with savings and investment becoming a necessary evil at best. Costs were sometimes deferred either because they were not readily recognizable at the time they were incurred, or because we felt these bills could be paid out of future income. We even began to believe that we could forever finance today's consumption with tomorrow's income. Financial excesses began to develop; resources once easily obtainable were now expensive if

available at all; our national endowments were prostituted for "progress"; and spending (consumption) in many sectors surpassed income.

The inevitable consequences of these tendencies have been severe inflation, shortages of real and financial capital, and a crisis of confidence. The evidence is scattered about the economic landscape all around us: New York City; Penn Central; Equity Funding; Lockheed; the Federal Debt; the Energy Crises; etc, etc, etc.

We now finally are starting to pay for the growth and excesses of the past. Paying in shortages, price increases, or both. The bills for what economists call "external diseconomies" of past production are now coming due. These costs were not reflected in the prices of past production, so now we are seeing them in the prices of present production (and consumption).

In the past year and a half, we have as a Nation been studying, discussing, debating, and worrying about the capital gap or shortage. We sometimes act surprised as if to ask how this could happen to <u>us</u>. We're the richest, most powerful nation in the world. Has some evil force crept upon us on our blind side? Hardly.

Why is the capital gap getting so much attention when we at SBA have been trying to deal with it for more than twenty years? The reason seems clear and it is because finally the capital gap began to impact upon <u>big business</u>.

When the small business capital gap was first recognized, no national crisis was built around it. A few laws were passed in the

50's to provide remedial solutions. But, as the evidence indicates, they have been only partially successful.

The fact of the matter is that collectively we have been remiss for not recognizing the small business capital gap for what it was -- a symptom of events to come. The problem of capital shortage hit small business first because it was the weakest and more vulnerable sector of the economy. Now, it has hit big businesses and has been escalated to the level of critical national concern. It should only be noted that a capital shortage for big business is magnified one hundred-fold as a capital "crisis" for small business.

1. SMALL BUSINESS IN THE ECONOMY

The vital role of small business in our economy is evidenced by the following facts:

Number of Firms*

The total number of all U. S. businesess in 1972 (excluding farms) was approximately 9.7 million (based on preliminary 1972 IRS data). Applying SBA size standards, 9.4 million of these may be defined as "small".

The group of 9.4 million firms includes about 5.6 million "very small part-time" firms with annual business receipts under $25,000. These are largely part-time operations, often operating without place of business. Their smallness may be seen in the fact that although they constituted 63.1 percent of the total (small and large) business universe of the U. S., they have accounted for only 1.8 percent of the Nation's total business receipts.

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* The Small Business Act of 1953 defines small business in broad and general terms, stating that since a firm is one which is independently owned and operated and is not dominant in its field of operations. The Act also states that criteria used in defining small business may vary from industry to industry. The Statute leaves the further and more detailed definition to the Small Business Administration to be worked out administratively, with a reference to two criteria-number of employees and dollar volume of business receipts among others. The SBA pursuant to this mandate, has developed a dual system of definitions which stem from the eligibility for SBA's two more important functions: financial assistance and procurement assistance. It has been SBA practice to consider size standards on an industry-by-industry basis and modify them from time to time. Generally, for manufacturers, average employment not in excess of 250; wholesalers, annual business receipts not over $5 million; and retail and service concerns, business receipts not over $1 million.

In no way does this identification of these "very-small, part-time" firms imply their exclusion from the SBA's assistance programs. Exclusion of these "very-small" firms, as well as firms in industries not qualifying for SBA business loans, leaves 3.2 million firms as the Agency's primary target.

This target group of 3.2 million businesses constituted in 1972, about 36.2 percent of the total U. S. business universe and accounted for approximately 36.7 percent of the total business receipts.

The percentage makeup of this group was as follows: proprietorships-53%; partnerships-11%, and corporations-36%. Retail trade, service and contract construction firms were the most predominant industrial groups accounting for over 70 percent of all target-group firms. Judging from IRS's data for 1969 through 1972, this group showed a rather constant behavior in terms of receipts and numbers. On the other hand, while the number of "very-small, part-time" businesses increased, this increase was accompanied by a decline in total business receipts.

Share of Business GNP

Small business contributes 48% to the business portion of the total GNP according to SBA estimates.

Employment

Fifty-five percent (55%) of workers in the private sector are employed in the small business sector of the economy. This estimate is based on U.S. Department of Labor data and SBA estimates of small business activity as shown in Appendix 3.

1. SMALL BUSINESS IN THE ECONOMY

The vital role of small business in our economy is evidenced by the following facts:

Number of Firms*

The total number of all U. S. busineses in 1972 (excluding farms) was approximately 9.7 million (based on preliminary 1972 IRS data). Applying SBA size standards, 9.4 million of these may be defined as "small."

The group of 9.4 million firms includes about 5.6 million "very small part-time" firms with annual business receipts under $25,000. These are largely part-time operations, often operating without place of business. Their smallness may be seen in the fact that although they constituted 63.1 percent of the total (small and large) business universe of the U. S., they have accounted for only 1.8 percent of the Nation's total business receipts. (Appendix 1.)

*The Small Business Act of 1953 defines small business in broad and general terms, stating that since a firm is one which is independently owned and operated and is not dominant in its field of operations. The Act also states that criteria used in defining small business may vary from industry to industry. The Statute leaves the further and more detailed definition to the Small Business Administration to be worked out administratively, with a reference to two criteria-number of employees and dollar volume of business receipts among others. The SBA pursuant to this mandate, has developed a dual system of definitions which stem from the eligibility for SBA's two most important functions: financial assistance and procurement assistance. It has been SBA practice to consider size standards on an industry-by-industry basis and modify them from time to time. Generally, for manufacturers, average employment not in excess of 250; wholesalers, annual business receipts not over $5 million; and retail and service concerns, business receipts not over $1 million.

In no way does this identification of these "very-small, part-time" firms imply their exclusion from the SBA's assistance programs. Exclusion of these "very-small" firms, as well as firms in industries not qualifying for SBA business loans, leaves 3.2 million firms as the Agency's primary target.

This target group of 3.2 million businesses constituted in 1972, about 36.2 percent of the total U. S. business universe and accounted for approximately 36.7 percent of the total business receipts.

The percentage makeup of this group was as follows: proprietorships-53%; partnerships-11%; and corporations-36%. Retail trade, service, and contract construction firms were the most predominant industrial groups accounting for over 70 percent of all target-group firms. Judging from IRS's data for 1969 through 1972, this group showed a rather constant behavior in terms of receipts and numbers. On the other hand, while the number of "very-small, part-time" businesses increased, this increase was accompanied by a decline in total business receipts.

Share of Business GNP

Small business contribute 48% to the business portion of the total GNP according to SBA estimates.

Employment

Fifty-five percent (55%) of workers in the private sector are employed in the small business sector of the economy. This estimate is based on U. S. Department of Labor data and SBA estimates of small business activity as shown in Appendix 3.

2. DIMENSION AND CHARACTERISTICS OF THE SMALL BUSINESS CAPITAL FORMATION PROBLEM

a. SUPPLY AND DEMAND FOR CAPITAL

The capital formation requirements of the American economy over the next decade will be staggering. One highly respected estimate, that of the New York Stock Exchange, places the cumulative gross private domestic requirement for the 12 year period 1974 - 1985 at $4.5 trillion or over 16 percent of the gross national product. Exclusive of housing, the requirements of the private sector will be $2.4 trillion, or $1.8 trillion in constant 1973 dollars. The same study concluded that there would be a $650 billion shortfall in meeting the demand with cumulated savings.

Flow of funds data published by the Federal Reserve Board show that in 1953 gross private domestic investment, less residential construction, totalled $34.6 billion. By 1973 this amount had increased to $152.1 billion. In 1953 non-farm non-corporate businesses invested $5.1 billion or 14.7% of the total. In 1973 these firms invested $11.4 billion or only 7.5% of the total.

Except for a minimal number, all non-farm non-corporate businesses are small. We do not have selective flow of funds investment data on the small corporate businesses. Small corporate firms constitute about 36% of the total of small businesses which have annual receipts of more than $25,000. Firms with receipts of $25,000 or less would

not make any significant investment and are therefore omitted from the analysis. Small corporate businesses are, on average, larger than non-corporate firms and it is estimated that their capital investment would be 45% of the investment by non-corporate firms.

Using this data, the gross private business investment by small business in 1953 (the year when SBA was created) was $7.4 billion or 21.4% of the total. In 1973, small business investment was $16.5 billion or 10.9% of the total. As can be seen, small business share of total private business investment declined nearly 50% in the 20 year period 1953 - 1973.

To arrest the continuing deterioration in the percentage of total investment accounted for by small businesses, and to merely maintain the percentage attained in 1973 will require 10.9% of the $2.6 trillion forecast by the N.Y.S.E. or $283 billion through 1985.

b. THE SMALL BUSINESS CAPITAL GAP

In terms of the $650 billion shortfall projected by the NYSE, the small business share would be $71 billion at the 1973 percentage or, the equivalent of $6 billion per year. Realistically, given the market imperfections and constraints, it is our belief that without strong corrective action, a major portion of the shortfall will be borne by small business and its share of total investment will continue to decline.

c. SHORTAGES OF CAPITAL SUPPLY

There are many reasons to believe the supply of capital, or available savings over the next decade will be weak while investment needs and demands will be strong.

The consumer is a basic source of savings in the economy. Yet population changes that will occur probably foretell a decline in the personal savings rate. The number of persons in the lower savings, high spending age bracket of 20 - 34 will rise substantially while the high savings age bracket of 40 - 54 will show a decline in total numbers.

Another factor dampening the savings rate is the governmental assistance programs such as Social Security, Welfare and Public Pension plans. With such plans, there is less incentive to save for the future.

Business savings are also inadequate. Studies by George Terborgh of the Machinery and Allied Products Institute convincingly explained how inflation has caused overstatement of business profits and inadequate depreciation allowances.

Murray L. Wiedenbaum, Director of the Center for Study of American Business at Washington University in St. Louis has demonstrated how our tax system is based against the saver. His comparative example of three factory workers demonstrates the problem:

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"Let us take the case of three factory workers, A, B, and C. Each is of the same age, has the same work experience and size of family, and earns the same wages. To keep it simple, let us also assume that each rents the house that he (or she) lives in. Mr. A regularly spends what he earns, no more and no less. Mr. B is our saver. Each week he deposits a portion of his paycheck into his savings account. Mr. C is the big spender. Not only does he spend everything he earns, but he borrows to the hilt, buying as much on credit as he can.

Which of the three pays the most income tax and which pays the least? Clearly, Mr. B, the saver, will have the highest tax bill, paying taxes on his wages as well as on the interest that he earns on his savings account. Mr. C winds up with the lowest tax bill, as he receives a tax deduction for the interest he pays on his borrowing. Actual practice, of cource, includes many variations in the tax treatment of financial transactions. Yet, as a general principle, it does seem that, for the average citizen, the existing personal income tax structure does favor comsumption over saving. In addition, many of the government spending programs operate with a similar effect.

"Let us assume that A, B, and C all get laid off at the same time and none of them obtains a new job. Mr. C, the big spender, gets food stamps, and related benefits. Mr. A, the pay-as-you-go man, will be next. And the last to qualify for the Federal assistance will be Mr. B, the big saver. Unlike the good Lord, the Feds do not seem to help those who help themselves."

Several studies have recently been made that tell us that savings flows might be adequate in the coming decade if the Federal Government will operate at a surplus. These studies make the assumption that a surplus will occur if no further change is made in the expenditure programs or revenue structure. Since the public appetite for new services from its government is likely to continue to exceed its willingness to pay for them through taxes, we believe that we must be realistic and assume the government will run at a deficit over the next decade and will not be a supplier of investment funds but rather a demander of credit in the market place.

d. CAPITAL MARKET IMPERFECTIONS AFFECTING SMALL BUSINESS

The markets for business capital present the smaller businessman with structural imperfections which severely impede capital formation.

These imperfections include barriers such as cost of entry structural characteristics of institutionalized lenders and investors; prices which must be paid to compensate the lender and investor for their risks, costs, and opportunity; and a lack of homogeneity with respect to the securities being offered.

Costs of Entry. On the equity capital side, these include the basic costs of floating securities and of complying with the maze of government (SEC) disclosure requirements. In spite of efforts such as Regulation A, the costs of flotation are prohibitively higher for the smaller issuer relative to the dollar amount of the issue.

Not only must the small issuer hire attorneys, accountants, engineers, and printers who are specialists in "SEC work", but he must also pay considerably higher relative spreads to underwriters for selling the securities. These spreads are much wider for small business primarily to compensate the underwriters for risk which they perceive in underwriting and distributing these shares.

Additionally, many times the small issuer must give free stock to underwriters as "sweeteners." There are no accurate figures

available to show the cost of these sweeteners. Data available from the SEC indicate flotation costs alone are 10 percent higher for small business issuers than to larger issuers. Definite economies of scale in the flotation of equity securities do exist.

In addition to costs of entry, if small business can sell its shares to the public, it must then comply on a continuing basis with SEC reporting requirements. Again, this is an expensive proposition.

RISK PREMIUMS. On the continuum of risk, small business is perceived as being ipso facto more risky than large business. Therefore, risk premiums which lenders and investors demand are much higher. Further, the cost to administer and monitor a small financing is, relative to the funds involved, much higher than comparative costs of a large financing. These costs, along with the risk premiums mentioned above, become packed into the required rates of return and thus make small business financing costs considerably higher.

LIMITED ACCESS TO MARKETS. One prerequisite for the existence of an efficient financial market is that the products offered and sold be homogeneous. Data examined

implies that due to risk and unique financial requirements, the menu of securities offered by small issuers may be so unique as to require a separate market mechanism. Since no separate market exists, small business has had to be content to take what's left on the fringes of the national capital markets. This slice of the pie has in effect disappeared.

CROWDING OUT AND INVESTOR FLIGHT FROM RISK. The crowding out theory which has been proposed and debated is a problem of determining if there is a cross-elasticity in the supply of capital.

If low risk and high return debt instruments are offered to investors by government (Treasury and Agency securities), two responses might be expected. First, the required rates on the riskier securities go up disproportionately. Since capital is a highly mobile quantity, funds flow out of the more risky investments into the safer variety.

The small investor has stopped supplying significant amounts of savings directly to the capital markets. He has instead chosen to purchase either safer debt instruments directly such as low-risk, high-return government and agency securities, or he has decided to let someone else manage his money through the intermediation process.

The institutional investors now making the decisions for this "little" man are reexamining their fiduciary obligations, especially in light of new government regulations such as the ERISA law and new emphasis by SEC on this aspect of regulation. The managers of other peoples money are becoming less risk oriented in their choices of securities for purchase especially since adequate yields are available at much lower risk levels.

If this flight takes place, there is an inverse relationship between the flow of new government securities and the flow of private sector securities, especially small business securities, both equity and debt.

SECONDARY MARKETS. A precondition for active participation in any primary market for securities, and especially equity securities, is a viable secondary market. If an investor is to go into a financing, he must be able to get out, for getting out is the only way that he can normally realize any profit. If a viable secondary market does not exist, or if there are transaction frictions caused by government regulation or otherwise, the primary financier will not invest.

e. EVIDENCE OF OTHER CAPITAL RELATED PROBLEMS

Notwithstanding certain data limitations, we have found that some significant changes have occurred between 1963 and 1974 in the small business corporate manufacturing sector.

Using the Quarterly Financial Statements of Manufacturing Corporations as published by the Federal Trade Commission, we compared information on manufacturing corporations with under $50.0 million of assets with that of those with over $50.0 million assets and following are some of the things we found.

(1) The assets of the larger corporations had increased at about a 9.7% compound rate over the period while the rate for the small corporations was only 5.2% compounded. If these rates are discounted by inflation, it is clear that the smaller corporations actually only stayed about the same while the larger corporations grew considerably.

(2) Comparing the change in the stockholder equity of these groups we find that for the smaller corporations, equity grew at a 3.5% compound rate while for the larger corporations it grew at a compound rate of 7.8%. In real terms, the stockholders equity of the smaller sector actually declined.

(3) In the larger sector, total debt due banks grew almost 17% per year compounded while in the small sector the rate was only 10.3%.

(4) Total liabilities in the large sector grew at a compound rate of 12.5% per year while in the small sector liabilities only grew at a 7.4% rate.

(5) If the growth of total liabilities and stockholders equity of the smaller group had kept pace with the larger group, an additional $92.0 billion dollars of capital would have had to be available for smaller business either in debt financing, equity financing, or in capitalized earnings. We must keep in mind that this estimate only applies to smaller manufacturing corporations. Data with which to make estimates of the gap in other sectors is not available.

From the above it is evident that the larger sector grew much faster during the period than did the smaller group. The net result of course is that the smaller business share of total manufacturing assets declined. The decline in fact was about 8.5% in eleven years. The share was only 20% in 1974. If that share decline continues at the rate as during the past eleven years, by 1985 it will be 11.5% and by 1996 only 3%.

If we look at when most of the share decline occurred, we find that it happened during the period 1965 through 1970, during which time

the share fell 7.5%. This was the period during which a major merger movement was underway. We can tentatively assume that a portion of the share decline was due to merger and that consequently the asset growth in the large sector was partially due to external growth created by acquisitions of small firms. A look at the FTC merger data bears this out since it shows for several years running in the 60's that the preponderance of mergers occurred between acquiring companies in the largest size class and acquired companies in the smallest size class.

We might make the general assumption that much of the merger activity in this period took place not so much for efficiency but more for financial convenience. Small firm owners exchanged their shares for the shares of large businesses thus liquifying their holdings and ensuring continuing financing from their holdings and ensuring continuing financing from their newly adopted parents. This enabled large firms to acquire earnings to which they could apply high price-earnings multiples and thus enhance the value of their equities.

One might also ask whether the funds borrowed by the larger businesses (remember the 17% growth in bank debt mentioned above) were used to acquire the smaller businesses and/or whether these

borrowings crowded the small companies out of the debt capital market. This concentration is partially the result of smaller business capital shortages.

Using the same data as above, it is clear that some of the significant measures of credit worthiness have been deteriorating steadily over this period.

Liabilities as a percent of stockholder equity have increased 34.3 percentage points for small corporations and 30.7 points for large.

Liquidity ratios have deteriorated as a consequence, and interest coverage ratios have become thinner. Internal financing due to cash flow scarcity has declined.

In the last fifteen years business in general has experienced a deterioration in financial position and has increased reliance on outside sources of capital. Borrowings have been much greater than increases in equity, and much of this borrowing has been short term. The relationship of long term debt to short term debt declined from 1.7 to 1 in the 1960's to just over 1 to 1 today. The ratio of liquid assets to short term debt declined in the same period from 1.5 to 1 to only 0.5 to 1.

A two-tiered market is in force. There is a market for high credit insurers who have a large range of financing alternatives, expansion, growth, and diversification. Needless to say these are the major corporations.

The second tier is those firms with weaker credit and high leverage, which are limited in where they can obtain financing and consequently pay higher financing costs. This group now contains many larger firms - firms which once had access to national financial markets but are now dependent on local suppliers of funds - primarily the banks. This has put further stress on the ability of small firms to obtain adequate financing.

The banking community has also had a deterioration in its financial position. Loan to deposit ratios have been at all time highs. The ratio of loans to total assets increased from 0.5 to 1 in the 1960's to 0.65 to 1. Banks have made an effort this year to improve their liquidity and they can be expected to continue this effort.

Historically, small businesses have relied heavily on capital consumption recoveries and retained earnings to meet their capital expenditure requirements. Without price stability, small businesses will experience difficulty in generating sufficient cash flows internally to meet increased investment requirements. These have already been heavily depleted by the spiraling inflation over the past several years, and this aggravated situation will continue to worsen unless greater price stability is soon achieved.

INTERNAL vs. EXTERNAL FINANCING PROBLEMS

One of the most striking aspects of the financing of small businesses* is the relatively slow rate of growth of internal financing as compared with external financing. Internal financing grew over the 25 year period from 1946 through 1971 at an annual compound rate of 4.3 percent. This compares with an annual compound growth rate of 12.1 percent in the external financing of these businesses. This suggests that the rate of growth in the external financing of small businesses is about three times the rate of growth in the internal financing of these businesses and that these small independently

* Unfortunately aggregate data does not exist for the total small business universe. This section is based on an analysis of non-farm, non-corporate businesses which are, except for a minimal number, small.

owned businesses are becoming less solvent, depending increasingly on external debt financing. It also indicates a growing need for expanding sources of equity capital for these small businesses. This is of major concern to the Small Business Administration.

Over the 25 year period from 1946 through 1971, the asset liability ratio of small businesses declined from 1.18 to 0.63. This pronounced deterioration in the financial asset/liability ratio has disturbing implications for the continued solvency of small, independently owned and operated business enterprises. Particularly disturbing is the declining rate of growth in proprietors' net investments. Equity investment is a declining proportion of the total capital employed in these small businesses. This is attributable in part, as previously noted, to increasing relative reliance on external debt financing. It may possibly also be attributed in part to increasing reliance on leasing of fixtures and equipment in lieu of outright ownership which, it should be noted, would be additional lack of liquidity that is not reflected in flow of funds data for credit market instruments.

The tremendous growth in outstanding financial liabilities of small businesses is largely in the form of loans, mortgages and other forms of credit supplied by the credit markets, and

possibly contractual liabilities increased under leasing arrangements. Trade debt by suppliers of these small businesses has not increased over the past 15 years.

The two fastest growing sources of small business financing are loans from commercial banks and from finance companies, particularly the latter. Finance company loans, it may be assumed, are more costly and otherwise more onerous than direct bank loans. This poses the question of why small businesses are turning to finance companies for credit. Is it because of limited availability of credit from commercial banks or is it because an increasing proportion of loans to small businesses are high risk loans that are unacceptable to commercial banks?

EXTERNAL DISECONOMIES

Small business requirements for pollution abatement facilities, to meet higher safety and health standards, and to keep pace with technological innovations will, indeed, be formidable for individual small businesses in the industries where these requirements will be concentrated. These requirements are expected to be beyond the limited financial capacity of thousands of these small enterprises. Unless they are given some relief or special assistance many of these may be expected to discontinue operations or be forced into mergers or otherwise consolidated with larger concerns.

Where does all this leave the small businessman? Obviously he has no access to national credit and equity markets and must continue to rely on traditional markets - the banks and trade credit. Improvement of debt to equity ratios will prove difficult if not impossible. With the return on long term corporate debt as high as the return on equity, investors will shun the equity market. In addition, with such economic uncertainty, venture capital investors will be highly selective in making investments. There is evidence to suggest that venture capitalists have become much more conservative and have joined the shift to safety and away from risk.

3. SBA FINANCIAL ASSISTANCE PROGRAMS AND THEIR IMPACT

A. Size Standards

In an effort to include a greater number of small businesses that would be eligible for SBA assistance, SBA recently increased its size standards relating to retail, wholesale, and service type businesses, taking into consideration inflationary factors.

In general, maximum allowable annual receipts of retail businesses and service companies are raised from $1 to $2 million, and from $5 to $9.5 million for wholesalers.

Standards for general construction firms are raised from annual receipts of $5 to $9.5 million for companies wishing to apply for loans, and from $7.5 to $12 million for the purpose of federal procurements.

Standards based on employment figures in manufacturing industries remain the same but will be reviewed in the near future.

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3b. Scope and Variety of Programs

(1) Description of Various Programs

Since the passage of the Small Business Act in 1953, with its specific mandate to provide financial assistance to small firms which could not otherwise obtain needed credit, the amount of assistance extended and the number of programs administered have been increasing. While our orignial legislation permitted us only to help physical disaster victims and small business concerns needing long-term business loans for plant construction, modification or expansion; to purchase equipment, supplies, inventory; or for working capital and debt payment, this has been broadened tremendously.

Our various programs now help small business comply with most Federal standards and regulations enacted in recent years to preserve the environment in which we live, the sanitary conditions under which meat, poultry, and eggs are processed, and to assure that the working conditions of employees across the country are free from health hazards.

Since 1958, we have been able to aid indirectly in the furnishing of risk or equity capital to small businesses through privately owned and operated Small Business Investment Companies, licensed and regulated by SBA.

We provide loans to State and Local Development Companies to aid in improving their economies, to create new jobs and preserve existing jobs and industry.

We provide loans for sound business purposes to low-income and disadvantaged persons to commence or strengthen small businesses owned by such persons, many of them being minorities who might not otherwise have an opportunity to own and operate their own business.

We have been able to give special loan assistance to those small businesses seriously and adversely affected by the energy crisis, and to those small concerns injured by the closing of major military installations.

SBA has a Lease Guarantee program permitting us to guarantee the rent for a small business, when it is unable to lease a good location without such assistance.

We are also committed to help make the bonding process more accessible to small contractors under the Surety Bond Program, by guaranteeing to a surety up to 90 percent of losses incurred under bid, payment, or performance bonds issued to contractors up to $1,000,000.

Recognizing that the needs of small business can be served best through the combined efforts of public and private sectors, SBA has continued to emphasize private sector participation in our programs. SBA's role continues to be one of leadership in stimulating and coordinating all possible sources of assistance

needed to develop new concerns and strengthen the competitive position of those already in existence. Although our direct funds have been limited in recent years, the Agency has reached new heights in the number of loans and amount of assistance extended through its participation with banks and other lending institutions under our guaranty loan plan.

SBA'S (a) BUSINESS LENDING PROGRAM 1964-75

Approved 7(a) Business Loans

(Dollars in Millions)

Fiscal Year	Total Amount	Private Sector Dollars	Lender %	SBA Direct Loans	SBA Dollars as % of Total Loans
1964	$ 312.2	$ 79.1	25.3	$233.1	74.7
1965	418.0	135.3	32.4	282.7	67.6
1966	354.8	193.0	54.4	161.8	45.6
1967	358.3	181.0	47.0	204.3	53.0
1968	495.6	297.2	60.0	198.4	40.0
1969	543.7	428.1	78.7	115.6	21.3
1970	528.3	444.1	84.1	84.2	15.9
1971	923.9	847.5	91.8	76.4	8.2
1972	1,365.6	1,292.5	94.6	73.1	5.4
1973	1,926.5	1,871.7	97.2	54.8	2.8
1974	1,726.6	1,659.1	96.2	67.5	3.8
1975	1,440.3	1,295.8	90.0	144.5	10.0

Although we are not in competition with banks and other private sources of financing, for we cannot make or guarantee a loan if the funds are otherwise available on reasonable terms, our lending authority and loan maturities close a gap that exists in the medium and long-term operating capital needs of the small business segment of our economy.

(2) Volume of Financial Assistance

Raw data on the aggregate number and amount of loans SBA has provided to small firms through its 22-year history (through June 30, 1975) are not the sole measure of the degree in which SBA programs have helped. However, they do represent one measure of the degree of help, and thus cited below:

Year Begun	Loan Program	Total Number of Loans	Total Dollar Amount (incl. bank share)
1954	Regular 7(a) Business Loans	201,671	$ 12.3 billion
1964	Economic Opportunity Loans	48,078	725.2 million
1961	Displaced Business Loans	3,663	383.8 "
1974	Handicapped Assistance Loans	156	13.0 "
1959	State Development Co. Loans	338*	30.0 "
1959	Local Development Co. Loans	5,629	715.2 "**
1954	Physical Disaster Loans (to businesses only)	55,861	1.4 billion
1956	Economic Injury Disaster Loans	2,107	50.8 million
1962	Product Disaster Loans	364	4.9 "
1969	Coal Mine Health & Safety Loans	13	1.7 "

Year Begun	Loan Program	Total Number of Loans	Total Dollar Amount (incl. bank share)
1971	Consumer Protection Loans	286	43.7 million
1972	Occupational Safety & Health Loans	140	29.5 "
1973	Strategic Arms Economic Injury Loans	64	3.7 "
1974	Base Closing Economic Injury Loans	219	17.7 "
1974	Air Pollution Control Loans	46	7.4 "
1975	Water Pollution Control Loans	17	6.9 "
1975	Emergency Energy Shortage Loans	1,036	77.8 "

* Estimate

** This amount generated an additional $469 million in private sector assistance to these small firms.

Financial assistance to small firms under other SBA programs has resulted in the following:

a. 958 licenses have been issued to Small Business Investment Companies, and 446 of these are presently outstanding. An estimated 37,000 small firms have been assisted by these SBIC's either in equity financing or term loans; disbursements by the SBIC's total $2.5 billion.

b. Under the lease guarantee program, SBA has guaranteed rental payments of 1,768 small firms in the total amount of $971 million.

c. Under the surety bond program, begun in Fiscal Year 1971, the Agency has assisted small firms, primarily construction contractors, by approving 52,477 surety bonds. Of these, a total of 31,621 contracts were obtained, totalling $2.1 billion.

Since mid 1973 the Agency has had loans outstanding to more than 100,000 small business firms at any given time and more than 85% of such firms have been maintained in current status. The assistance provided to assure this continuous record of current loans has involved a variety of financial and management assistance actions, all of which are designed first, to prevent problems and second, to resolve problems.

(3) Status of Portfolio

The Agency is, of course, a benevolent creditor in line with its mandate to foster the success and development of the firms that come within its purview. Since many of said firms are new businesses or involve managers new to business, this continuing 85% success rate is a mark of favor. It is the result of constant and consistent efforts on the part of all concerned.

On the whole, the Agency's losses, while larger than commercial bank experience, have been modest, especially when the marginal nature of the firms involved are noted. The range is from a rate of

1/2 to 1% for displaced business loans (the more experienced business firms with which we deal) to a high of approximately 17% for our EOL program (which involve those new to business and in a disadvantaged situation). The major program, 7(a) business, has experienced actual losses on only 2.6% since its inception.

DOLLARS

STATUS OF PORTFOLIO
BUSINESS LOANS ONLY (7(a), DBL, DCL & EOL)

	CURRENT 0 to 30 DAYS		PAST DUE 30 to 60 DAYS		DELINQUENT 60 DAYS & OVER		LIQUIDATION		TOTAL
	$	%	$	%	$	%	$	%	$
June 1972	2,446.6	89.6	35.7	1.3	60.8	2.2	167.6	6.1	2,728.7
June 1973	3,349.7	91.2	43.3	1.2	87.7	2.4	190.2	5.2	3,671.1
Sept.	3,560.8	91.1	44.7	1.1	93.6	2.4	208.1	5.3	3,907.1
Dec.	3,689.8	90.5	51.6	1.3	108.8	2.7	222.6	5.5	4,072.7
Mar. 1974	3,925.5	90.4	49.8	1.1	112.1	2.6	252.7	5.8	4,340.2
June 1974	4,079.6	90.4	46.6	1.0	120.1	2.7	267.5	5.9	4,513.6
Sept.	4,135.8	89.7	50.1	1.1	130.6	2.8	296.2	6.4	4,612.7
Dec.	4,223.9	89.2	56.0	1.2	136.0	2.9	319.0	6.7	4,734.0
March	4,293.7	89.3	49.5	1.0	130.0	2.7	322.2	6.7	4,805.2
June 1975	4,363.0	89.2	52.1	1.1	138.2	2.8	339.3	6.9	4,892.7
July	4,345.5	88.9	56.9	1.2	136.0	2.8	350.0	7.2	4,888.1
Aug.	4,374.1	88.6	62.4	1.3	144.8	2.9	356.1	7.2	4,937.2
Sept.	4,437.3	88.7	56.8	1.1	147.3	2.9	361.7	7.2	5,002.9

NUMBERS

STATUS OF PORTFOLIO
BUSINESS LOANS ONLY (7(a), DBL, DCL & EOL)

	CURRENT 0 to 30 DAYS		PAST DUE 30 to 60 DAYS		DELINQUENT 60 DAYS & OVER		LIQUIDATION		TOTAL
	NUMBER	%	NUMBER	%	NUMBER	%	NUMBER	%	NUMBER
June 1972	69,780	86.3	2,082	2.6	3,043	3.8	5,934	7.3	80,842
June 1973	84,167	86.9	2,410	2.5	4,391	4.5	5,934	6.1	96,902
Sept.	87,097	86.5	2,335	2.3	4,802	4.8	6,423	6.4	100,657
Dec.	88,122	85.8	2,582	2.5	5,271	5.1	6,780	6.6	102,755
March	91,321	85.6	2,517	2.3	5,347	5.0	7,445	7.0	106,630
June 1974	93,223	85.6	2,567	2.4	5,416	5.0	7,673	7.0	108,879
Sept.	93,937	85.1	2,401	2.1	5,671	5.1	8,368	7.6	110,377
Dec.	94,887	85.1	2,559	2.3	5,479	4.9	8,576	7.7	111,501
March	95,513	86.1	2,424	2.2	4,829	4.3	8,083	7.3	110,849
June 1975	97,194	86.6	2,482	2.2	4,665	4.2	7,898	7.0	112,239
July	96,505	86.3	2,466	2.2	4,700	4.2	8,089	7.2	111,760
Aug.	96,943	85.9	2,620	2.3	5,084	4.5	8,202	7.3	112,849
Sept.	98,060	86.0	2,517	2.2	5,125	4.5	8,236	7.2	113,938

Actual Loss Rates
(Dollars in Millions)

As of	Cumulative SBA Share of Disbursements	Actual Losses	Actual Losses as a percent of Disbursements
	7(a) Business Loans		
6/30/65	$1,809.4	$ 14.7	.81%
6/30/66	2,067.7	20.8	1.01
6/30/67	2,317.1	31.4	1.36
6/30/68	2,641.2	44.1	1.67
6/30/69	2,978.5	56.6	1.90
6/30/70	3,338.5	66.5	1.99
6/30/71	3,718.6	79.4	2.13
6/30/72	4,862.5	105.3	2.17
6/30/73	6,188.2	132.5	2.14
6/30/74	7,526.2	163.3	2.17
6/30/75	8,627.7	229.5	2.66
	Economic Opportunity Loans a/		
6/30/67	$ 41.4	$ 0.6	1.44%
6/30/68	69.3	3.0	4.28
6/30/69	106.8	6.7	6.27
6/30/70	162.4	12.1	7.45
6/30/71	233.4	20.1	8.59
6/30/72	323.9	36.7	11.33
6/30/73	435.3	54.0	12.41
6/30/74	535.6	71.4	13.33
6/30/75	607.3	104.6	17.23
	Displaced Business Loans a/		
6/30/67	$ 53.6	$ 0.1	.12%
6/30/68	83.1	0.1	.11
6/30/69	114.4	0.2	.20
6/30/70	145.6	0.3	.21
6/30/71	181.2	0.4	.21
6/30/72	218.4	0.7	.32
6/30/73	243.3	0.9	.37
6/30/74	278.9	1.2	.43
6/30/75	319.7	1.6	.51
	Local Development Company Loans a/		
6/30/67	$ 135.2	$ 0.3	.20%
6/30/68	178.2	0.5	.28
6/30/69	216.2	1.0	.47
6/30/70	272.7	3.0	1.10
6/30/71	314.9	3.9	1.24
6/30/72	371.4	5.7	1.53
6/30/73	425.3	7.6	1.79
6/30/74	495.0	12.5	2.53
6/30/75	574.9	16.3	2.83

2

Actual Loss Rates
(Dollars in Millions)

As of	Cumulative SBA Share of Disbursements	Actual Losses	Actual Losses as a percent of Disbursements
	Disaster Loans		
6/30/65 b/	$ 258.0	$ 2.4	.92%
6/30/66 b/	469.8	3.2	.67
6/30/67	471.8	4.5	.96
6/30/68	568.4	7.6	1.34
6/30/69	600.2	11.4	1.90
6/30/70	724.5	14.3	1.97
6/30/71	967.6	17.4	1.80
6/30/72	1,053.1	22.4	2.13
6/30/73	1,710.6	27.4	1.60
6/30/74	1,979.8	31.2	1.58
6/30/75	2,164.7	45.2	2.09

a/ Loss studies not made in prior years.

b/ Includes Displaced Business Loans in these years.

c/ Disbursements net of Disaster Relief Credits

3C. IMPACT OF SBA PROGRAMS

During its twenty years of serving the small business community, SBA has addressed economic and social needs with which no other government program has been specifically concerned. The task has been large, and SBA's resources necessarily limited. Nevertheless, we have been able to make a meaningful contribution to the Nation's small business community and some of the problems of capital formation. The Agency's objectives and impact in these areas are briefly described below:

(1) A major objective of the Small Business Administration is to preserve full and free competition through compensating for inequities in small business access to financial markets. Free competition is the cornerstone of the Nation's economy. Small firms are hampered from competing through reduced access to sources of financing which favor larger firms. Because some imperfections in the market for business loans are traceable to Government policies traditionally thought desirable, the Government should help close the credit gap for small firms which are unduly impacted.

(2) The Agency's loan programs aid small businesses which are denied access to business loans on reasonable terms. The Agency has stimulated competition by helping close the credit gap

through approving approximately 260,000 business loans for over $14 billion since the program's inception in 1954. This has been achieved at relatively low drain on the Treasury as 2/3rds of the $14 billion was extended by banks under the guaranteed loan program. In fact, participating banks have historically loaned three times the dollars loaned by the Agency under the direct and I/P programs. In recent years the percentge of 7(a) program loans that have been guaranteed has been in the 95% area.

(3) Another important objective of the Small Business Administration is to maintain and strengthen a well-balanced national economy through encouraging the actual and potential capacity of small business. The critical role of small business in the Nation's economy is evidenced by their contribution of 48% to the business gross national product and of 55% of private sector employment. In times of economic stress this vital segment of the country's enterprises is the first to be hit and suffers the most arguing strongly for the kind of aid offered by the Agency's programs.

The SBA business loan programs have helped approximately 260,000 firms in the past two decades and have further strengthened the health of

the economy through creating or maintaining over 1.8 million jobs. The potential capacity of small business is encouraged through a focus on helping firms become bankable. Thus, SBA's term lending aid is seen as a bridge to sustain a firm until such time as it can succeed on its own.

(4) In addition, the Agency works to assure potential entrepreneurs free entry into business. The freedom of an entrepreneur to start his own business creates more firms resulting in more active competition. In additon, the growth of individual initiative is fostered.

SBA has several programs specifically aimed at encouraging new business formation. In FY 1975, over 5,900 loans were approved for new businesses, 26% of all 7(a) loan approvals.

(5) Assuring opportunities for the expression and growth of personal initiative and individual judgment is a goal to which the Agency is firmly committed. Since the founding of this Nation, the opportunities for individual initiative have created a healthy way of life for a large segment of our population. Preserving the viability of this American tradition in the face of economic imperfections inimical to its success is a proper role for government and this Agency.

There are 9.4 million small businesses in the United States. Of these, it is estimated that 3.2 million are full-time occupations of their owners. SBA loans are currently reaching over 3.5% of these small firms. Because of the risks involved in starting and operating small businesses, these enterprises might otherwise have failed without SBA's aid.

(6) Minority entrepreneurs are one segment of the economy of special concern to SBA. Our record shows that we are making a significant impact in this area. Of the 382,000 minority enterprises in the Nation as of the last census, it is estimated that 127,000 represent a portion of the small business population which is the primary target for SBA's program efforts. The Agency's business loans outstanding at the end of FY 1975 were reaching an estimated 24% of these firms. Impact on the manufacturing sector was particularly high -- 65% of these firms are being reached.

(7) The Agency works to assist small firms through a flexible program designed to address a wide range of business needs and enlist the participation of the private sector for maximum effectiveness. The small business community has a diversity of needs requiring a

flexible response as these change over time. Although other loan programs are aimed at specific problem areas or target groups, SBA loans address the wide range of business financial needs. These multi-use funds are constantly available and can be flexibly guided in response to pressing business or national problems.

(8) The guaranteed loan program currently solicits the participation of over 14,500 banks and branches. SBA's loan specialists serve as a lobbying force to sensitize the banking community to the needs of small firms. This is evidenced by increasing receptiveness to longer term lending. In addition, whether or not a loan is made, credit counselling is provided to the small firm applying for funds. The guaranteed program is a proper catalytic method in a capitalistic system to help small business bridge the credit gap with the maximum possible use of the private sector and the minimum use of government.

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4. RECOMMENDATIONS

The implications of the projected capital shortage are serious. Free enterprise and the preservation of our economic future are dependent on a "sufficient supply of capital to meet our investment needs." To facilitate this flow of funds into capital investments, the following proposals are recommended for consideration:

a. OVERALL

(1) REDUCED FEDERAL DEFICITS

To increase the supply of savings to help meet the investment requirement of the economy, consideration must be given to reduced federal deficits, especially as we proceed in our recovery toward full employment. Federal deficits absorb potential savings and redistribute these resources away from capital investments. As we approach full-employment we can start to plan for a balanced budget or even a budget surplus. This would increase the supply of savings, especially at the corporate level, and provide potential capital funds for investment.

(2) ECONOMIC IMPACTS OF LEGISLATION

Greater consideration must be given to the potential impact that pending legislation could have on small businesses. In recent years many new laws, and the regulations and reporting requirements resulting from them, have, unwittingly perhaps, placed serious burdens on America's small businesses. As new legislation is being considered, the economic impact on small businesses should be included in the proceedings to ensure that we are not forcing such hardships on these small firms so

as to jeopardize their continued existence. We would recommend the Congress consider undertaking an "economic impact" analysis as an integral part of its legislative process.

4(b) ACTIONS SBA IS TAKING

SBA itself is undertaking several specific initiatives which are intended to assist in providing an increased flow of capital funds to the Small Business Community. These include:

(1) SECONDARY MARKET IN SBA GUARANTEED LOANS

Increasing participation by lenders in SBA's lending programs is predicated on the establishment of a ready secondary market for the guaranteed portion of the loans. One major inducement to lenders to make loans is the availability of a liquidity opportunity so that the guaranteed portion of loans can be converted to cash on an immediate basis.

In a typical transaction in our currently limited secondary market program, the lender sells, with SBA's approval the guaranteed portion of the loan at its face value to an investment banker or directly to an institutional investor. The lender gives up a portion of the monthly payment from the small businessman. The portion of the payment retained is composed of the amortization of the 10% portion of the loan that is the lenders risk, and a servicing fee. Since the guaranteed portion of the loan has the full faith and credit of the U. S. Government, the yield to the investor will be similar to other agency issues. The difference between the payment made

by the small business and the required yield to the investor can increase the yield to the lender and provide funds to compensate the investment banker to create and sustain a market.

Currently, the guaranteed portion of SBA loans is sold in what is essentially a "primary market". The investor who purchases the loan generally retains it - there is little secondary distribution or trading.

Some activity has been seen in the secondary market for SBA Loans:

FY 1973	-	663 loans	$61.2 million
FY 1974	-	753 loans	92.9 million
FY 1975	-	883 loans	94.6 million

Most of the distribution has been made in "local" markets involving sales directly to state pension and retirement funds seeking good yield but also desiring to retain the funds in the State.

A breakthrough to "national markets" is essential if SBA is to increase its guaranteed loan volume and have a significant impact on the financial needs of the small business community.

Currently we are revising our required transfer documentation to streamline the procedure into a workable process. While this "streamlining" will be of great assistance in our endeavors we recognize that a more sophisticated system is needed, and we are planning for a certificate type of transfer with standardized procedures and a central transfer facility or registrar. We also need a standardized procedure for loan and lender servicing.

The certificate and centralized registration system will provide the mechanism for ready transferability of the guaranteed portion of the loans between investors, lead to increased marketability and provide a more competitive return. A lower return required by the investor should lead to a lower cost of money to the small business.

The present secondary market requires the sale of individual loans. Marketability could be broadly enhanced if loans could be pooled and participations in such pools sold in standard denominations. SBA does not now have the legislative authority to establish pools of loans and participations in such loans.

An even better system of providing liquidity to lenders and lower cost to the small business community would be a government sponsored facility similar to GNMA or Sallie Mae which would have the authority to buy the guaranteed portion from lenders, make advances to lenders when necessary and sell its own "full faith and credit" securities either directly to the investment community or to the Federal Financing Bank. The lower cost of money could be passed through to the small business. Legislation would be necessary for this organization to be established.

(2) SMALL BUSINESS LENDING COMPANIES

Small business, because of its relative competitive disadvantage, cannot easily afford risks resulting from excessive financing costs or the unwillingness of financial institutions to provide financing. In SBA's loan programs, SBA assumes some of these financial risks primarily through the loan guaranty program.

While SBA has participation in the guaranty loan program by a majority of the 14,000 banks in the United States, less than 600 have 10 or more loans outstanding. Less than 125 have 50 or more loans. The importance of these statistics is that most lenders participating with SBA do not consider the program as a profitable source of business, do not actively seek loans that can be guaranteed, and do not devote resources and talent in any significant degree to the guaranteed loan program

Because the financing needs of the small business community are substantial, SBA must continue its efforts to induce greater participation in the loan guaranty program. We believe the guaranty program is the most effective way to provide financial assistance to the greatest number of small businesses.

As a new initiative to direct additional capital funds into the small business community, we propose to create a new class of financial entities, Small Business Lending Companies (SBLC's) The SBLC's would be private corporations established for the sole purpose of providing financing to small businesses with the guaranty of SBA. SBLC's would be expected to provide long-term loans to small businesses which are not acceptable to banks. This program would lead to greater availability of financing and more favorable terms to small business.

The operational nature of an SBLC would be to make a loan with SBA's guaranty, immediately sell the guaranteed portion in the secondary market to an institutional investor, and make another

loan to another small business with the proceed of the sale. The profitability of SBLC's will depend on a volume of good loans. They will continually seek additional qualified small businesses for loans and will develop substantial portfolios. With their total resources devoted to small business, they are expected to hire well qualified credit analysts and to present to SBA well documented, complete and detailed loan applications.

The success of these new entities, in terms of profitability, requires some form of incentive. SBA is contemplating permitting the SBLC's to charge the small business points for the financing. Because the small business would have been declined for a loan by its bank of account, the small extra cost for a loan from an SBLC would be acceptable to him to obtain financing otherwise not available.

We anticipate this program could eventually generate billions of new and needed capital investments into small business firms.

(3) EQUITY CAPITAL INITIATIVES

(a) STUDY OF NEW EQUITY CAPITAL TECHNIQUES

Conventional sources of equity and long-term debt capital for all but top-grade corporations have virtually disappeared and economic projections clearly indicate the shortfall in availability of equity capital will increase in the future. Consequently, the lack of small business access to venture capital is now serious and will become critical in the future unless positive, corrective actions are taken.

This is of great concern to SBA, and we have undertaken a comprehensive study to determine what new initiatives might be launched to address this problem.

We have been collecting all the studies, papers, speeches, and relevant articles and material that are available with respect to the so-called capital shortages or capital gap.

We are reviewing these studies from the small business perspective in an effort to isolate the factors specifically relevant to small business. One major study being done under contract for another government agency is due for completion by year-end. That one will focus in more detail on small business so we are anxiously awaiting its completion.

Results of the study should provide new methods and techniques by which small business may attain ready access to needed equity capital resources, thereby sustaining the continued growth, development and competitive position of the small business sector of the economy.

Following are some of the preliminary proposals which have been made by several sources covering three areas: Tax Proposals; Transactions in Small Business Equities; and Investor Risk Protection. These are not mutually exclusive and will be analysed as a starting point in the discussions of potential change in SBA's program and policy mix.

Tax Proposals

(i) Gains realized from the sale of small business equities or participations in pools of small business equities should not be taxed if:

1) the equities or participations are purchased upon original issue; and
2) the equities are held at least three years.

(ii) Dividends received from small business equities should not be taxed.

(iii) Losses realized on small business equities should be treated as "ordinary losses."

If all of the above were to be legislated, the Government would have no more to do to promote investment in small business.

Transactions in Small Business Equities

(i) The government could provide insurance to investment bankers to cover underwriting risk assumed on "firm underwriting" of small business securities. This might promote more"firm underwritings" instead of the "best efforts" technique.

(ii) Subsidize the difference between the big business relative costs of flotation and the small business relative costs of flotation of equity securities. This would put the small business on equal footing with the big business as far as flotation costs are concerned.

(iii) Establish a Small Business Equities Trust. This could be a joint private sector, Government-sponsored trust investing in unseasoned small business concerns and selling participations in the trust to institutional and individual investors with a SBA-Guaranteed repurchase agreement which would protect the investor from risk of principal loss. This could be a pass through type trust and because of the SBA-Guaranteed Repurchase Agreement would be a legal investment for fiduciaries.

Investor Incentives

(i) Provide Small Business Equity Portfolio Insurance. This could be run through the private sector with SBA as reinsurer. This would protect intermediaries against principal loss and therefore would be another way to protect the fiduciary.

(ii) SBA could write contracts with investors which would provide investors a "Put" at a specified time point (or frame) and at a specified price (probably cost). These contracts would provide the investor the following options

1) hold the securities past the "Put" dates for gains (tax free - see above);
2) put the securities to SBA (or to SBA through the trust) at cost;
3) take any losses for tax reasons; or
4) a combination of the above.

b(3)(b) INCREASING THE FLOW OF VENTURE CAPITAL - THE SBIC's

There are currently over 330 operating Small Business Investment Companies with a total portfolio of over $580 million invested in 6,400 small businesses. About 77% of these dollars are in investments considered to be venture capital - subordinated debt, convertible securities, warrants and equity stock.

Because of the extreme need for venture capital by the small business community, SBA is seeking ways to increase the venture capital investments of SBIC's.

Discussions with executives of SBIC's indicate that only 10 of every 100 proposals for investment merit a full review and only one or two will result in financing. SBA together with the SBIC industry is seeking ways to improve this marketing problem and to generate more acceptable financing applications.

Under its loan programs, SBA reviews many applications where the critical need is not for a relatively short-term collateralized loan, but for long-term venture capital. We are studying ways in which such applicants could be referred to active SBIC's and for cooperation between SBA and SBIC's to provide joint financing to meet the needs of the small business community.

b(3)(c) ESOTS - A NEW APPROACH TO EQUITY CAPITAL

One of the ways to provide equity capital to business has been recognized by the Congress is through the tax advantages to an employee stock ownership plan contained in Section 40(a) of the Internal Revenue Code. SBA is currently studying this new method of financing and whether financial assistance could be extended under our programs.

Under the ESOP concept, a corporation requiring long-term capital for productive assets establishes an ESOT that qualifies as a tax-exempt stock bonus trust. The trust would be under the control of a committee named by management. The relative interest of each employee in the trust would be proportional to his annual compensation.

The trust obtains a loan from a lender and uses the proceeds to purchase newly issued stock in the employer corporation. The lender receives a pledge of the purchased stock and a guarantee from the employer corporation to make annual payments at least sufficient to amortize the loan. The lender may also obtain other collateral as well. The payments made by the employer corporation to the trust are, within limits, deductable for tax purposes. Thus the principal of the loan is repaid with pre-tax dollars.

Small firms with limited credit and weaker collateral will be unable to utilize this method of equity financing since the loan would be unavailable from a lender. In those situations where the business situation is sound and there is potential for growth, SBA may be able to extend its guarantee to the lender to induce the loan to the ESOT for the benefit of the small business.

As the payments by the employer corporation are made to the trust, the loan is repaid. The beneficial ownership in the stock accrues to the employees on a proportionate basis related to their compensation. Depending on the vesting requirements of the trust, the stock will be distributed at termination or retirement. Most trusts have a "put" so that the employee can sell the stock back to the trust at the then recognized value. Further, the trust or the company may have a right of first refusal to purchase the stock, thus retaining control in the employee group.

The benefits to the small business can be many:

1. It provides a retirement plan for its employees.
2. It obtains new, sorely-needed capital and pays for it with pre-tax dollars.
3. Because employees are owners in the business, they will have a more positive attitude and greater productivity.
4. The ownership interest will deter termination and lead to lower turnover.

In order to maintain free competition and private enterprise, it is essential that small business have access to equity financing. ESOT financing with SBA support is one way to provide this equity.

b(4) IMPROVED BANK PARTICIPATION - OPERATION STREAMLINE

To encourage greater bank participation in SBA guaranty loans, we have just completed an in-depth evaluation of our loan processing procedures to determine how we can "streamline" our operations, simplify requirements and reduce paperwork. Some of the improvements being considered are:

1. Maintaining an up-to-date Lenders' Handbook to provide better guidance to participating lenders.
2. Keeping banks better informed of our programs and any changes in our procedures.
3. Simplifying instructions for SBA loan applications.
4. Using computer applications to assist SBA loan officers with loan analyses and freeing them to concentrate on the prospective borrowers' total needs and to work more closely with the participating lenders.

Although all paperwork and report requirements can't be eliminated, SBA is concerned about its quality of service to the small business community and we are improving it.

b(5) RAIL SERVICE STUDY

A study is under way regarding the impact on small business firms arising out of the planned elimination of 6,900 miles of light-density rail line from the rail system in certain areas of the Northeast and Midwest Region (17 states and D.C.).

As soon as we have the results of this study, SBA will evaluate the potential impact to these small business concerns and will assess the potential assistance that can be made available for these firms.

C. LEGISLATION (OTHER THAN TAX MATTERS)

There are numerous proposals involving SBA financial assistance to small businesses now pending before Congress. These include:

(1) Increasing the maximum amount of 7(a) and Development Company Guaranteed Loans from $350,000 to $500,000.

(2) Increasing the Economic Opportunity Loan maximum amount from $50,000 to $100,000.

These increases apparently take into consideration the rate of inflation that has occurred since 1959 when the existing ceilings were established. Since 1959, the value of the dollar has decreased by 39.4 percent, so that the "real" dollar legislative limit on 7(a) loans is now $210,000 (which is less than any other year in SBA's history with the exception of the first two years when the loan limit was $150,000).

(3) Increasing the maximum maturing of 7(a) loans for <u>all</u> construction and the purchase of existing facilities to 15 years. (Currently 15-year maturities are available for only <u>new</u> construction, while all other construction and acquisition is limited to only 10 years).

D. TAX LEGISLATION

The constraints on small business capital formation and investment are reinforced by a tax system that weighs particularly heavily on investment benefits and wages of those actively involved in the small business sector. In the enactment of any revisions to the Federal Income and Estate Tax Laws, special consideration should be given to the requirements of small business and the individuals investing in, and employed by, that sector of the economy.

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E. EXECUTIVE AND REGULATORY

(1) In those areas where compliance with regulatory requirements imposes a unique financial burden on small business (such as Labor, OSHA, etc.), we would suggest that consideration be given to providing some reasonable period of "breathing space" to adjust for costly improvements which do not help the earnings capacity of small firms. Saddling these firms with additional debt through conventional financing or SBA's "special" loan programs is not always the best answer.

(2) We would also like to reinforce the Administration's priority of reducing the paperwork, regulatory and reporting burdens imposed on small business. SBA itself is making a special effort in this area, yet it is an area that requires continued monitoring and emphasis by all Government agencies and departments.

SUPPLEMENT REGARDING

DATA DEFICIENCIES

Supplement

DATA DEFICIENCIES

In the preparation of this statement, estimates of the historical dimensions of the capital formation and investment requirements of small businesses are based on flow of funds statistics that are compiled and published by the Federal Reserve Board. These provide data relating to investments by non-farm, non-corporate businesses, but corresponding data are not available for small corporate businesses. Such data are available for all corporations, but these are not sub-classified for large and for small corporations. As a consequence, investment data for small corporate businesses are only estimated.

Data specifically applicable to small business in forms which meet the requirements of the Small Business Administration are very limited. During the lifetime of the SBA the Agency has participated financially in the development of selected types of small business data and in formal and informal discussions with personnel of various data gathering agencies about small business data deficiencies. To date, the inroads which have been made by these efforts are extremely disappointing. In general, data gathering agencies have been slow to include the development of small business statistics in their plans and

budget requirements. As a result, types of data applicable to fundamental analyses of small business have not noticeably increased in number or quality during the past decade and, in total, may have declined in their usefulness for these purposes.

To date, SBA must depend on gross estimates or proxies to serve as indicators of direction and performance in most areas of small business activity because specific information generally cannot be extracted from economic and business indicators. In the category of economic indicators, data are deficient for the purpose of estimating precise small business input to gross business activity and employment. There is insufficient information on the impact of unemployment on small business; their demand for capital, sources of funding, and supply of capital; and the effect of changes in fiscal policy on small concerns. Business indicators are deficient for the purpose of determining the net growth or decline of the total small business community, new starts and discontinuances. Data on small business profits are lacking for all but a small portion of these firms, and statistics on overall performance of business is lacking in areas of rapid growth and significant small business activity. Statistics on changes in energy costs do not permit an assessment of their impact on small concerns. These examples by no means represent all deficiencies in small business data, but they include significant areas of need.

The substantial, continuing unfilled small business data needs appear to be related primarily to two conditions: (1) technical complexities and cost of development of small business data and (2) those agencies which have data development responsibilities place a lower priority on small business data as compared to their total data development priorities.

Appendix

FINANCING OF NONCORPORATE BUSINESSES, 1945-1971

A. STUDY BY SMALL BUSINESS ADMINISTRATION

October 1973

FINANCING OF NONCORPORATE BUSINESSES, 1945-1971

Introduction

This analysis is limited to the financing of nonfarm, nonfinancial, noncorporate businesses, exclusive of housing, consisting primarily of small businesses that are independently owned and operated as sole proprietorships or partnerships. Farm businesses, businesses providing commercial residential housing, and enterprises whose main function is providing insurance, loans, brokerage services, and other forms of financing and finance-related activities are excluded. The analysis relates primarily, with some important exceptions (see Appendix A), to those enterprises which in general reference are usually thought of as typical small businesses. Because of data limitations, it is not possible to include small corporate businesses. This is unfortunate since it precludes an analysis of the financing of the entire small business sector of the economy.

Repeated usage of the technically accurate expression "nonfarm, nonfinancial, and noncorporate businesses, exclusive of housing" would be very cumbersome. Therefore, less precisely accurate expressions are used in this paper to refer to businesses. Nevertheless, the businesses fall within the aforementioned category. Most of these businesses are small, although there are some exceptions.

The analysis is based upon data derived from the Flow of Funds statistical series compiled by the Federal Reserve Board. (For a discussion of the limitations of these data see the technical note in Appendix A.)

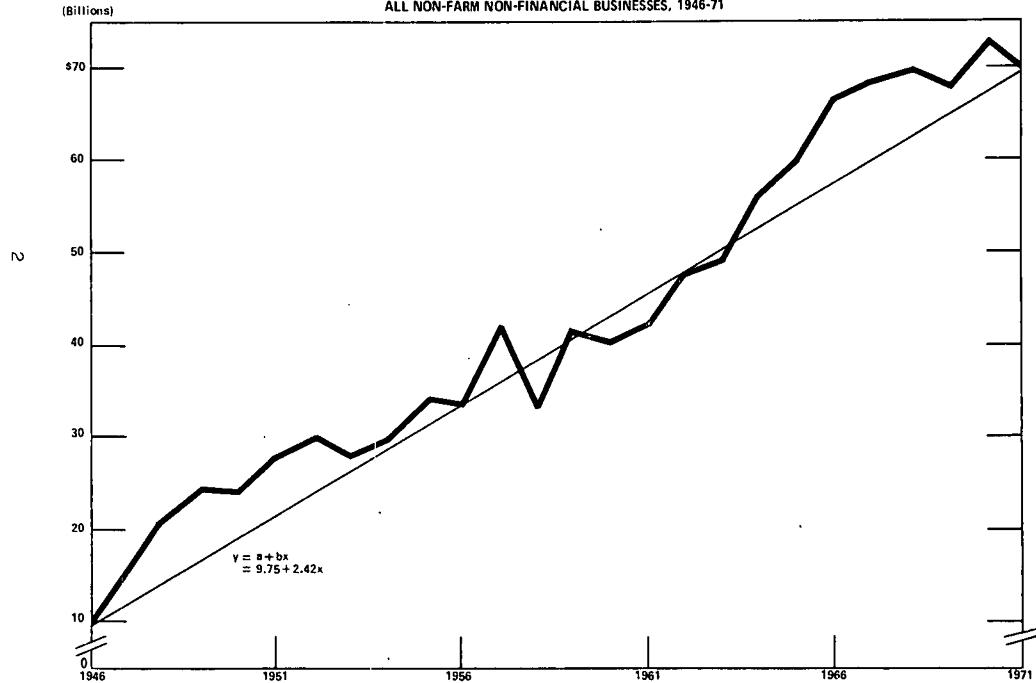
Small, Noncorporate Businesses in the Total Economy

Successive annual gross investment in nonfarm, nonfinancial businesses in the total economy is indicated in Chart 1. These investments consist of gross business savings (capital consumption allowances, retained earnings, etc.) and of net external business financing. These data do not exclude investments that are necessary to replace capital consumed in the production process.

CHART I

GROSS INVESTMENT,

ALL NON-FARM NON-FINANCIAL BUSINESSES, 1946-71



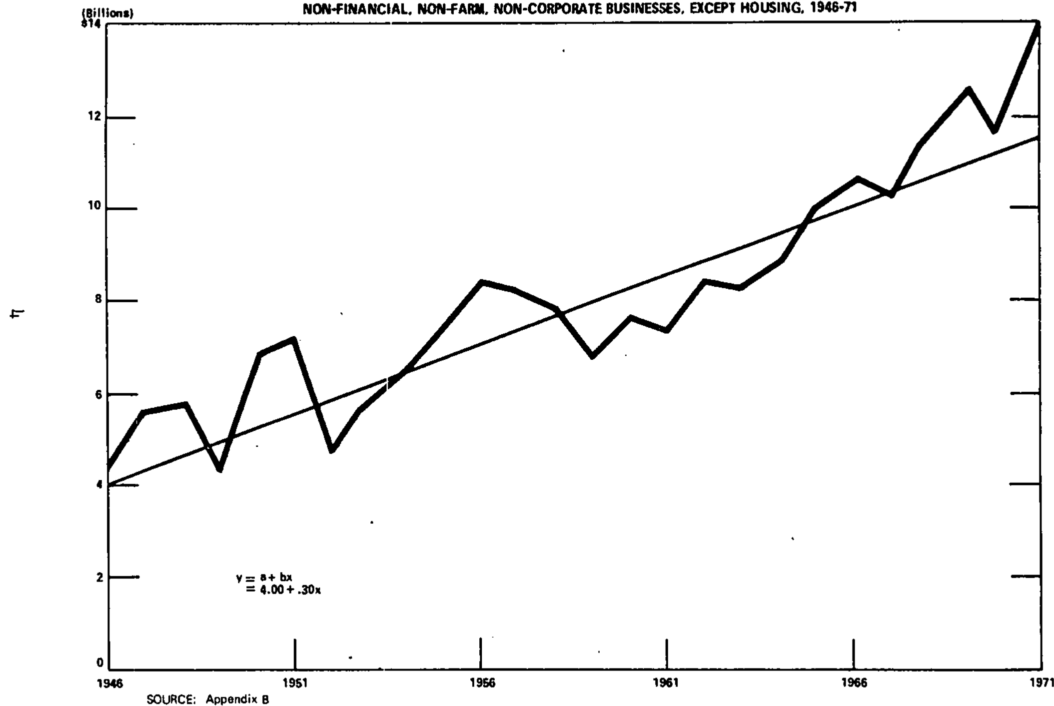
SOURCE: Flow of Funds Accounts; Annual Flows, 1946-71

The least squares regression, Chart 1, shows that successive annual increases in the total investment in nonfarm, nonfinancial businesses, both corporate and noncorporate, over the 25-year period from 1946 through 1971 have averaged around $2.42 billion. In comparison, as indicated statistically by the data in Appendix B and pictorially in Chart 2, similar increases in investments in the noncorporate sector, exclusive of housing, have averaged about $300 million annually.

The comparative magnitudes of these investment flows at the beginning of this 25-year period were in the order of 2.5 to 1, or $9.75 billion as compared to $4.0 billion. At the close of the period these comparative magnitudes had increased to a ratio of 6 to 1, or to a ratio of $70.0 to $11.5 billions respectively. This suggests that the average annual rate of increase in gross investment in the total nonfarm, nonfinancial sector of the economy has been about twice as great as in that portion of this sector that is owned and operated by sole proprietors and partnerships. It is evident from these comparisons that, while investments in small independently owned noncorporate businesses are increasing modestly, these investments are of declining relative importance in the total economy. Most of this modest increase in the rate of investment in small businesses is probably concentrated in the service industries. If so, the rate of growth in investments in most other noncorporate businesses is indeed modest.

A more detailed analysis of Charts 1, 2, and 3 reveals that investment in small, noncorporate businesses also is much more cyclically sensitive than investment in all nonfinancial businesses in the total nonfarm economy. This cyclical sensitivity is particularly pronounced in years immediately preceding, during, or immediately following years of general economic recession. One reason for this, as will be indicated in some detail by subsequent analyses, is the less ready availability of external financing and proprietor net investment in small as contrasted with large corporate businesses. There probably are other reasons, such as comparative differences in the cost and other terms required by suppliers of capital funds, but this is not indicated by the data employed in this analysis.

CHART 2
GROSS INVESTMENT,
NON-FINANCIAL, NON-FARM, NON-CORPORATE BUSINESSES, EXCEPT HOUSING, 1946-71



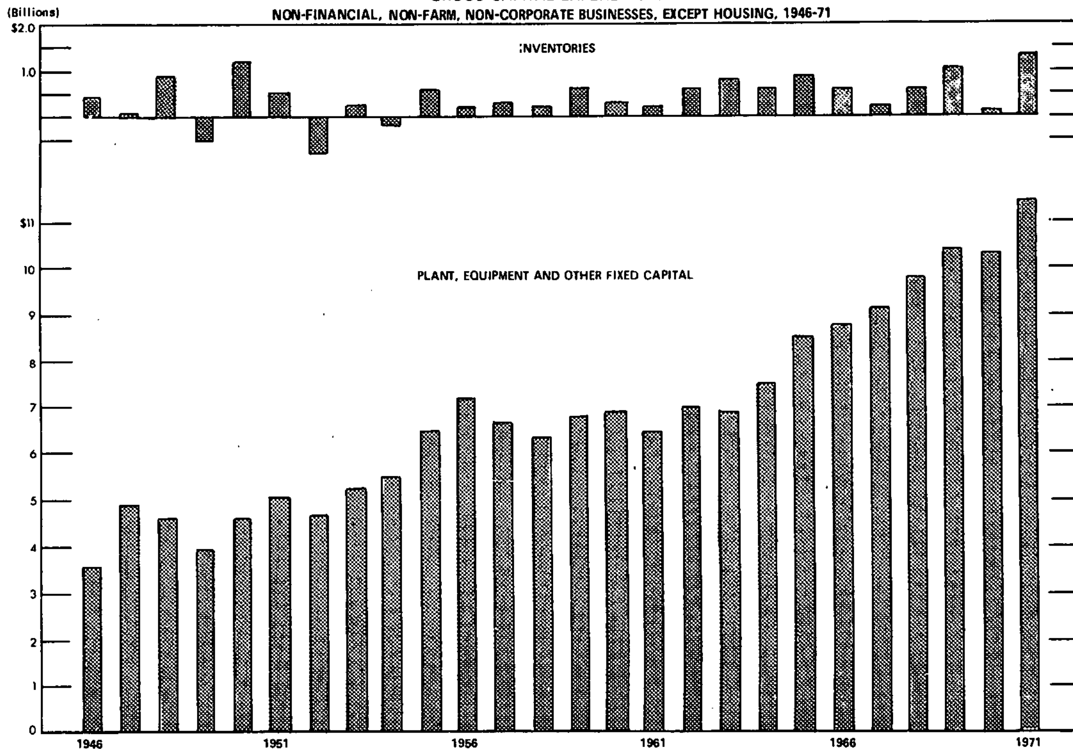


CHART 3
GROSS CAPITAL EXPENDITURES
NON-FINANCIAL, NON-FARM, NON-CORPORATE BUSINESSES, EXCEPT HOUSING, 1946-71
(Billions)
$2.0
1.0
INVENTORIES
$11
10
9
8
7
6
5
4
3
2
1
0
PLANT, EQUIPMENT AND OTHER FIXED CAPITAL
1946
1951
1956
1961
1966
1971
SOURCE: Appendix B

Comparative Trends in Internal and External Financing of Small, Noncorporate Businesses

Comparative trends in the internal and external financing of small noncorporate businesses are indicated statistically by the data in Appendix B and pictorially by Charts 4, 5, 6, and 7. Proprietor net investment is treated as internal financing, partly because of data limitations, but primarily because the owners of small sole proprietorships and partnerships think of the returns from their businesses in terms of their total personal finances, irrespective of whether these returns should be treated in strict accounting terminology as personal compensation or as net profits.

The most striking thing about this comparison is the relatively slow rate of growth of internal financing as compared with external financing. The growth in internal financing, as indicated by the least squares trend line in Chart 4, was from around $3.9 billion in 1946 to $8.9 billion in 1971, or by an annual compound growth rate of about 4.3 percent. This compares with the corresponding growth in external financing, as indicated by Chart 7, from $140 million in 1946 to $2.4 billion in 1971, or by an annual compound growth rate of 12.1 percent. This suggests that the rate of growth in the external financing of small, noncorporate businesses is about three times the rate of growth in the internal financing of these businesses and that these small independently owned noncorporate businesses are becoming less solvent, depending increasingly on external debt financing. It also indicates a growing need for expanding sources of equity capital for these small businesses. This should be of major concern to the Small Business Administration. Probable causes of the divergency in these trends in internal and external financing are noted later.

A second significant financing pattern that may be observed from these data is the rapid decline during recessions and the rapid increase during the first year immediately following recessions in external financing of these small businesses. Large declines over the preceding year occurred in 1947-49, 1951-52, 1958, and 1970, and large increases occurred in 1950, 1953-55, 1959, and 1971. This consistency of declines and spurts in external financing during and immediately following periods of credit

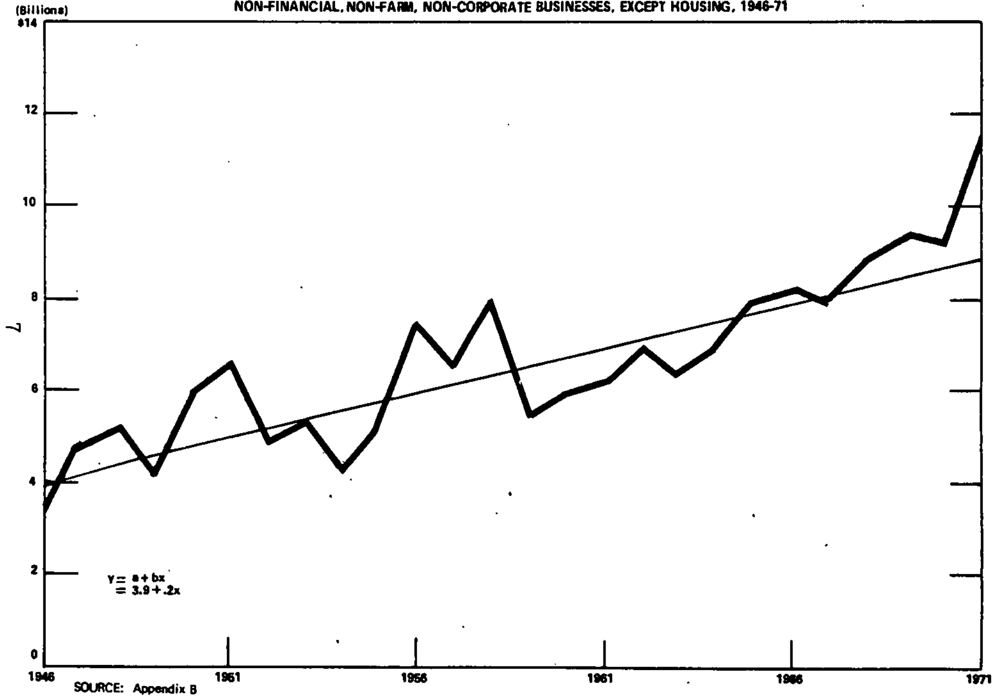
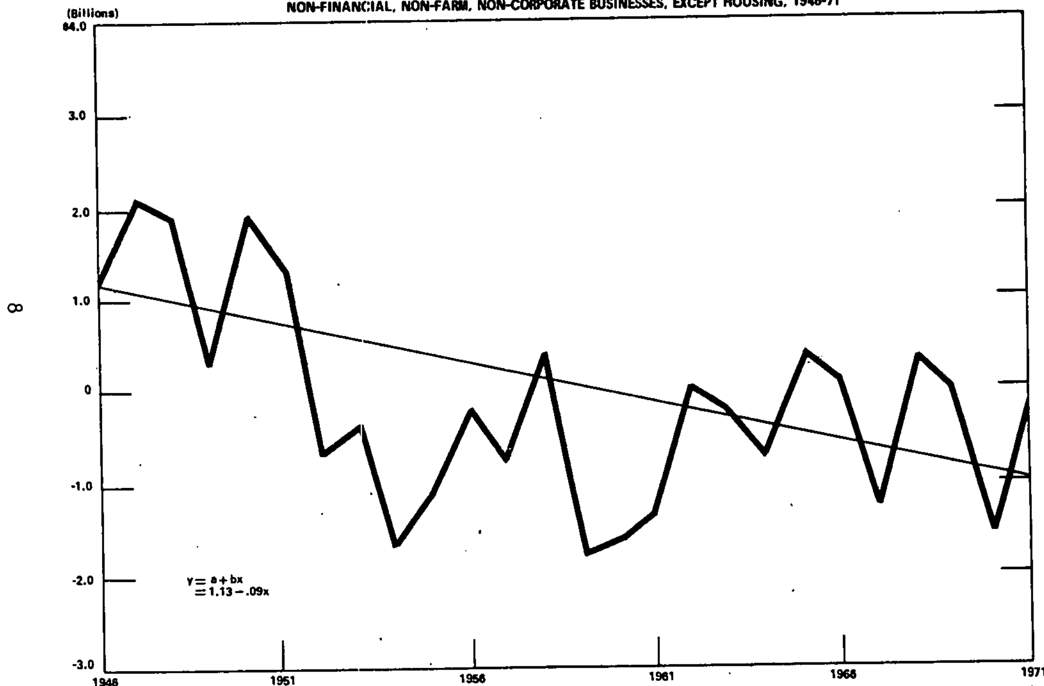


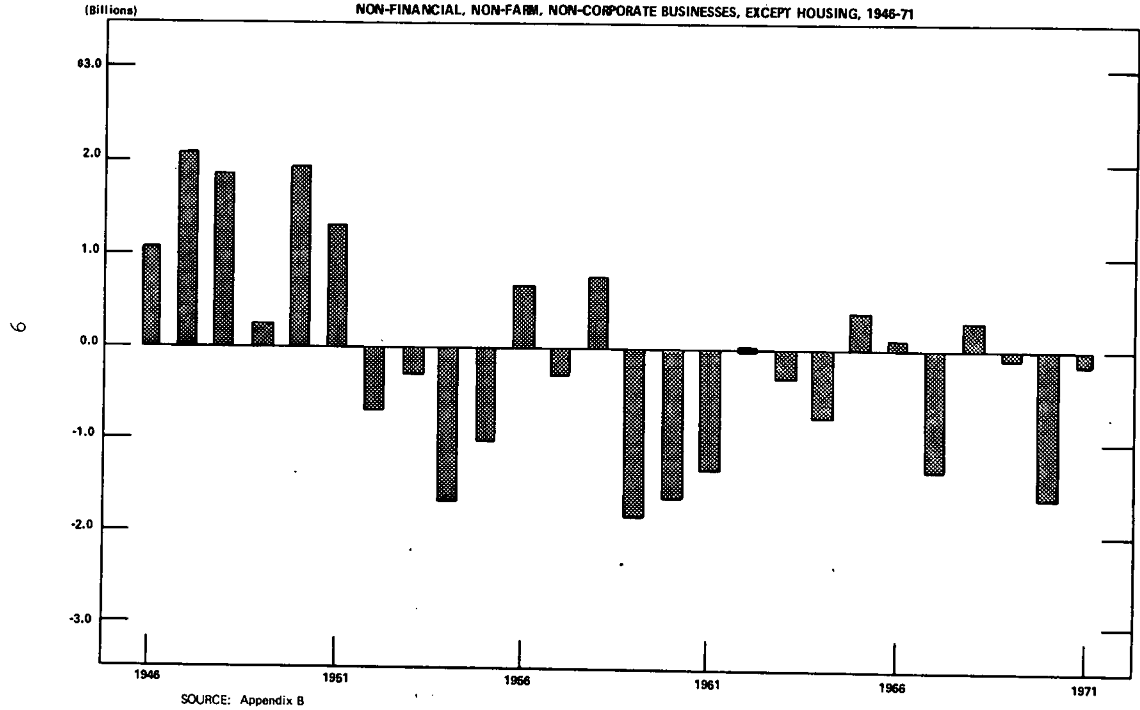
CHART 4
NET INTERNAL FINANCING,
NON-FINANCIAL, NON-FARM, NON-CORPORATE BUSINESSES, EXCEPT HOUSING, 1946-71
(Billions)
$14
12
10
8
6
4
2
0
1946
1951
1956
1961
1966
1971
Y = a + bx
= 3.9 + .2x
SOURCE: Appendix B

CHART 5
PROPRIETOR NET INVESTMENT,
NON-FINANCIAL, NON-FARM, NON-CORPORATE BUSINESSES, EXCEPT HOUSING, 1946-71



SOURCE: Appendix B

CHART 6
PROPRIETOR NET INVESTMENT,
NON-FINANCIAL, NON-FARM, NON-CORPORATE BUSINESSES, EXCEPT HOUSING, 1946-71



SOURCE: Appendix B

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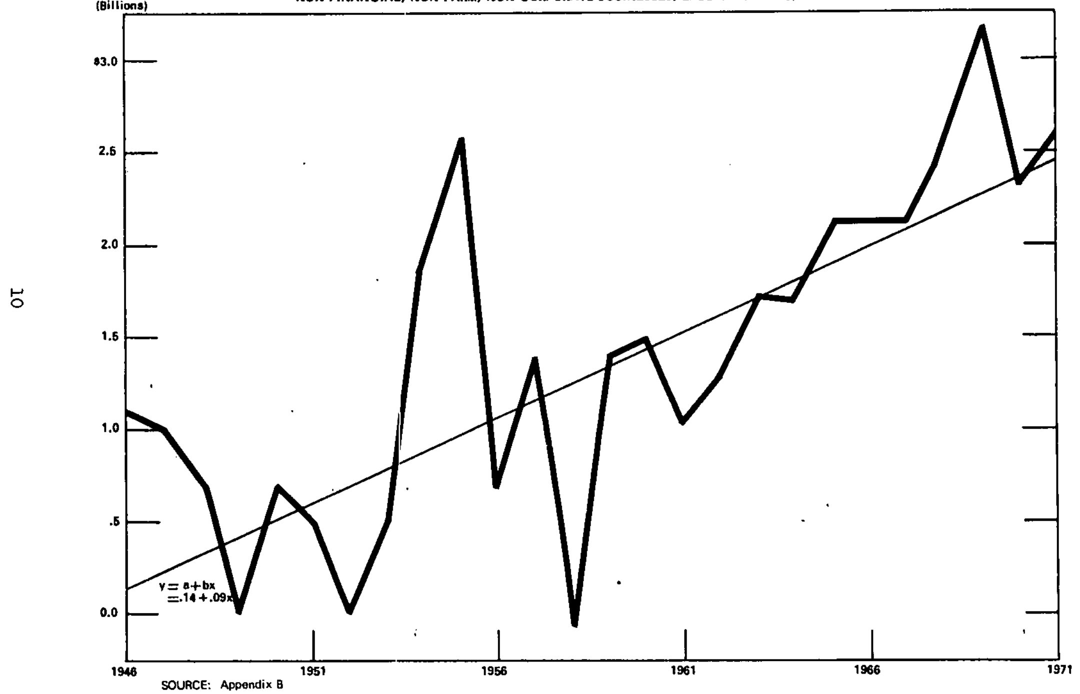
CHART 7
NET EXTERNAL FINANCING,
NON-FINANCIAL, NON-FARM, NON-CORPORATE BUSINESSES, EXCEPT HOUSING, 1946-71



SOURCE: Appendix B

stringency suggests that these small businesses are unsuccessful in obtaining adequate credit during tight money situations and that they come out of recession years with pent up credit demands that are largely satisfied during brief intervals following recessions when credit becomes more generally available.

Internal Financing of Small, Noncorporate Businesses

Successive annual flows in gross internal investment (gross in the sense that investment necessary for capital replacement is not netted out) by these small businesses are indicated statistically in Appendix B and pictorially in Charts 4, 5, and 6. These internal investments consist of gross business savings (capital consumption allowances) and proprietor net contributions (retained earnings and net proprietor contributions and withdrawals of capital funds). The trend in proprietor net contributions is of particular concern.

Proprietor net investments in nonfinancial, nonfarm enterprises that are owned and operated by sole proprietors or in partnership, as shown pictorially in Chart 5 and as indicated by the least squares regression analysis, have declined over the last 25 years. This decline was very pronounced prior to 1954. This trend does not mean that the equity interest of the owners of these businesses has declined. On the contrary, the owners of these businesses may have increased their equity investment. But it does mean that their equity investment in these businesses is a declining proportion of the total capital employed. This is attributable at least in part, as observed above, by increasing illiquidity, or by increasing relative reliance on external debt financing, and possibly also by increasing reliance on leasing of fixtures and equipment in lieu of outright ownership.

Declines in proprietor net investment in noncorporate businesses may be partially explained by the exodus of equity that results from incorporating these businesses. There is an increasing tendency for small businesses to select the corporate form of business organization for their operations. Other possibilities not indicated by the data employed here may include the preferential treatment by our income tax laws of debt as contrasted with

equity financing. It may also mean that there is a substantial element of truth in the frequently voiced complaint of small business proprietors that the combined load of Federal, State and local taxes, both personal and business taxes, consumes so much of their operating income that inadequate income is left after taxes from which sufficient savings can be accumulated and plowed back into their businesses. Whatever the causes, the declining relative magnitude of equity investment by small business proprietors has implicit social implications which vindicate the concern of Congress as expressed in its declaration of policy in authorizing the establishment of the Small Business Administration and the Small Business Investment Companies.

Major declines over the preceding year in net equity investment by small business proprietors, as indicated by Charts 5 and 6, occurred in 1949, 1952, 1954, 1957, 1959, 1967 and 1970. Except for 1952 these were years immediately preceding, during, or immediately following recessions in the general economy. It would seem that these would be years during which there would be the greatest need for larger contributions of equity funds by small business proprietors, particularly during such years as 1967 and 1970, which immediately followed the credit stringencies of 1966 and 1969. The only plausible explanation that is apparent is that small business proprietors simply did not have the funds that were needed, possibly because they could not generate sufficient savings to continue their usual rate of investing in their businesses. Additional support for this conclusion is provided by subsequent analyses.

External Financing of Small, Noncorporate Businesses

From Table 1, on the following page, and from Appendix C, it may be observed that at the end of 1971 the outstanding liabilities in the form of trade debt and credit market instruments of these noncorporate small businesses totaled $54.0 billion. Corresponding off-setting financial assets totaled $34 billion, a financial asset/liability ratio of 0.63. This compares with corresponding financial liabilities of $7.1 billion and corresponding financial assets of $8.4 billion at the close of 1945, a financial asset/liability ratio of 1.18. This represents nearly

a 50 percent decline in this liquidity ratio over the 26-year period, with no account being taken of increasing reliance on leasing of capital assets.

Table 1

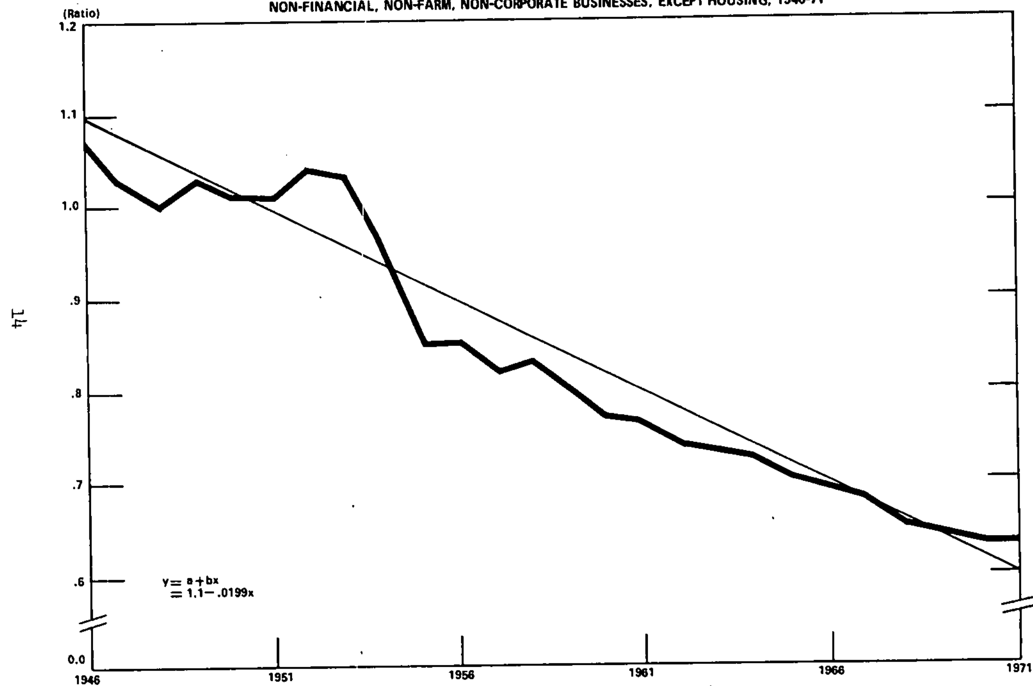
ANNUAL CHANGES IN FINANCIAL ASSET/LIABILITY RATIOS
NONFINANCIAL, NONFARM, NONCORPORATE BUSINESSES, EXCEPT HOUSING
1945 - 1971

Year	Ratio	Year	Ratio	Year	Ratio
1971	.63	1962	.74	1953	1.03
1970	.63	1961	.76	1952	1.04
1969	.64	1960	.77	1951	1.01
1968	.65	1959	.80	1950	1.01
1967	.68	1958	.83	1949	1.03
1966	.69	1957	.82	1948	1.00
1965	.70	1956	.85	1947	1.02
1964	.72	1955	.85	1946	1.07
1963	.73	1954	.95	1945	1.18

SOURCE: Computed from data in Appendix C

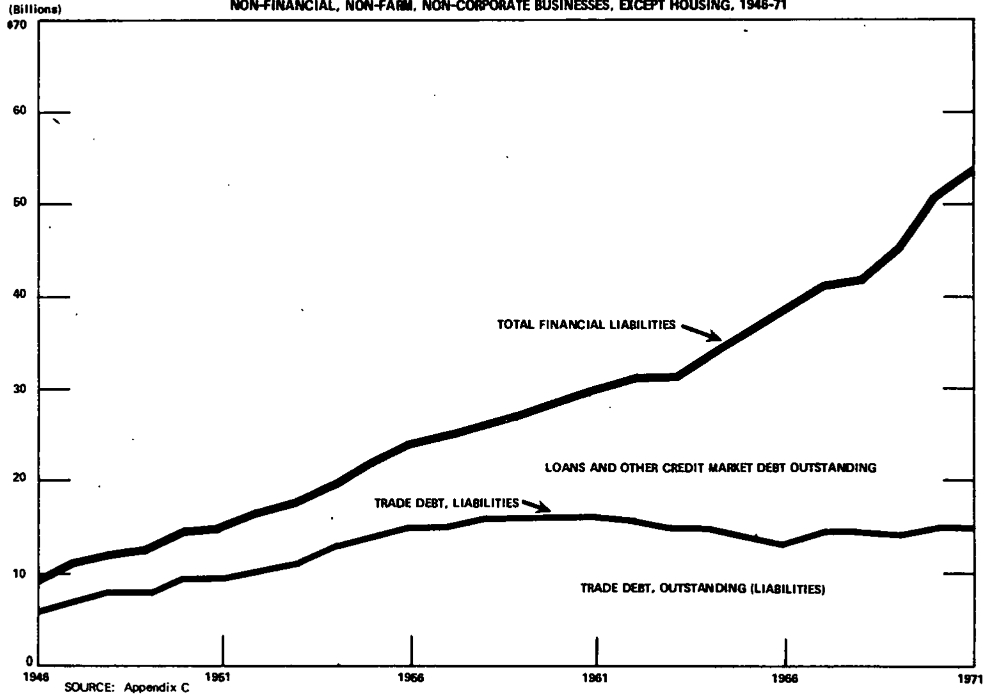
The decline, as may be observed from Table 1 and Chart 8, was especially pronounced during 1945-47 and during 1954-55. Both of these periods were marked by very large increases in financial liabilities. A separate examination of financial asset/liability ratios in the corporate sector reveals a liquidity trend, as measured by these ratios, in the corporate sector that approximates closely these trends in the noncorporate sector. Nevertheless, this pronounced deterioration in the financial asset/liquidity ratio has disturbing implications for the continued solvency of small, independently owned and operated business enterprises.

From Chart 9 it may be observed that the tremendous growth in outstanding financial liabilities of these small businesses since the mid-1950's is in loans, mortgages and other forms of credit supplied by the credit markets, and, possibly, contractual liabilities under leasing arrangements. Trade debt supplied by other businesses has not increased over the last 15 years. Prior to the mid-1950's credit market debt and debts to other businesses increased about proportionately. The data employed here provide no explanation for this distinct change in trends that



SOURCE: Calculations based on data in Appendix B

CHART 9
TRADE AND CREDIT MARKET DEBTS OUTSTANDING,
NON-FINANCIAL, NON-FARM, NON-CORPORATE BUSINESSES, EXCEPT HOUSING, 1946-71



SOURCE: Appendix C

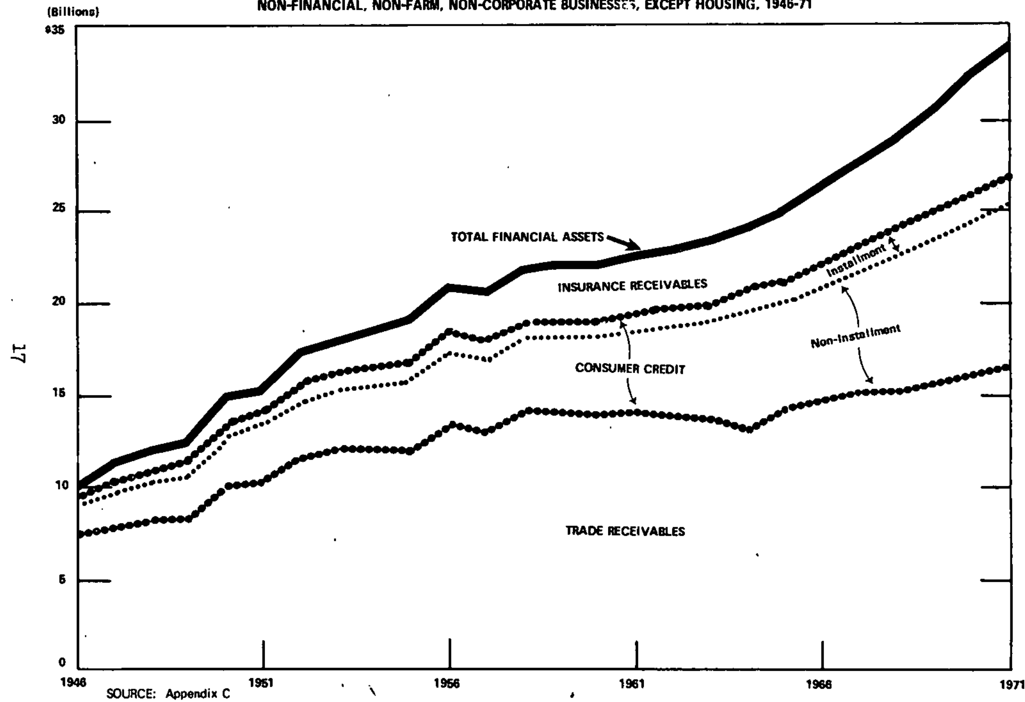
occurred during the mid-1950's. It may be, however, that these trend changes are attributable in large measure to the pronounced shifts that have occurred in the industry composition of the small business sector. The comparatively slow growth of small businesses in wholesaling and retailing, for instance, may be primarily responsible for the lack of growth in recent years in small business trade debt. Also, the comparative rapid growth in service industries, motels for instance, which normally rely heavily on external financing, may be responsible, in large degree, for the comparatively rapid growth in other forms of small business debt.

From Chart 10 it may be observed that a somewhat similar change occurred during the mid-1950's in trends in the types of financial assets acquired by small businesses. Prior to the mid-1950's the growth in trade debt receivables, insurance receivables, and consumer credit was roughly proportionate. Since the mid-1950's relatively little change has taken place in the amount of trade debt carried by these small sole proprietorships and partnerships. Over this 15 year period the growth in financial assets acquired by these small businesses has been largely in the form of insurance receivables and consumer credit.

A comparison of Charts 9 and 10 indicates that the net trade debt position (receivables less payables) changed relatively little over the entire 26-year period. A different picture, however, would probably be obtained if data were available for outstanding liabilities under leases of fixtures and equipment.

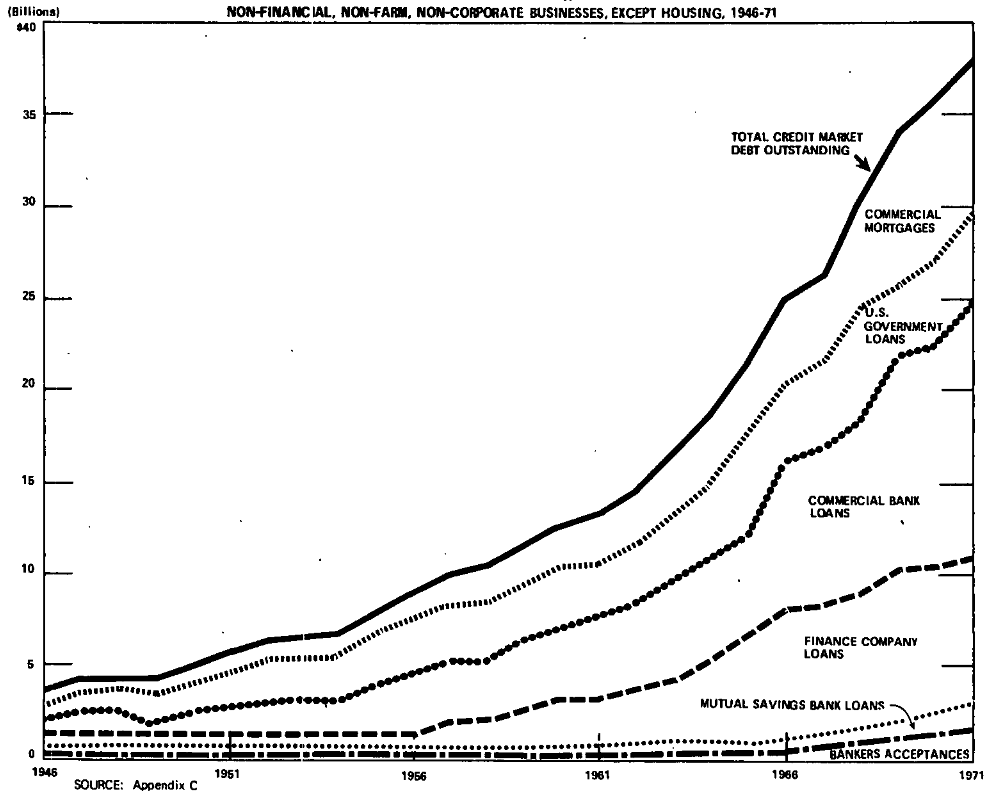
The types of credit market debt incurred by these small businesses are indicated in Chart 11. Particular note should be taken of the changing trends in the relative importance in the total of bank and finance company loans. Whereas direct loans from banks of $777 million at the end of 1946 represented 21.4 percent of the $3.6 billion total credit market debt instruments outstanding, bank loans of $13.9 billion at the close of 1971 represented 35.6 percent of the total credit market debt of $38.9 billion.[1] This slow growth in relative importance took place throughout the entire 25-year period. The total volume of finance company loans changed very little until 1957, from $1.3 billion in 1945 to $1.2 billion in 1956. In relative importance,

CHART 10
FINANCIAL ASSETS OUTSTANDING,
NON-FINANCIAL, NON-FARM, NON-CORPORATE BUSINESSES, EXCEPT HOUSING, 1946-71



SOURCE: Appendix C

CHART 11
CREDIT MARKET DEBTS OUTSTANDING, BY TYPE OF DEBT
NON-FINANCIAL, NON-FARM, NON-CORPORATE BUSINESSES, EXCEPT HOUSING, 1946-71



SOURCE: Appendix C

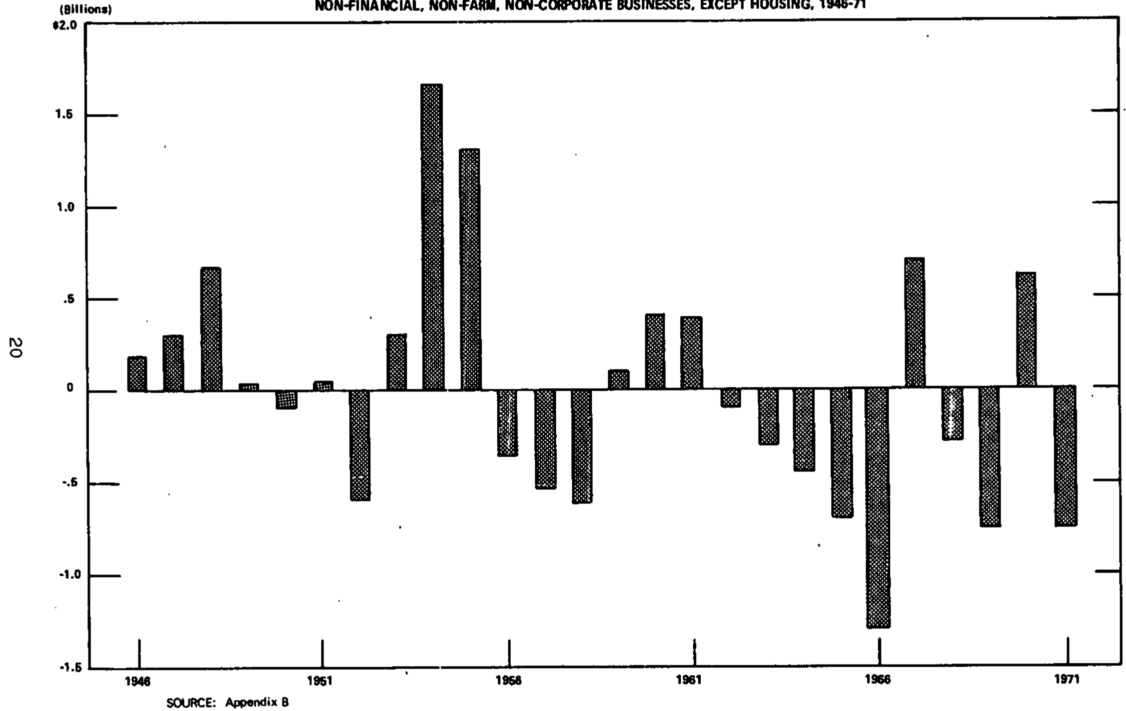
however, the decline was from 48.5 percent to 13.8 percent of the total outstanding credit market debt. Since 1956, outstanding finance company loans have increased from $1.2 billion to $7.7 billion or from 13.8 to 19.9 percent of the total credit market debt outstanding. The reasons for this reemergence of finance companies as an important source of credit for these small, noncorporate businesses are not apparent from the data on which this analysis is based.

The Small Business Administration should perhaps conduct an intensive study of changes in industry composition of small business and of this recent reversal in the trend in small business financing. These loans, it may be assumed, are more costly and otherwise more onerous than direct bank loans. Why, then, are these small, noncorporate businesses turning to finance companies for credit? Is it because of limited availability of credit from commercial banks or is it because an increasing proportion of total loans to these businesses are high risk loans that are unacceptable to commercial banks? Is the Small Business Administration achieving the objective with which it is charged of providing credit to small businesses that are unable to obtain credit on reasonable terms from other sources?

The financing of small, noncorporate businesses during and immediately following recessions in the general economy is of particular interest. This is indicated by Charts 12 through 17.

The observation may be made from Chart 3 that the rate of increase in net expenditures for plant, equipment, and other fixed capital facilities tends to slacken off slightly during the first year immediately following general recessions in the economy, but this is not a pronounced tendency. The striking feature about this use of funds is its relative consistency from year-to-year throughout the 26-year period. These expenditures seem to be relatively insensitive to cyclical changes in the economy. In contrast, inventory changes evidence a high degree of cyclical sensitivity. Very modest increases were made in inventories during 1953, 1967 and 1970 and declines in inventories occurred in 1949, 1952, and 1954. All of these years, excepting 1952, followed recessions. Whether this tendency in inventory changes is attributable to sales prospects, availability of financing, or to both is not indicated by the data employed here. When Chart 3 is read

CHART 12
ANNUAL INCREASES (DECREASES) IN NET TRADE DEBT
NON-FINANCIAL, NON-FARM, NON-CORPORATE BUSINESSES, EXCEPT HOUSING, 1946-71



SOURCE: Appendix B

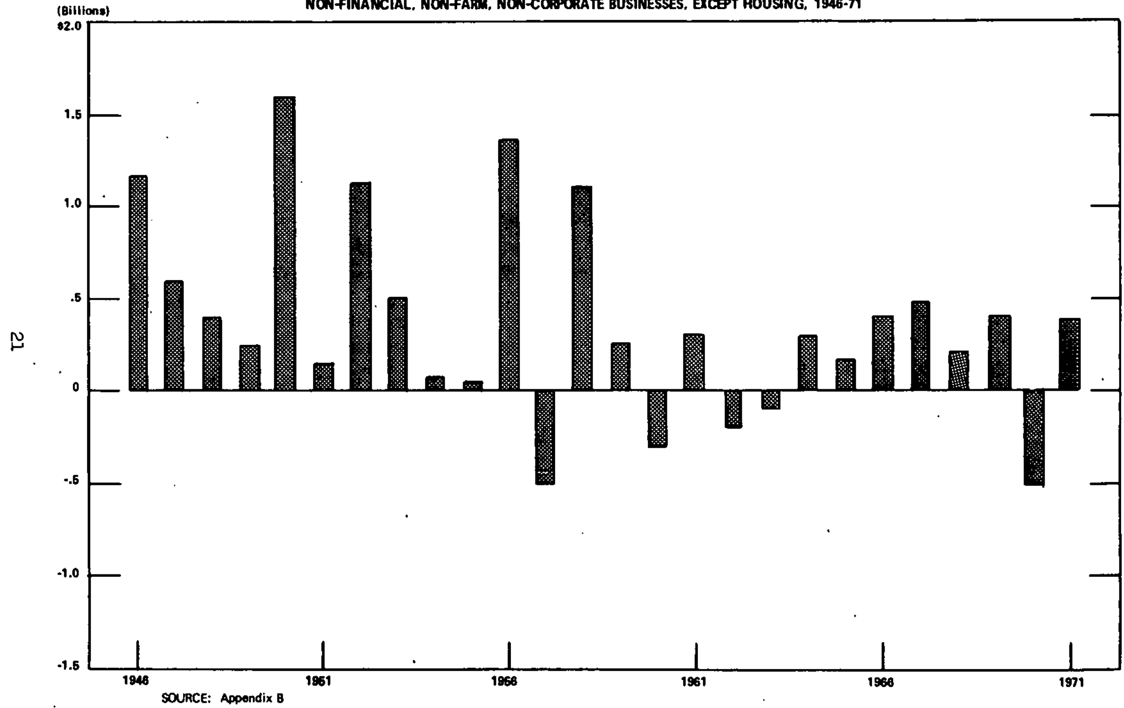


CHART 13
ANNUAL INCREASES (DECREASES) IN TRADE DEBT RECEIVABLES
NON-FINANCIAL, NON-FARM, NON-CORPORATE BUSINESSES, EXCEPT HOUSING, 1946-71

SOURCE: Appendix B

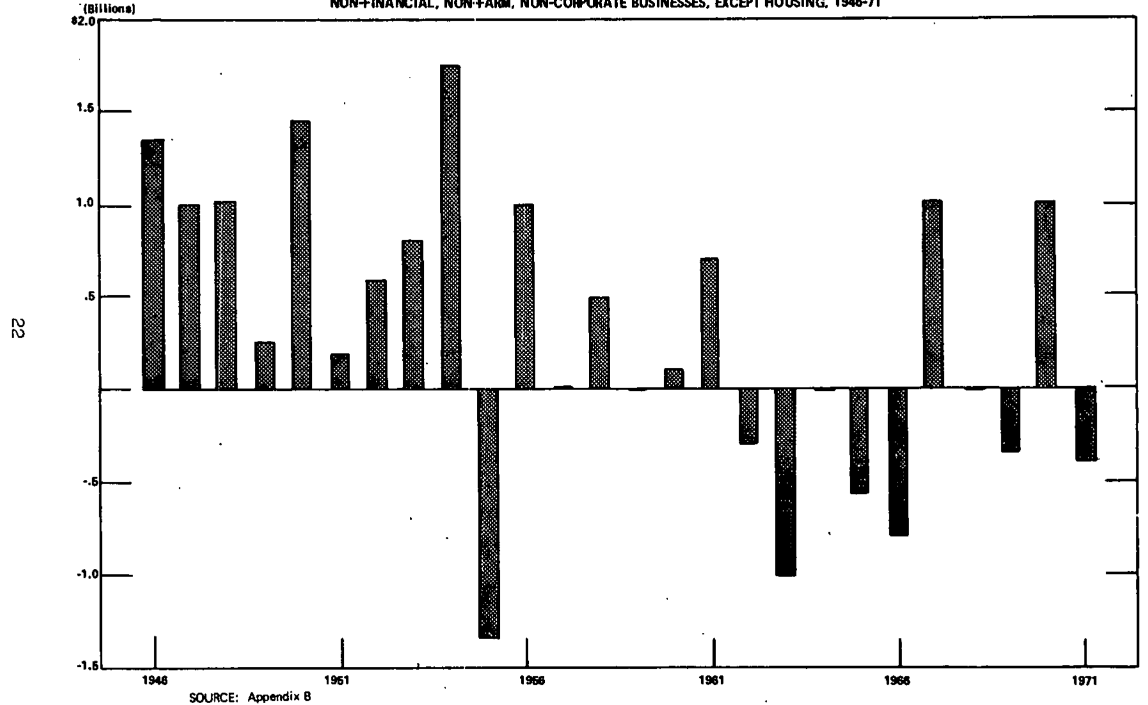
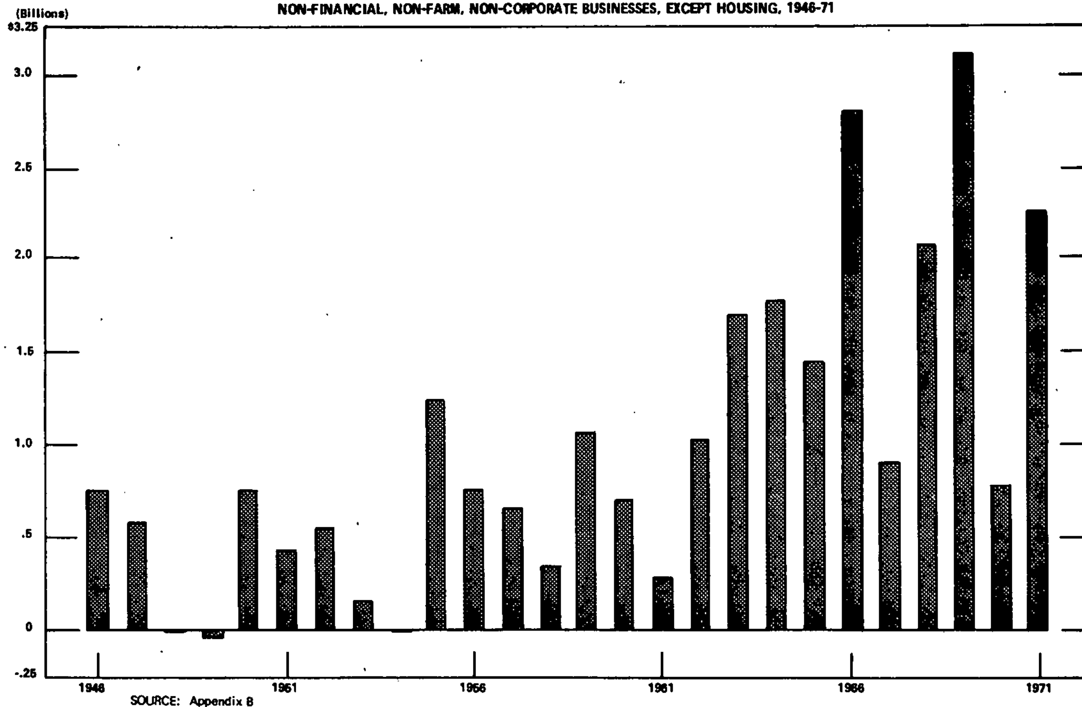


CHART 14
ANNUAL INCREASES (DECREASES) IN TRADE DEBT LIABILITIES
NON-FINANCIAL, NON-FARM, NON-CORPORATE BUSINESSES, EXCEPT HOUSING, 1946-71
(Billions)
$2.0
1.5
1.0
.5
-.5
-1.0
-1.5
1946
1951
1956
1961
1966
1971
SOURCE: Appendix B

CHART 15
ANNUAL INCREASES (DECREASES) IN TOTAL LOANS
NON-FINANCIAL, NON-FARM, NON-CORPORATE BUSINESSES, EXCEPT HOUSING, 1946-71



SOURCE: Appendix B

CHART 16
ANNUAL INCREASES (DECREASES) IN COMMERCIAL BANK LOANS
NON-FINANCIAL, NON-FARM, NON-CORPORATE BUSINESSES, EXCEPT HOUSING, 1946-71

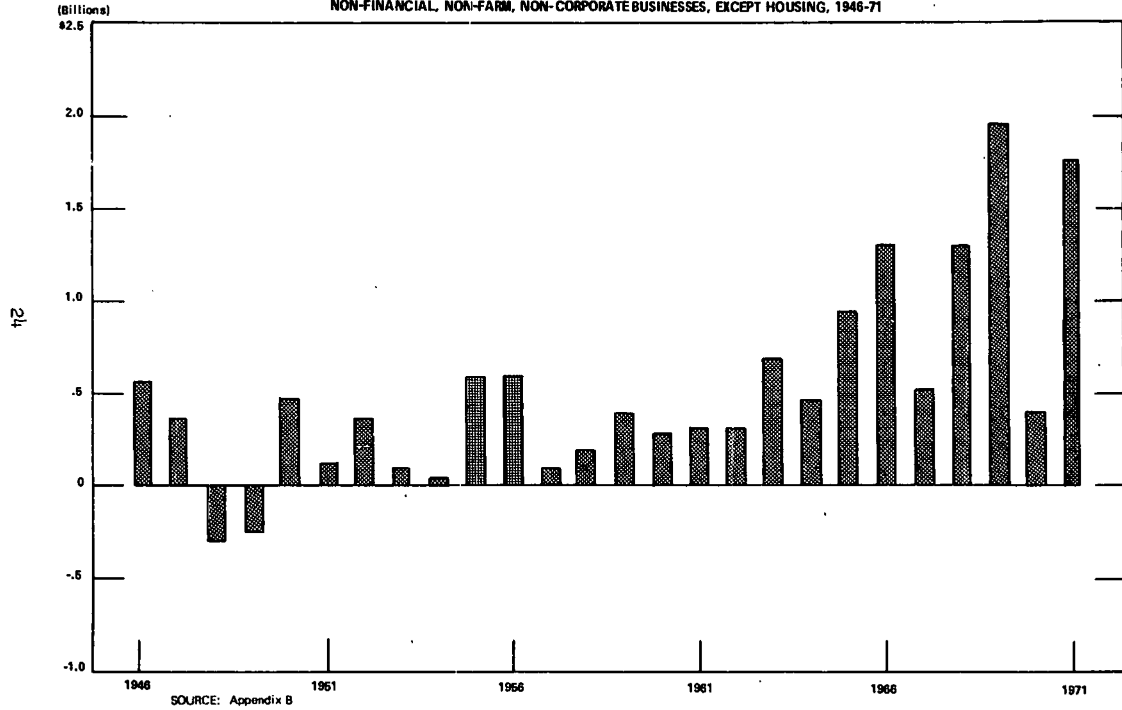
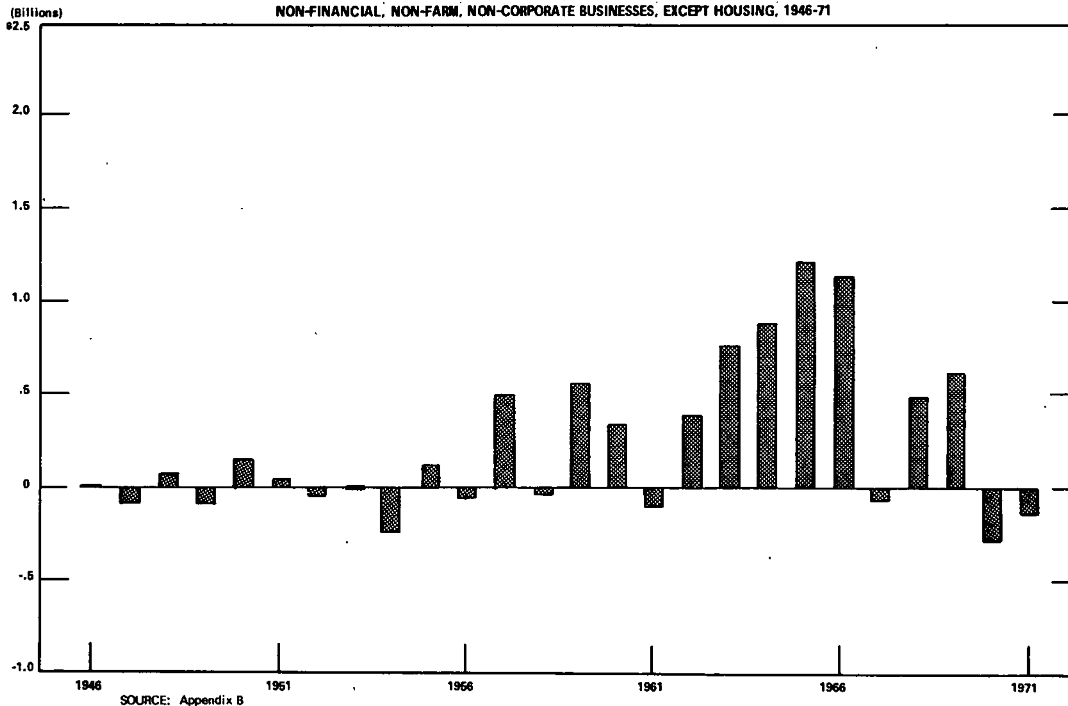


CHART 17
ANNUAL INCREASES (DECREASES) IN FINANCE COMPANY LOANS
NON-FINANCIAL, NON-FARM, NON-CORPORATE BUSINESSES, EXCEPT HOUSING, 1946-71



in connection with other charts, it appears that this tendency in inventory changes is attributable, at least in part, to limited credit availability, a general move to improve liquidity, or to both.

From Charts 5 and 6 it is apparent that annual flows of proprietor net investments into these small businesses decline sharply during and immediately following general recessions. This suggests that the proprietors of these businesses rely very heavily upon annual savings from net operating profits for funds to increase their equity positions.

Chart 12 indicates that general improvement occurs in the net trade debt position of small, noncorporate businesses during and immediately following general recessions. Chart 13 shows only modest increases or actual reductions in trade debt receivables during and immediately following recessions, and this is complemented, as indicated in Chart 14, by pronounced increases in trade debt liabilities immediately following recessions. Both tendencies may be to improve liquidity, or they may be a consequence of more restricted availability of credit from banks, finance companies, and other sources of direct loans, as indicated by Charts 15, 16, and 17.

There appears to be a degree of inverse correlation between trade credit and direct loans from banks, finance companies, and other sources immediately following recessions. During post recession years these small, noncorporate businesses obtain little additional financing in the form of direct loans from banks. They appear to place increased reliance during these years on trade credit, on loans at higher interest rates from finance companies, and on proprietor net investment. This switch suggests that adequate bank credit is unavailable during these years when it is most needed. Also, the fact that the proprietors of these small businesses tend to increase their injections of capital following recession years when profits are lower than usual suggests that this tendency is in response to financial desperation by a substantial proportion of these businesses.

In conclusion, this analysis of the financing of small, independently owned and operated businesses has numerous disturbing implications. One fact clearly emerges

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from the analysis: There is an urgent need for intensive, in-depth study of the underlying causes for some of the trends in small business financing that are indicated by the statistical data employed in this analysis.

Footnotes

1 The percentages appearing in this paper were computed from the non-rounded numbers shown on the tables. Slight variations will occur if the rounded numbers in the text are used.

APPENDIX A

This is a technical note designed to give a more precisely accurate definition of some of the terminology employed in the preceding analysis of Flow of Funds data.

Nonfarm, noncorporate, nonfinancial business. The *Flow of Funds Accounts, 1945-1967: Annual Total Flows and Year-end Assets and Liabilities* (Board of Governors of the Federal Reserve System, February, 1968) presents the following account (page I.34) of those businesses which comprise this sector:

> "Nonfarm noncorporate business covers unincorporated nonfinancial enterprises, predominantly in trade, construction, and the professions. It includes mutual organizations engaged in production or commerce - such as farm marketing, purchasing and utility co-operatives - but not farm credit cooperatives. The landlord activities of individuals (except for home and multi-family residence financing) are included, as are nonprofit organizations serving business, for example trade associations. The sector excludes both housing activities by owner-occupants and the consumer activities of business proprietors, which are both in the household sector. To the extent that household and business activities of sole proprietors are comingled in their own accounts, this sector is a departure from the principle that all activities of a unit are to be in a single sector account. The noncorporate business sector can be viewed as an activity sub-account of the household sector, with connection through the proprietors' equity transaction account."

The data in Appendices B and C were derived by eliminating the following transactions relating to housing from the nonfarm, noncorporate, nonfinancial sector accounts as defined above:

1. Fixed capital expenditures on home construction and multi-family residences.

2. Acquisitions of equity in Government-sponsored credit agencies.

3. Home and multi-family mortgages.

Proprietors' net investment in noncorporate business (as defined on p. I.42 in above source note) covers net flows of equity funds in investments by proprietors in unincorporated businesses . . . . All net income of noncorporate business is treated as withdrawn by proprietors . . . ."

In the preceding analysis proprietor net contributions of equity funds were classed as internal financing. These are classed as external financing in the Flow of Funds data.

APPENDIX B

ANNUAL FLOWS OF FUNDS EMPLOYED BY NON-FINANCIAL, NON-FARM, NON-CORPORATE BUSINESSES, EXCEPT HOUSING, 1946-71

(Amounts in Millions)

	1971	1970	1969	1968	1967	1966	1965	1964	1963	1962	1961	1960	1959
SOURCES OF FUNDS													
Total Funds Raised	14,013	11,511	12,600	11,507	10,118	10,277	9,978	8,708	8,129	8,185	7,183	7,327	6,918
Internal Financing	11,372	9,244	9,378	8,946	8,026	8,220	7,868	7,038	6,441	6,890	6,171	5,854	5,473
Gross Savings (Capital Consumption)	11,519	10,839	9,464	8,631	9,349	8,126	7,472	7,775	6,759	6,890	7,495	7,483	7,325
Proprietor Net Investment	-147	-1,595	-86	315	-1,323	94	396	-737	-318	0	-1,324	-1,629	-1,852
External Financing	2,641	2,267	3,222	2,561	2,092	2,057	2,110	1,670	1,688	1,295	1,012	1,473	1,445
Credit Market Instruments	3,404	1,642	3,967	2,827	1,384	3,358	2,805	2,128	1,979	1,406	610	1,053	1,313
Commercial Mortgages	862	404	422	547	349	442	324	278	409	384	308	231	226
Bank Loans, nec[1/]	1,756	386	1,951	1,285	519	1,323	941	473	687	343	327	299	422
Other Direct Loans	521	448	1,240	860	395	1,462	1,503	1,333	1,000	677	-56	402	659
U.S. Government	358	570	330	327	366	212	168	366	276	176	30	10	32
Mutual Savings Banks	280	160	279	47	88	111	-2	59	-59	100	28	48	52
Finance Companies	-117	-282	631	486	-59	1,139	1,337	908	783	401	-114	344	575
Bankers Acceptances[2/]	265	404	354	135	121	131	37	44	-117	2	31	121	6
Net Trade Debt	-763	625	-745	-266	708	-1,301	-695	-458	-291	-111	402	420	132
Liabilities	-384	1,143	-348	-48	1,182	-837	-569	-132	-1,108	-307	710	104	-24
Receivables	378	-508	405	217	474	398	153	329	-90	-200	295	-319	256
USES OF FUNDS													
Total Funds Used	14,013	11,511	12,600	11,507	10,118	10,277	9,978	8,708	8,129	8,185	7,183	7,327	6,918
Capital Expenditures	12,769	10,391	11,397	10.302	9,276	9,420	9,271	8,076	7,611	7,672	6,730	7,230	7,453
Plant, Equip. & Other Fixed Capital	11,493	10,336	10,416	9,777	9,072	8,832	8,531	7,501	6,868	7,068	6,508	6,925	6,834
Change in Inventories	1,276	55	981	525	204	588	740	575	743	604	222	305	619
Financial Assets Acquired	1,244	1,120	1,203	1,205	842	857	707	632	518	513	453	97	-535
Consumer Credit	587	451	544	734	451	507	436	391	315	397	196	258	220
Instalment	139	93	77	101	64	110	86	90	39	-24	-1	-50	51
Non-Instalment	448	358	467	633	387	397	350	301	276	421	197	308	169
Insurance Receivables	657	669	659	471	391	350	271	241	203	116	157	131	179
Demand Deposits & Currency	0	0	0	0	0	0	0	0	0	0	100	-292	-934

APPENDIX B

ANNUAL FLOWS OF FUNDS EMPLOYED BY NON-FINANCIAL, NON-FARM, NON-CORPORATE BUSINESSES, EXCEPT HOUSING, 1946-71
--Continued
(Amounts in Millions)

	1958	1957	1956	1955	1954	1953	1952	1951	1950	1949	1948	1947	1946
SOURCES OF FUNDS													
Total Funds Raised	7,900	8,070	8,166	7,711	6,107	5,865	4,851	7,094	6,624	4,156	5,891	5,805	4,491
Internal Financing	8,007	6,648	7,511	5,159	4,214	5,345	4,868	6,559	5,913	4,146	5,190	4,815	3,427
Gross Savings (Capital Consumption)	7,266	6,963	6,832	6,190	5,884	5,677	5,535	5,255	3,960	3,899	3,323	2,747	2,340
Proprietor Net Investment	741	-315	679	-1,031	-1,670	-332	-667	1,304	1,953	247	1,867	2,068	1,087
External Financing	-107	1,422	655	2,552	1,893	520	-17	535	711	10	701	990	1,064
Credit Market Instruments	510	877	998	1,234	236	223	590	492	826	-26	13	681	882
Commercial Mortgages	213	165	172	142	109	65	41	44	9	20	70	106	112
Bank Loans, nec 1/	171	114	623	612	49	69	365	134	415	-242	-323	357	553
Other Direct Loans	145	533	124	615	-35	68	173	295	369	182	266	220	188
U.S. Government	128	33	167	347	204	60	213	275	221	297	190	328	170
Mutual Savings Banks	47	1	5	14	16	9	11	0	6	-6	8	5	13
Finance Companies	-30	499	-48	254	-255	-1	-51	20	142	-109	68	-113	5
Bankers Acceptances 2/	-19	65	79	-135	113	21	11	19	33	14	0	-2	29
Net Trade Debt	-617	545	-343	1,318	1,657	297	-607	43	-115	36	688	309	182
Liabilities	479	34	1,024	-1,354	1,746	808	600	198	1,452	273	1,044	928	1,357
Receivables	1,096	-510	1,365	36	89	512	1,274	155	1,566	235	399	618	1,175
USES OF FUNDS													
Total Funds Used	7,900	8,070	8,166	7,711	6,107	5,865	4,851	7,094	6,624	4,156	5,891	5,805	4,491
Capital Expenditures	6,518	6,921	7,405	7,104	5,291	5,550	4,593	5,609	5,824	3,435	5,549	4,953	4,007
Plant, Equip. & Other Fixed Capital	6,320	6,702	7,214	6,545	5,493	5,294	4,678	5,104	4,647	3,923	4,626	4,895	3,624
Change in Inventories	198	219	191	559	-202	256	-85	505	1,177	-488	923	58	383
Financial Assets Acquired	1,382	1,149	761	607	816	315	258	1,485	800	721	342	852	484
Consumer Credit	-20	174	282	165	92	178	403	297	488	256	364	330	334
Instalment	-101	-52	44	-24	-45	99	154	19	128	118	125	107	46
Non-Instalment	81	226	238	189	137	79	249	278	360	138	239	223	288
Insurance Receivables	117	168	130	149	194	189	203	149	89	99	130	158	139
Demand Deposits & Currency	1,285	807	349	293	530	-52	-348	1,039	223	366	-152	364	11

1/Loans elsewhere classified include: mortgages, consumers credit, security credit, commercial paper, and hypothecated deposits

2/May include farm business

SOURCE: Derived or compiled from Flow of Funds Accounts: Annual Flows, 1946-1971 Board of Governors of the Federal Reserve System, August, 1972.

APPENDIX C

SELECTED FINANCIAL ASSETS AND LIABILITIES OUTSTANDING NON-FINANCIAL, NON-FARM, NON-CORPORATE BUSINESSES, 1945-71

(Amounts in Millions)

	1971	1970	1969	1968	1967	1966	1965	1964	1963
TOTAL LIABILITIES	53,966	50,946	48,172	44,544	40,969	38,403	35,946	33,683	31,684
Credit Market Instruments	38,915	35,511	33,880	29,904	26,281	24,897	21,603	18,771	16,640
Commercial Mortgages	7,046	6,184	5,780	5,358	4,815	4,466	4,023	3,699	3,421
Bank Loans, nec	13,861	12,105	11,730	9,770	8,487	7,967	6,664	5,723	5,252
Other Direct Loans	16,198	15,677	15,229	13,989	12,327	11,932	10,470	8,967	7,634
U.S. Government	7,141	6,783	6,213	5,883	4,754	4,388	4,176	4,008	3,642
Mutual Savings Banks	1,313	1,033	873	594	547	459	348	350	291
Finance Companies	7,744	7,861	8,143	7,512	7,026	7,085	5,946	4,609	3,701
Bankers Acceptances	1,810	1,545	1,141	787	652	532	446	382	333
Trade Debt, Liabilities	15,051	15,435	14,292	14,640	14,688	13,506	14,343	14,912	15,044
TOTAL FINANCIAL ASSETS LESS DEMAND DEPOSITS & CURRENCY	33,951	32,328	30,701	29,092	27,671	26,355	25,099	24,239	23,278
Consumer Credit	10,359	9,771	9,321	8,776	8,043	7,592	7,084	6,648	6,257
Instalment	1,577	1,438	1,345	1,268	1,167	1,103	993	907	817
Non-Instalment	8,782	8,333	7,976	7,508	6,876	6,489	6,091	5,741	5,440
Insurance Receivables	7,172	6,515	5,846	5,187	4,716	4,325	3,975	3,704	3,463
Trade Debt, Receivables	16,420	16,042	15,534	15,129	14,912	14,438	14,040	13,887	13,558

	1962	1961	1960	1959	1958	1957	1956	1955	1954
TOTAL LIABILITIES	30,810	29,714	28,409	27,254	26,066	25,077	24,165	22,143	19,555
Credit Market Instruments	14,658	13,255	12,660	11,609	10,387	9,877	8,999	8,001	6,767
Commercial Mortgages	3,011	2,627	2,319	2,088	1,862	1,649	1,484	1,312	1,170
Bank Loans, nec	4,564	4,223	3,911	3,613	3,234	3,063	2,948	2,325	1,713
Other Direct Loans	6,634	5,957	6,013	5,611	5,000	4,855	4,322	4,198	3,583
U.S. Government	3,366	3,190	3,160	3,150	3,118	2,990	2,957	2,790	2,443
Mutual Savings Banks	350	250	222	174	170	123	122	117	103
Finance Companies	2,918	2,517	2,631	2,287	1,712	1,742	1,243	1,291	1,037
Bankers Acceptances	449	448	417	297	291	310	245	166	301
Trade Debt, Liabilities	16,152	16,459	15,749	15,645	15,679	15,200	15,166	14,142	12,788
TOTAL FINANCIAL ASSETS LESS DEMAND DEPOSITS & CURRENCY	22,850	22,536	21,890	21,819	21,677	20,484	20,652	18,873	18,523
Consumer Credit	5,942	5,544	5,350	5,091	4,872	4,892	4,718	4,434	4,269
Instalment	778	802	803	853	802	903	955	911	935
Non-Instalment	5,164	4,742	4,547	4,238	4,070	3,989	3,763	3,523	3,334
Insurance Receivables	3,260	3,144	2,987	2,856	2,677	2,560	2,392	2,262	2,113
Trade Debt, Receivables	13,648	13,848	13,553	13,872	14,128	13,032	13,542	12,177	12,141

	1953	1952	1951	1950	1949	1948	1947	1946	1945
TOTAL LIABILITIES	17,573	16,539	15,238	14,584	12,316	12,071	10,971	9,363	7,125
Credit Market Instruments	6,531	6,305	5,604	5,148	4,332	4,360	4,304	3,624	2,743
Commercial Mortgages	1,061	995	910	902	902	882	812	706	595
Bank Loans, nec	1,664	1,592	1,160	1,026	610	852	1,133	777	224
Other Direct Loans	3,618	3,550	3,377	3,082	2,713	2,531	2,265	2,045	1,857
U.S. Government	2,239	2,179	1,966	1,691	1,470	1,173	983	655	485
Mutual Savings Banks	87	78	67	67	61	67	59	54	41
Finance Companies	1,292	1,293	1,344	1,324	1,182	1,291	1,223	1,336	1,331
Bankers Acceptances	188	168	157	138	107	95	94	96	67
Trade Debt, Liabilities	11,042	10,234	9,634	9,436	7,984	7,711	6,667	5,739	4,382
TOTAL FINANCIAL ASSETS LESS DEMAND DEPOSITS & CURRENCY	18,148	17,268	15,388	14,787	12,644	12,054	11,161	10,055	8,407
Consumer Credit	4,177	3,998	3,595	3,298	2,810	2,554	2,190	1,860	1,526
Instalment	980	881	727	708	580	462	337	230	184
Non-Instalment	3,197	3,117	2,868	2,590	2,230	2,092	1,853	1,630	1,342
Insurance Receivables	1,919	1,730	1,527	1,378	1,289	1,190	1,060	902	763
Trade Debt, Receivables	12,052	11,540	10,266	10,111	8,545	8,310	7,911	7,293	6,118

SOURCE: Derived or compiled from Flow of Funds Accounts: Financial Assets and Liabilities Outstanding, 1945-1971, Board of Governors of the Federal Reserve Systems, June, 1972.

Senator HUMPHREY. We will now hear from Governor Henry C. Wallich, member, Board of Governors of the Federal Reserve System.

STATEMENT OF HON. HENRY C. WALLICH, MEMBER, BOARD OF GOVERNORS, FEDERAL RESERVE BOARD, WASHINGTON, D.C.

Governor WALLICH. Mr. Chairman, I am happy to be here and have this opportunity to present my views on some financial issues of concern to small business. I have focused on the overall supply and demand for capital because I believe this is a very decisive matter for small business.

In my opinion, based on the evidence, the United States faces the danger of a possibly serious capital shortage. Over 9 million small business firms must compete with other sectors of the economy for the available supply of capital. For all users of capital—small business, homeowners, other consumers, large businesses, State and local authorities, and last, but by no means least, the Federal Government—an adequate supply of capital is important.

Historically, the total volume of gross savings and investment in the American economy has been remarkably stable at about 15 percent of our GNP, to which one might add another 2 percent to allow for public construction. Other countries count the latter as part of gross savings and investment, and I do not see why we could not add it to ours, but statistically we do not. This rate is modest in comparison to other countries. In many European countries, the savings and investment rates are around 25 percent of GNP; some developing countries save in the order of 20 percent of GNP; and Japan at times has saved and invested as much as 40 percent of its GNP. That accounts for the enormous growth of the Japanese economy and the great flow of capital in that economy. The 15-percent savings rate in our economy, however, is deeply embedded in the structure of our economy and no great changes ought to be expected. What we have to be concerned about are small, but nevertheless critical, increases and decreases in particular sectors of the economy.

I would like to focus first on factors influencing the demand for capital. Most of the new investment needs are familiar, although not easy to quantify. There is investment related to energy and to the restructuring of the economy to reflect higher energy costs. Some of these additional investments—for environmental improvements, health and safety on jobs, and mass transit—stem from political decisions that we, as a Nation, have made. There are some potential areas of reduction of investment requirements in housing, urban construction, schools and hospitals, and inventory investments. Demographic and economic factors are likely to bring some reductions in these areas. On balance, however, I believe that the required increases in investment will outweigh the cutbacks by a margin of the order of 1 percent of GNP, which is approximately $15 billion at the present time.

It has been argued that because we have so much excess capacity we do not need to invest as much over the next few years as we have in the past. I think that view is unfounded. First of all, a capacity utilization rate in manufacturing of 69 percent, as experienced recently, does not mean that something like one-third of our effective capacity stands idle. We have some capacity that is not used because it has become eco-

nomically obsolete. We have seen widespread shortages arise when the capacity utilization rate on average is still in the lower 80's. Therefore, one cannot look to these capacity figures as evidence that we have plenty to spare and do not need to invest. We also have had a dramatic increase in our labor force in recent years, and I doubt that we have the capacity to supply jobs for everyone—even if the demand were there. The labor force is now growing less rapidly than it did, but still substantially; and it may turn out when the economy gets back to full employment that our capital stock, rather than being too large, is too small to provide jobs for all.

Now I would like to turn to the sources of supply of capital, which are essentially the three familiar ones: Personal savings, business savings, and Government savings. The Government may be a net saver or a net user of capital. The aggregate of these savings, with minor qualifications, is equal to aggregate investment.

Personal savings in recent years have amounted to about one-third of total savings. They have varied with the business cycle but have otherwise been fairly stable at about 5 percent of GNP. At the present time, personal savings are high, probably reflecting the concern of savers about the stability of their jobs, inflation and its impact on living standards, and an effort to make up for the inflation losses to their past savings. As inflation abates and the economy recovers, personal savings are likely to move back to their long-term rate.

Corporate savings have trended downwards in recent years, if we allow for the overstatement of profits resulting from the inclusion of inventory gains, which contribute no investable funds, and do not solve any capital shortage. In 1974, this overstatement amounted to $35.1 billion.

For the small business sector, we have some interesting data that bear not so much on aggregate profits, but on the profit margin. For small business with assets of less than $1 million, profits per dollar sales have moved in the very modest range of 1.5 to 3.5 cents. This is a very low rate of profit, which evidently creates problems in accumulating funds for investment.

The fact that profits per dollar of sales went as high as 3.5 percent reflects in part the difficulty many small businesses encounter in protecting themselves from spurious inventory profits—and the taxes thereon—by using sophisticated techniques like LIFO accounting, that require specialized expertise. It would be very helpful if simplified forms of LIFO, and simplified methods of accelerated depreciation, could be made available for the use of small business.

Now, let me sum up the outlook for savings. As personal savings return to their historical levels and with business savings, realistically stated, at a lower level, the key to an adequate flow of savings is in the hands of Government—in particular the Federal Government. Historically the Federal Government has shifted back and forth as a supplier and as a user of savings—in recent years, obviously most often as a net borrower. In recesssions this is an appropriate fiscal policy. When the economy begins to get to full employment, the Government begins to compete with the private sector and the danger of "crowding out" private projects begins.

The full employment surplus is one measure of the stance of the Federal Budget and is a useful tool if correctly interpreted. At the

present time, a full employment surplus by some experts is estimated to be a deficit of $10 billion. In other words, full employment along with current tax and expenditure policies would produce a deficit of $10 billion. That means that the Government, at full employment, would be taking $10 billion out of the economy and there would be less for all of us, including of course small business. That does not mean that when the economy recovers from the recession there will still be a full employment deficit, because if expenditures are controlled and the taxes are not reduced any further, the situation will shift from a full employment deficit to a full employment surplus. But if expenditures increase at the pace of recent years, there will not be a shift to a full employment surplus. Instead, there will very probably be a full employment deficit, and the Federal Government, instead of supplying savings, will be draining them away.

Now, I would like to summarize very briefly the findings of various experts, most of whom concluded that there is not going to be a capital shortage. I hope they are right, but I think they are wrong.

There are two categories of experts in this game. One of them concludes that investment needs are going to be high, and I think they are right on that.

Senator NELSON. They are what?

Governor WALLICH. Investment needs will be high.

They point to the environment, energy, mass transit, and so forth, saying we have to invest more; but when they come to their estimates of available savings, they say the Federal Government will have a large surplus which is going to cover the deficiency of savings in the private sector. There is a second group of experts who say that our investment needs in the private sector are not going to be very high. But they are realistic about saying that in all probability the Federal Government will run a deficit, so they come up with a realistic estimate of the Federal deficit and compensate for that by what seems to me an unrealistic estimate of our needs for investment in the private sector.

I put together the two things I think are realistic: High capital needs in the private sector and the Federal deficit, and conclude that there is likely to be a capital shortage. That is what I fear and that is why I am making the point that the Federal Government really has the key to this.

I will not take too much more time, Mr. Chairman. Let me propose a change in the corporate tax system that would help to relieve some of the financing problems that the Secretary and Mr. Laun have referred to. The proposed tax change, by itself, will not correct the overall capital shortage but will ameliorate the financing difficulties of business. Today, many businesses have been drained by liquidity. Their capital structure has deteriorated, debt has risen relative to equity, short-term debt until recently has risen relative to long-term debts, and outside financing has increased relative to inside financing—all of which makes further financing more difficult.

There are many suggestions for improving this situation. They are well known, such as an enlarged investment tax credit, depreciation facilities more realistically recognizing inflation, tax deductability of dividends, an outright cut in the corporate tax rate and—at the individual taxpayer level—adjustment of capital gains taxes for inflation, reduction in the capital gains rate for longer holding periods, and in-

tegration of personal and corporate income taxes. These techniques all work to relieve the financial bind. However, they mostly share the disadvantage of reducing the Treasury's revenue and shifting the distribution of income in the direction of greater inequality, or at least of partly reversing a move toward greater equality that may have occurred. A loss of Treasury revenue, besides, means more Treasury borrowing and to that extent does not help resolve the capital shortage.

If it is our objective to avoid a loss of revenue and a shift in the income distribution, it would still be possible to improve the capital structure of corporations and facilitate financing. My suggestion is that we change the corporate income tax so as to tax not only income going into dividends and retentions, but also that part of net operating income that is used to pay interest.

It sounds very ominous to make interest nondeductible, but it is possible to reduce the tax rate on these three flows of the corporate income—and dividends, retentions, and interest—and still raise the same revenue. The income distribution will be unchanged, the Treasury will not be deprived of revenue, and the Treasury will not be compelled to go into the market to borrow back money, thereby taking away with one hand what it gave with the other. Such improvements cannot be accomplished overnight, quite clearly, but I think the technical means exist for implementing the change.

I would think that serious consideration should be given to this kind of an approach to corporate income tax reform that does not reduce tax revenues, but simply removes the bias in favor of debts so as to encourage issuance of equity.

Thank you very much.

Senator HUMPHREY. Thank you very much.

Thank you for your constructive suggestions, here, and I am sure they are provocative.

Governor WALLICH. Thank you.

[The prepared statement of Governor Wallich follows:]

FOR RELEASE ON DELIVERY

Statement by

Henry C. Wallich
Member, Board of Governors of the Federal Reserve System

Before the

Joint Economic Committee

and the

Senate Select Committee on Small Business

Washington, D.C.

Friday, November 21, 1975

I am happy to have this opportunity to appear before the Joint Economic Committee and the Senate Select Committee on Small Business to present my personal views on some financial issues of concern to small businesses. In accordance with indications received from the Committee, I intend to address myself to problems concerning the overall supply of and demand for capital.

For small business, this overall supply and demand situation is of course of great importance. In my opinion, based on the evidence, the United States faces the danger of a possibly serious capital shortage. Over 9 million small business firms, according to data supplied by the Small Business Administration, must compete with other sectors for the available supply of capital. For all users of capital -- small businesses, homeowners, other consumers, large businesses, State and local authorities, and last but by no means least the Federal Government -- an adequate supply of capital is important.

Historically, the total volume of gross savings and investment in the American economy has averaged about 15 per cent of GNP, to which one might add perhaps another 2 per cent to allow for public construction. This rate, of course, is modest compared to the savings of many European countries, ranging around 25 per cent of GNP, and even those of some developing countries, surpassing 20 per cent in quite a few instances, to say nothing of Japan, which at times has saved and invested as much as 40 per cent of its GNP. But our comparatively modest rate of saving and investment is deeply embedded in the structure of our economy.

Major changes do not seem to be in prospect. What we have to be concerned about are small but nevertheless critical increases and decreases in particular sectors of the economy.

First I would like to review briefly the factors influencing the demand for capital. Most of the new investment needs that add to our regular capital requirements and thus may call for an increase in total saving are familiar, although not easy to quantify. The most important of them relate to energy and to the restructuring of parts of our economy reflecting higher energy costs to the environment, health and safety on jobs, and mass transit. Some of these additional investment outlays are required by political decisions that we, as a nation, have made. Some declines in sectoral investment requirements also seem ahead, especially in the areas of housing, urban construction such as schools and hospitals, and inventory investment. These, for the most part, reflect demographic and economic influences. On balance, I believe that the required increases in investment will outweigh the cutbacks by a margin of the order of 1 per cent of GNP.

It has been argued that the high existing excess capacity in industry will allow us to invest less in plant and equipment over the next few years than we have on average in the past. This, some observers have said, means a cutback in our total investment requirements. I regard this view as unfounded. A capacity utilization rate in manufacturing of 69 per cent, as experienced recently, does not mean that almost one-third of our effective capacity stands idle. In 1973 and

1974, severe and widespread shortages were experienced while that index stood only a little above 80 per cent. Moreover, the changing price of energy is bound to have made some of our capacity obsolete, while changing consumption habits, technological advances and environmental factors probably have rendered another part inoperative.

Our labor force has increased dramatically in recent years, and I very much doubt that we have enough capacity to supply jobs for everyone even if the demand were there. The peak rate of labor force growth seems to be behind us, but rates of labor force growth of 1.6-1.8 per cent per year are still projected through the early 1980's. Thus, once the effects of the recession are overcome, our capital stock, in view of our growing labor force and the need for more jobs, may well turn out to be too small rather than too large.

Allow me to turn next to the sources of supply of capital. There are essentially three: personal savings, business savings, and government savings (which could be positive or negative). The aggregate of these savings, of course, is equal to aggregate investment.

Personal savings in recent years have amounted to about one-third of total savings. They have varied with the business cycle but have otherwise been fairly stable at about 5 per cent of GNP. At the present time, personal savings have tended to rise above these long-term savings rates, probably reflecting concern of savers about the stability of their jobs, inflation-induced uncertainty about future living standards, and an effort to make up for the loss in the purchasing power of past

savings. As inflation abates and the economy recovers, personal savings, if precedent is a guide, are likely to move back to their long-term rate.

Corporate savings have trended downward in recent years, if we correct for the overstatement of profits resulting from the inclusion of inventory gains, which contribute no investable funds. In 1974, this overstatement amounted to $35.1 billion.

For the small business sector, these macroeconomic profit data find a concrete counterpart in the behavior of after-tax earnings per dollar of sales in manufacturing. For firms with assets of less than $1 million, profits per dollar of sales have moved approximately in the very modest range of 1.5-3.5 cents. The high second figure reflects in part the difficulty many small businesses encounter in protecting themselves against the appearance of spurious inventory profits -- and the taxes thereon -- by resort to sophisticated accounting techniques such as LIFO (Last In First Out). I might add that small business profits, besides supplying resources for expansion, perform an important social function in diffusing profits among a large number of claimants. Thus, making more accessible to small business simplified forms of LIFO and accelerated depreciation would produce significant benefits in terms of greater small business savings.

The conclusion with respect to the outlook for saving is simple: with personal savings likely to return to historical levels, and with business saving, realistically stated, at a lower level, the

key to an adequate flow of savings is in the hands of government, in particular the Federal Government. Historically the Federal Government has shifted back and forth between surplus and deficit with deficits preponderating by far in recent years. Thus the Federal Government has occasionally been a saver and supplier of capital to the economy, while more often it has been a net borrower, drawing capital from the private sector. In recessions, of course, the latter stance often has represented an appropriate fiscal policy. The danger that a Federal deficit might compete for savings with the private sector and "crowd out" some would-be borrowers rises as the limits of the private sector's ability to generate savings are being approached.

The full employment surplus is one measure of the stance of the Federal Budget, useful if correctly interpreted. It tells us what the surplus, i.e., the savings, of the Federal Government would be at a benchmark level of economic activity. At the present time, a plausible estimate of this hypothetical magnitude reveals that the full employment surplus is in fact a deficit of $10 billion. This estimate, which suggests that the Federal Government would be competing severely for capital with the private sector if we now were at full employment, does not, of course, tell us what would happen hereafter once the economy recovers from recession. If expenditures are held down, and taxes are not reduced further, the budget would move into substantial full employment surplus. But if expenditures increase at the pace of recent years while revenues rise only in response to rising

economic activity, the prospect in my opinion is for a full employment deficit even at high levels of economic activity.

It may be useful to the Committee to note very briefly the results of a number of quantitative studies made by various experts concerning the outlook for the balance of demand and supply of capital. My reading of these studies is that a real concern is in order over the prospect of a capital shortage, although most of the authors would not agree with me and are in no way responsible for my conclusions.

Most of these studies essentially fall into two categories. One group arrives at fairly high estimates of the capital needs of the private sector, for much the same reasons that I have given in this testimony. Most of these authors, however, tend to assume that the government will produce a surplus and thus cover the capital deficit of the private sector. A second group, more realistically in my view, projects a Federal deficit. At the same time, however, this group tends to envisage a lower rate of investment in the private sector, which would make room for the government deficit. If the second group is right with respect to their expectation of a Federal deficit, a high rate of investment in the private sector clearly would produce a capital shortage.

A significant capital shortage clearly would be adverse to small business, as it would be for all sectors. This prospect, as I have noted, hinges essentially on the outlook for the Federal Budget.

In addition, however, there are problems of a financial order that need to be overcome if small as well as large businesses are to have adequate access to the flow of financing.

Today many businesses find it harder to finance because their liquidity has been drained. They have seen their capital structure deteriorate, with debt rising relative to equity, and short-term debt, at least until very recently, rising relative to long-term debt. A variety of measures has been suggested that would improve both conditions by raising cash flows and enabling enterprises, large and small, to improve their capital structure. Familiar proposals of this sort involve an enlarged investment tax credit, depreciation facilities more realistically recognizing inflation, tax deductibility of dividends, an outright cut in the corporate tax rate and, at the individual taxpayer level, adjustment of capital gains taxes for inflation, reduction in the capital gains rate for longer holding periods, and integration of personal and corporate income taxes. All these techniques have advantages. However, they mostly share the disadvantage of reducing the Treasury's revenue and of shifting the distribution of income in the direction of greater inequality, or at least of partly reversing a move toward greater equality that may have occurred. A loss of Treasury revenue, besides, means more Treasury borrowing and to that extent does not help resolve the capital shortage.

If it is our objective to avoid a loss of revenue and a shift in the income distribution, it would still be possible to improve the capital structure of corporations and facilitate financing. This could be done by removing or reducing the bias in favor of debt as against equity that is a familiar feature of the corporate tax system. In order to accomplish this, I would suggest a sharp reduction in profit tax rates while at the same time including interest in the tax base. The same revenue could then be raised, as with the present higher rates under which interest remains tax exempt. This would diminish the present bias of the tax system in favor of debt financing. It would favor equity financing at no cost to the government, improve capital structures of business, and permit easier financing.

Implementation of such a tax on net operating income (interest plus profits before taxes) would, of course, require a phasing in process, to avoid the severe impact on enterprises with above-average debt that would result from sudden non-deductibility of interest, even at a moderate rate. This could be done by phasing in the change over a number of years, so that a growing fraction of interest paid would become nondeductible over time and a growing fraction of dividends would be taxed at the reduced rate. Alternatively, it could be done by applying the tax change to debt and equity issued after enactment.

The first method -- phasing in gradually -- exerts only limited pressure toward more equity financing in the early years and for that reason seems less desirable, even though it has administrative

advantages. The second method -- application to new debt and equity only -- would immediately end the existing bias in favor of debt financing. It poses administrative difficulties because in effect there would be two tax rates, one on old debt and equity and another on new. Regulations would have to be written with a view toward closing the obvious loopholes that such a situation presents.

It should be stressed once more that the foregoing tax changes would do no more than to improve the structure of business capitalization and thereby ease corporate financing. They would not, by and of themselves, increase the supply of saving. The number of devices that have been suggested to increase saving is large, and most of them have been so thoroughly discussed that there is no need here to pass them in review. Most of them share the defect of making the distribution of income more unequal. It seems desirable to emphasize tax and other reforms that would facilitate financing without such consequences.

Senator HUMPHREY. Our next witness is Mr. Needham.

STATEMENT OF HON. JAMES J. NEEDHAM, CHAIRMAN, NEW YORK STOCK EXCHANGE, INC.

Mr. NEEDHAM. My name is James J. Needham. I am chairman of the board of directors and chief executive officer of the New York Stock Exchange, Inc.

The small businessman has been described as America's "new forgotten man"—and I appreciate this opportunity to contribute to this committee's evident intent to show that while he may have been neglected for a while, Congress has not really forgotten him.

In deference to the committee's request that oral statements be kept brief, I should point out that my remarks this morning are elaborated in considerable detail in the longer statement that the exchange has filed for the record of these hearings.

I would also like to submit at this time a series of four research studies recently completed by the exchange on the future of the U.S. capital markets.

Ideally, the long-term thrust of this committee's efforts could be to eliminate the need for an agency such as the Small Business Administration—by helping to create an economic climate in which deserving small enterprises would not have to look to Government for financing assistance.

Right now, however, the need is perhaps greater than ever before, while the neediest are least likely to obtain help. With the SBA's direct lending authority severely restricted by budgetary constraints—and with SBA-guaranteed loans limited for a variety of reasons stemming from the lending policies of commercial banks—the odds against starting up or sustaining an innovative or high-risk enterprise are, to say the least, intimidating.

Significantly, small business investment companies—the privately owned SBIC's established exclusively to furnish financial and advisory services to small businesses—also tend to invest primarily in larger small businesses.

One recent study showed that over a 13-year period, small companies with assets of $1 million or more obtained nearly 40 percent of all SBIC disbursements, while companies with assets of less than $50,000 received less than 15 percent.

Moreover, many of the smaller SBIC's which, typically, helped finance the smaller enterprises, have themselves been going under—further aggravating an already discouraging situation.

Indeed, the combination of recession and the relative scarcity of capital for small business has inexorably driven smaller businesses into the ground.

More than 8,000 U.S. businesses failed during the first 8 months of this year—a 20-percent increase over the comparable 1974 period. And while a W. T. Grant may get most of the headlines, the disappearance of hundreds or thousands of smaller companies arguable has a deep and pervasive effect on the national economic well-being.

The massive capital formation problems facing the Nation in the decade ahead are documented in considerable detail in the series of exchange studies I have submitted for the committee's consideration.

One of our principal conclusions is that U.S. corporations will have to raise an average of $23 billion a year in new equity capital alone between now and 1985. That annual sum is more than double the amount raised in 1971, the peak year for equity financing by non-financial corporations.

The prospect is that a large equity gap will develop in the context of an overall capital deficiency. We project that the national demand for capital could outstrip the available supply of savings by some $650 billion through 1985. This could conceivably force a downward reorganization of our national economic priorities, accompanied by increasing unemployment and inevitable serious political and social repercussions.

Closer to the point of this committee's current inquiries, it should be obvious that while a major capital shortage will have a powerful impact on all sectors of the economy, small business will be particularly vulnerable. And small business is, of course, the grassroots of our national economic structure.

Professor Irving Kristol of New York University has written eloquently of the value of small business in America. The following brief excerpts from an article that appeared just 8 days ago in the Wall Street Journal make clear why every one of us, in government and in the private sector, cannot help but be deeply concerned with the present plight of small business:

"Small business," writes Professor Kristol,

> is integral to that diffusion of power and wealth, and to the economic and social mobility which are the hallmarks of a liberal society.
>
> It is the successful small businessman who maintains his roots in a local community and supports all those local activities—social or cultural—which keep community and morale high. And it is in the small business sector that those who are discriminated against, whether it be for their politics, race or religion, can find and have traditionally found sanctuary.
>
> Indeed, when we talk about liberal capitalism we are talking specifically about a political-economic system in which small business is given the opportunity not only to survive, but to prosper.

Clearly, if the small businessman is in trouble now, the prospect of a severe national capital insufficiency point to far worse problems ahead for him.

The deceptively easy solution, of course, would be to make it easier for small business people to borrow. But U.S. corporations of all sizes are already heavily in debt, many of them right up to the limits of prudence.

Back in New York, we are all too painfully aware of how excessive confidence in the ability to borrow can threaten a municipality's independence. For the small entrepreneur—whose borrowing power is sharply limited to begin with—the perils of excessive debt financing, and the prospective loss of independence, cannot be overstressed.

Recognizing that too heavy debt structures have come to characterize virtually every area of financial management in the United States today—from the Federal Government itself to the smallest struggling private enterprise—the New York Stock Exchange has strongly emphasized the importance of counterbalancing debt with equity financing.

At the same time, we have repeatedly pointed out that risk-oriented equity financing efforts can succeed in attracting adequate amounts

of capital to the corporate sector only if our Federal tax laws stop treating investment profits as if they were the damnable progeny of some kind of economic adultery—and investment losses as though they were a suitable punishment for the sin of trying to earn a profit.

These misguided concepts underlying our tax laws discriminate particularly against small business. Investors will assume greater risks only if they have some assurance that the greater part of their gains, if a risky venture succeeds, will not wind up in the Federal Treasury—and if they know they will be able to deduct fully any capital losses sustained in the course of helping to finance such enterprises.

As many members of this committee are aware, the New York Stock Exchange has offered Congress a comprehensive program for a major overhaul of the investment tax laws.

In addition to calling for liberalization of the treatment of capital gains and losses, we have strongly urged at least partial elimination of existing double taxation of distributed corporate earnings—a step that would, on the one hand, ameliorate a patently unfair measure that has led many corporations to rely excessively on debt financing; and, on the other, give millions of investors additional incentives to commit their savings to equity ownership.

We have a number of additional suggestions for specifically aiding small businesses. To begin with, the 1975 temporary tax benefits—including the $50,000 surtax exemption and the reduced base corporate tax rate of 20 percent—should be made permanent at those levels.

Congress may also wish to explore the possibility of extending the progressivity feature of the corporate profits tax.

One specific suggestion made by Professor Kristol, that the tax be graduated up to $2 million of corporate income after which a flat 48 percent rate would apply would seem to merit careful study.

The dependence of small businesses on external sources of capital could be reduced by modifying existing "Keogh Plan" provisions to permit small business people to invest in their own enterprises.

At present, noncorporate taxpayers can establish pension-profit-sharing plans by deferring taxes on as much as 15 percent of each eligible employee's compensation—to a maximum of $7,500 a year. The deferred income can be placed with specified types of financial intermediaries or can be invested in corporate and other securities.

We believe the small businessman should be permitted to obtain similar tax advantages by investing in his own business. This would help provide an additional source of capital for small businesses, with really no long-term tax loss to the Treasury. The reinvested funds would still be subject to the tax, which would merely be deferred.

In another area, the present method of accounting for depreciation—based on historical costs rather than, more realistically, on replacement costs—severely affects small business cash flows. The value of the investment tax credit is often lost to small businesses because they have insufficient taxable income.

We believe it would be desirable to examine in detail how the concept of the investment tax credit might meaningfully be extended to small business enterprises.

The exchange also strongly supports congressional efforts to simplify the tax laws for small businesses which often do not have access to the kind of accounting and tax-planning expertise routinely available to larger organizations.

In many instances, smaller business may end up by paying higher taxes than they should, simply because they do not make full use of favorable tax provisions.

Obviously, where this is the case, the small businessman suffers a very special—if not very visible—competitive disadvantage.

I would hope that the various congressional committees now examining the problems of small business will develop some welcome initiatives aimed at helping small business people cope with the intricacies of the Internal Revenue Code.

However, the possibilities for providing legitimate assistance to small business are not limited to tax-related measures.

For example, small business investment companies could play a greater role than they now do in generating equity capital for smaller enterprises. Many SBIC's have been plagued by inadequate capitalization, poor management and less-than-astute investment decisions—all of which have limited their ability to respond to the needs of fledgling enterprises.

One way to help remedy these problems might involve reexamining the current restrictions on the extent to which commercial banks may participate in SBIC's—with a view to enabling them to help improve the investment companies' management and capital bases.

Additional attention should also be directed to providing venture capital for minority-owned businesses. At year-end 1974, some 70 investment companies licensed under section 301(d) of the Small Business Investment Act were operating in 26 States, the District of Columbia, and Puerto Rico, with $65 million available for investment in minority-owned enterprises.

But while existing programs have helped boost the number of minority group enterprises in recent years, much more needs to be done to bring minority entrepreneurs into the business mainstream.

For example, a number of so-called "packaging" organizations—such as the Rochester Business Opportunities Corp., and the Chicago Economic Development Corp.—today are helping minority businesses prepare to participate in the credit markets.

More such organizations are needed to assist fledgling businesses in preparing feasibility studies, cash flow and balance-sheet projections and related financial documentation which really are essential prerequisites for obtaining needed capital from lenders or investors.

Both Congress and the private sector should be trying to find ways of funding additional "packaging" facilities in major economic centers across the country.

Although I would be one of the last people in this country to support the pernicious notion that Federal credit allocation should in any way supplant free market competition, I do believe it may be desirable to assure risk-prone but meritorious smaller enterprises that they will have full and equal access to sources of credit. This is not to suggest that credit be made indiscriminately available to each and every fly-by-night operator who may seek it—far from it.

But it is a fact that the commercial banking industry is disposed to prefer lending to larger, better-established corporations—and it is also a fact that lending to smaller businesses, however promising their prospects, is much riskier.

The tendency of commercial banks to stress high-quality loans and liquid investments has been strengthened by recent losses stemming

from investments in and loans to real estate investment trusts and other shaky enterprises—to say nothing of investments in certain illiquid municipalities.

The so-called "flight to quality"—combined with the inability of banks themselves to raise adequate equity capital—has virtually deadened whatever enthusiasm commercial bankers may once have had for making small business loans.

Two constructive measures to help overcome these problems would require the cooperation of the Federal Reserve System.

The Fed could, for example, encourage commercial bank lending to smaller enterprises by providing sufficient overall reserves to permit the maintenance of adequate bank liquidity.

And second, some thought might be given to the pros and cons of reducing the reserve requirements on small bank loans.

Finally, there is the question of regulatory reform. Recent reports have shown that Federal and State regulatory agencies often develop guidelines and standards based only upon their perceptions of the practices of the larger corporations in a particular industry. The resulting regulations can often prove disastrous for smaller businesses unless the Small Business Administration is able to intervene in time.

Congress might consider requiring regulatory agencies to submit small business impact statements to the SBA in advance of implementing them, to help assure that new measures will not discriminate against one sector or another.

In conclusion, I believe it should be axiomatic that a better overall investment climate in this country would make it easier for all well-managed enterprises—large and small—to attract urgently needed capital.

But we must also recognize that the Federal Government must put its own house in order as the first major step in developing a healthier economic climate. Federal budgetary deficits, in particular, must be scaled down as the economy moves further along the recovery path.

The omnipresence of Government in the credit markets tends to place a floor under interest rates—automatically increasing the borrowing costs of the private sector.

Once the budget is brought under reasonable control, however, the Federal Reserve will be in a better position to develop the type of accommodation monetary policy needed to sustain productive business expansion.

Mr. Chairman, that concludes my statement. I would like to add only that it is a rare privilege for me to appear before a committee of Congress—and to strongly support a congressional effort—on a matter in which I do not believe anyone can purport to find a parochial interest for the New York Stock Exchange.

Unless, of course, someone chooses to remind us that yesterday's small, innovative Haloid Co., is today's internationally known Xerox Corp.—whose shares are listed and traded on the exchange. But I believe most of us would agree that is what private enterprise capitalism is all about.

Thank you.

Senator HUMPHREY. Thank you very much for a fine statement. I see we have a great deal of literature, and we will make this a part of the record.

[The documents follow:]

STATEMENT BY JAMES J. NEEDHAM, CHAIRMAN, THE NEW YORK STOCK EXCHANGE, INC., FILED WITH THE JOINT ECONOMIC COMMITTEE HEARING ON THE CAPITAL FORMATION PROBLEMS OF SMALL BUSINESS

November 21, 1975

Over the past year, the New York Stock Exchange has been alerting the nation to the danger of a major capital shortage in the decade ahead. The Exchange has published four major research studies on this critical issue. In September 1974, the first of these reports -- The Capital Needs and Savings Potential of the U.S. Economy -- focused on the prospect that, through 1985, America's capital needs could exceed the available supply of savings by some $650 billion. The second study, released in February 1975, The Need for Equity Capital, analyzed the serious deterioration in corporate balance-sheet positions. Demand and Supply of Equity Capital, the third report in this series, was issued in June 1975. It centered on the future equity capital needs of U.S. industry, indicating that U.S. corporations will have to raise an average of $23 billion a year in new equity capital between now and 1985. This sum is more than double the amount raised in 1971 -- the peak year for equity issues by non-financial corporations. The final report, International Implications of a United States Capital Shortage, examined the effect that a shortfall in savings in this country would have on

world capital markets and other national economies. This study was released in conjunction with the NYSE-sponsored Conference on Encouraging International Capital Flows, held in New York on September 22nd. Copies of all four reports are submitted for the record.

The Exchange's views on America's capital needs have been supported by independent research undertaken by numerous other organizations and knowledgeable individuals. For example, the Brookings Institution has published a report on Capital Needs in the Seventies which concluded that periods of capital stringency are likely unless the Federal government is able to run a budgetary surplus. In viewing the capital shortage issue, it should be recognized that several periods of capital deficiency have been experienced over the past decade. They were labeled years of "disintermediation," or "crunch," or "crisis," and they always produced rising interest rates reflecting an inadequate supply of savings. Such years as 1966, 1969, and 1974 illustrate what we mean by capital shortage. Their recurrence in the future appears likely. Significantly, when investment funds are in short supply, small business is prominent among those squeezed out first and hardest.

Importance of Small Business

While the effects of a capital shortage will impact on all sectors of the economy, small business will be particularly hard hit. This should be a matter of major concern for Congress --

and for all Americans. The small businessman represents the innovative and entrepreneurial heart of the free enterprise system. It is through the initiative and determination of small businessmen that new products, such as the Xerox copier, Polaroid camera and mini-computers have come to market.

Professor Irving Kristol, writing in the November 13 issue of the Wall Street Journal, eloquently spoke of the value of small business in this country.

> Small business...is integral to that diffusion of power and wealth, and to the economic and social mobility which are the hallmarks of a liberal society. It is the small businessman who builds up these large fortunes which then help sustain the not-for-profit sector -- the universities, foundations, philanthropies --which is so important a buffer between the public and private sectors.... It is the successful small businessman who maintains his roots in a local community, becomes a visible symbol of success to everyone, gives the politicians in our smaller towns and cities their own access to funds...and supports all those local activities -- social or cultural -- which keeps community morale high. And it is in the small business sector that those who are discriminated against, whether it be for their politics, race or religion, can find and have traditionally found sanctuary. Indeed, when we talk about liberal capitalism we are talking specifically about a political-economic system in which small business is given the opportunity not only to survive, but to prosper.[1]

A capital shortage will directly affect small business by making it more difficult for these companies to secure adequate financing at reasonable costs. Smaller companies are always

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1/ Irving Kristol, "The New Forgotten Man," Wall Street Journal, November 13, 1975, p. 20.

"last in line" at the credit markets. In the face of an inadequate supply of investment capital, the smaller firm will be left out in the cold.

Effects of Lopsided Financial Structures

Our research studies point not only to an over-all capital deficiency to finance an adequate rate of economic growth, to achieve greater energy production, and to meet minimum demands of society for an improved environment, but they also highlight the financing problems generated by lopsided balance sheets. Even large corporations are currently experiencing great difficulty obtaining adequate financing in the form in which they need it, particularly in the form of new equity capital.

Dr. Benjamin M. Friedman, a member of the Economics Department at Harvard University, focused in on the linkage between economic growth, investment and financing capabilities in a recent article in the Sloan Management Review:

> A major key to the U.S. economy's growth, once the current recession has ended, will be fixed investment for a wide range of basic plant and equipment needs.... To an unusually great extent, financial considerations may act during this period as effective constraints on the amount of fixed investment which the economy in aggregate is able to do. During 1977-81 financial constraints may well constitute a greater determinant of the basic course of U.S. economic events than has been the case at anytime during the post World War II era.... Financing this fixed investment, a task which must combine a redirection of financial flows with an expansion of total flows, will be the major problem confronting the money and capital markets. As business undertakes more investment in the

> aggregate, any individual investment project will have to face increasingly severe competition for financing, since the financial markets' expansion at the margin will be due not to an oversupply of funds but to the pressure of demand for funds for fixed investment purposes.2/

Severe financial strains are already being reflected through adverse movements in a number of key balance-sheet ratios. For example, the debt/equity ratio for larger manufacturing corporations rose to nearly 43% in the first quarter of 1975, compared with 41% a year earlier and 30% just ten years ago. Interest coverage -- the measure of a corporation's ability to meet interest payments on its debt -- fell to a record low of only 4.1 times pre-tax profits for all non-financial corporations, compared with 5.8 for all of 1974 and 11.8 just a decade ago. The ratio of liquid assets to short-term indebtedness has also been plummeting -- from 95% in 1965, to 61% in 1970 and 51% last year, with a further decline to below 50% likely for the first half of this year.

The debt maturity ratio (bond indebtedness divided by short-term indebtedness -- excluding trade payables) has also plummeted for larger companies. This measure had fallen by year-end 1974 to a post-war low of nearly 1 to 1 -- compared with 1.37 in 1965 and 1.30 in 1970 -- mainly because of the massive turn to bank

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2/ Benjamin M. Friedman, "Financing the Next Five Years of Fixed Investment," Sloan Management Review, Spring, 1975, p. 52.

borrowing by major corporations in 1972-74. For manufacturing companies with more than $1 billion in assets, bank borrowing increased to approximately 5% of total assets in the first half of this year, more than double the 2.3% rate seen in 1965.

Sources of Financing for Small Business

Commercial Banks

The financing problems of small business will be greatly affected by the severe deterioration in the balance sheet positions of major corporations. In particular, as larger companies turn increasingly to commercial banks for funds -- which should happen as the economy picks up steam -- smaller borrowers may find themselves pushed even further to the rear of the borrowing queue. Since commercial banks are the chief source of small business financing, the possibility of major cutbacks in small business lending should not be viewed lightly.[3]

Developments within the banking industry, unrelated to small business, appear to have already reduced significantly the availability of small loans. Commercial banks have been hit by a constellation of adverse circumstances. Perhaps most important has been the damage done to bank balance sheets by double-digit inflation and the accompanying tight credit conditions of recent years.

3/ Small businesses borrow from commercial banks at a far higher rate than do larger corporations. For the first half of this year, the bank borrowings of small manufacturing companies were at a rate of 14% of total assets, nearly triple the 5% rate for major manufacturing corporations.

To raise funds, banks have increased their own short-term debt in the form of certificates of deposit. These instruments soared from $40 billion outstanding at the end of 1972 to $80 billion two years later. This increase in bank liabilities occurred at a time when stock prices were severely depressed, making new bank equity financing too difficult and too costly. With bank debt rising and new bank equity unavailable at acceptable costs, the financial structure of commercial banks, as measured by their debt to equity ratios and other balance-sheet items, deteriorated.

Moreover, funds raised by escalating commercial bank short-term debt were often employed in high-risk loans, including more than $10 billion in real estate investment trust (REIT) loans and investments. Many of these loans and investments are carried by banks today as "non-interest" assets. More recently, commercial banks, especially in New York, have been affected by a weakening municipal market in general and the financial problems of New York City and State in particular.

All of these factors have led commercial banks to adopt a posture of conservatism in making new loans. To restore needed liquidity and quality to their assets at a time of slack loan demand, commercial banks have bought large quantities of short-term U.S. Treasury obligations. Credit standards across the board have been tightened. Some observers have rightly referred to this new

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bank loan stringency as a "flight to quality," or a "flight from risk."[4/]

From the point of view of commercial banking, this new attitude toward risk and liquidity is probably healthy. But the effect on medium-size and small businesses, and ultimately on economic growth, is considerably different.

Public Offerings of Debt and Equity Securities

Aside from commercial banks, small business has few other sources of available funds. The flotation of long-term public debt offerings or the private placement of debt securities are out of the question for most small corporations. They have neither the financial standing nor the borrowing needs to attract an underwriting syndicate or a financial intermediary (for direct placement).

In the present stock market environment, raising capital via new equity is also a nearly impossible task for small business. This is borne out by recent Securities and Exchange Commission statistics which show that:

1. For the fiscal year ended June 30, 1974, "Regulation A" small business offerings dropped from 1,087 in the prior fiscal

4/ Commercial bank investments in government securities aggregated to $78 billion in September of this year, up nearly 60% from the $49 billion level in December 1974. The tightening of credit standards is seen in the widening spread between the interest rate on large and small short-term bank loans (large loans tending to be associated with larger corporations). This spread was 0.37% in November 1974 and has since widened to 1.42% in August 1975 (the latest period for which data are available). For really small business, the spread is considerably wider. In many cases, small business bank loans are unavailable at any rate.

year to 438, a decline of 59.7%. The dollar amount of these small stock issues (up to a maximum of $500,000) also fell by about 60%.

2. Fully registered initial stock issues of companies (including large as well as small business) fell from 633 in fiscal year 1973 to 80 (primarily utility issues) in fiscal year 1974. This represented a decline of 87.4% in number and 90.7% in dollar volume (from $1,690 million to $158 million).[5/]

Other Private Sources of Funds

Non-bank private sources of capital for small business are quite limited. Venture capitalists generally invest only in companies with the potential for high growth in revenues and profitability -- and when funds are available, terms tend to be rather harsh. Usually, the entrepreneur must give up a substantial portion of his equity to obtain needed funds.

Small Business Investment Companies (SBICs) -- privately owned companies established for the exclusive purpose of furnishing financial and advisory facilities to small business -- tend to invest only in larger small businesses. According to a recent study on SBIC investment practices,[6/] firms with less than $50,000 of

5/ Available data for calendar 1975 show a further deterioration in initial stock registrations. Through September, 19 such issues were registered, with a value of $47.6 million. For the similar 1974 period, 35 issues were registered, valued at $50.5 million.

6/ Richard C. Osborn, "Providing Risk Capital for Small Business: Experience of the SBICs," The Quarterly Review of Economics and Business, Spring, 1975.

assets received only 14% of total SBIC disbursements, while those with $1 million or more of assets obtained 37% of this financing. As might be expected, larger SBICs tend to provide financing primarily to larger corporations while the smaller SBICs focus on financing proprietorships and very small businesses.

The potential for future growth in SBIC financing for the smaller company is not encouraging. The absolute number of SBICs has been declining, with the smaller finance units often going bankrupt because of high losses in the face of undercapitalization. Since it is these smaller units that tend to finance truly small companies, the effect is to aggravate an already serious situation.

Government Sources of Financing for Small Business

At the governmental level, the Small Business Administration provides direct and guaranteed loans to small businesses. At present, the SBA's direct lending authority is severely limited by budgetary constraints, and no direct loan applications are being processed. The guaranty program operates in conjunction with the commercial banking system. However, banks are under no obligation to accept guaranteed loan applications. Indeed, the general conservatism of commercial bankers, and the interest rate limitations on SBA approved loans, tends to limit the actual number of loans made under the program. In periods of capital stringency, banks tend to sharply curtail their SBA activities. For example, in 1974 -- a period of high interest rates and tight money -- the

number of SBA guaranteed loans fell sharply to roughly 22,000, from 31,000 in 1973.

It might also be noted that the SBA borrowing and guaranty loan program perversely fosters even greater levels of debt financing by borrowing companies. In already highly leveraged small businesses, increased debt only further drains the cash resources of the firm and places the balance sheet in an even more precarious position.

Business Failures on the Rise

The combination of recession and a relative scarcity of capital for small business has resulted in a marked increase in business failures and a decline in new business incorporations. Cumulative 1975 data through August show 8,035 business failures, compared with 6,570 in the comparable 1974 period. Liabilities of failed companies are up even more sharply, totaling $2.5 billion through this August, compared with $1.9 billion for 1974. At the present annual rate, business failures for 1975 would exceed 12,000 (a 20% increase over 1974), and liabilities would reach a staggering $3.7 billion (up nearly 25% from last year). New incorporations, which totaled roughly 330,000 in 1973 and 319,000 in 1974, are expected to cumulate to only 310,000 this year.[7/]

7/ Source for these data is Dun and Bradstreet, Inc.

Needed: A Program for Small Business

Clearly, if the small businessman is in trouble now, he will be in even worse straits in the event of a severe capital insufficiency. The New York Stock Exchange believes that actions must be taken to ease financing and other burdens so that small business may continue to play its vital role in the economy. The Exchange's recommendations in this area, both general and specific, are detailed below.

Reduction in Federal Deficit Spending

The Federal government must put its own house in order as a first step in creating an economic climate conducive to the needs of small business. In particular, Federal budgetary deficits must be scaled down as the economy moves further along the recovery path. The continued active presence of government in the credit markets tends to place a floor under interest rates, which only increases the costs of borrowing to the private sector. Once the budget is brought under control, the Federal Reserve will be in a better position to provide for the type of accommodative monetary policy necessary for sustained business expansion.

Measures to Promote Equity Investment

The NYSE's research reports point out the urgent need of American business for equity capital. On a relative basis, the need is probably greatest for small business. Our studies indicate that over the 1975-85 period, U.S. corporations -- large and small -- will have to raise approximately $250 billion in new

equity capital. This works out to roughly $23 billion a year -- more than double the quantity of stock raised in 1971, the peak year for corporate flotations.

Against this $23 billion a year in net equity requirements, Exchange economists estimate that annual net purchases of corporate stock will aggregate only $16 billion. This represents the sum of net purchases of corporate securities by financial institutions (averaging $20 billion a year), net purchases by foreigners (averaging $3 billion a year), and net <u>sales</u> by households (averaging $7 billion annually). Households have been consistent net sellers of corporate securities since 1958.

Comparison of net requirements with net purchases leaves an annual shortfall of some $7 billion a year -- a gap that can be realistically closed only by increasing incentives for individuals to purchase corporate stock. Some specific programs to increase the attractiveness of equity issues of smaller corporations are discussed below.

<u>Treatment of Capital Losses</u>. To increase the willingness of investors to purchase higher-risk new issues, existing tax laws should be changed to permit for <u>full</u> deductibility of net losses in the tax year in which they are realized. The distinction between long and short-term capital losses should also be eliminated, permitting the investor to deduct 100% of each dollar lost -- regardless

of how long the asset is held. To the investor, a loss is a loss, no matter how quickly or slowly it was incurred. Acknowledging this fact, and treating capital losses appropriately, may encourage more investors to put their capital at risk.

Elimination of the Double Taxation of Distributed Corporate Earnings. The double taxation of distributed earnings discourages public interest in stock investment and exacerbates the difficulties corporations are experiencing in attracting fresh equity capital. Under present law, corporate profits are taxed once, when earned, and are taxed a second time when distributed as dividends.

To relieve this double taxation, the Exchange favors a deduction from corporate income taxes for dividends paid to stockholders. This approach would ease the inequities inherent in double taxation of corporate income and eliminate the typical corporation's built-in bias against equity financing. Today, interest on debt is a deductible expense, while dividends must be paid from after-tax earnings. Thus, heavier reliance on debt financing enables corporations to post higher after-tax profits.

The Exchange recognizes that an immediate shift to complete deductibility for dividends could be unsettling, because it would have far-reaching ramifications for both traditional corporate financial policy and portfolio investment, and a considerable impact on Federal revenues. However, an initial step in the direction of neutralizing the disparity between tax treatment of dividend

and interest payments could be taken by providing a partial deduction of, say, 25% for dividends.

To be sure, even partial deductibility of dividends would be a major departure from past practice -- an experiment that could, however, represent a meaningful, measured step toward developing a balanced program of sorely needed investment incentives, both individual and corporate. While larger corporations would tend to benefit the most from this recommendation, its effect should permeate down to smaller corporations as well.

Greater Use of SBICs. Small Business Investment Companies could play a greater role in providing equity capital than they now do. However, poor management and highly questionable investment decisions often limit the capabilities of SBICs to respond to the legitimate needs of fledgling enterprises. In some cases, inadequate capitalization is also a restrictive factor. It might be worthwhile to examine ways of improving SBIC management and strengthening the capital base of SBICs. In this regard, commercial banks could play a leading role. At present, their participation in SBICs is limited.[8/] The reasons for existing restrictions ought to be reconsidered in light of current circumstances.

8/ Commercial banks currently may hold SBIC shares to the extent that they (1) do not have a majority interest in the SBIC, and (2) that SBIC shares comprise no more than 5% of the bank's capital and surplus.

Additional attention also should be given to improving and expanding the operation of Section 301(d) licensees (formerly called MESBICs), which provide venture capital for minority-owned businesses. As of year-end 1974, 70 Section 301(d) investment companies were licensed and operating in 26 states, the District of Columbia and Puerto Rico, with $65 million for investment in minority businesses. While the number of minority group enterprises has grown in recent years, they still represent a small portion of the total.[9/] Clearly, more will have to be done to improve representation by all members of society in the business mainstream.

Other Programs to Promote Equity Investment. A number of Federal and privately funded "packaging" organizations have been created to help minority businesses prepare for the credit markets. These companies, which include the Rochester Business Opportunities Corporation and the Chicago Economic Development Corporation, assist in preparing feasibility studies, cash flow and balance-sheet projections, and related financial documentation.

More of these organizations are needed. Congress, as well as the private sector, should consider increased funding to establish additional "packaging" facilities in major economic centers throughout the nation.

9/ For example, 195,000 Black businesses were in operation in 1972 -- a 19% increase from the previous Census Bureau survey conducted in 1969.

Commercial Bank Lending Policies

Because of the present state of the commercial banking industry and its disposition to favor loans by larger corporations, the Federal government should give special thought and attention to how smaller enterprises can be financed. The greater risks involved in lending to small business are generally recognized, as is the need to apply appropriate credit criteria to such loans lest the problems of the banks be compounded. A high mortality rate has always afflicted young enterprises and the indiscriminate provision of credit can itself produce pernicious results. At the same time, direct government intervention in the credit markets must be avoided. Nothing would destroy as quickly the essence of this country's capital markets -- namely, the efficient allocation of credit according to impersonal standards of productivity, return, and risks -- as the substitution of government edict for free market competition. Nonetheless, some broad, indirect help to small business may be desirable to help assure full and equal access to sources of credit. To this end, the Federal Reserve can encourage commercial bank lending to small business by providing sufficient reserves to permit a restoration of adequate bank liquidity. Perhaps a reduction in the reserve requirements on small bank loans should also be considered.

Retention of Present Reduction in Small Business Taxes

The 1975 temporary tax reductions for smaller businesses, which increased the surtax exemption from $25,000 to $50,000 and

decreased the base corporate tax rate from 22% to 20%, should be made permanent. The $25,000 exemption is woefully inadequate, particularly in this inflationary era. It has been in effect for nearly 40 years -- a period in which the price level has nearly quadrupled.

Congress might also wish to explore the possibility of adding additional progressivity to the corporate profits tax. For example, Irving Kristol has suggested that the tax be graduated up to $2,000,000 of corporate income, after which a flat 48% rate would apply. That proposal merits careful study.

Modification of Keogh Plan Provisions

To reduce the dependence of small business on external sources of capital, the NYSE suggests that Congress modify existing "Keogh Plan" provisions to permit small businessmen to invest in their own enterprises. At present, Keogh plans enable non-corporate entities to establish pension-profit-sharing plans by deferring taxes on as much as 15% of eligible employee compensation -- to a maximum of $7,500 per employee. Under existing law, the deferred income can be placed with various financial intermediaries or can be invested in corporate and other securities. The Exchange suggests that the small businessman be allowed to obtain similar tax advantages by investing in his own business. While the mechanics of such a program would have to be worked out, such a plan would provide the smaller enterprise with increased capital -- with

really no long-run tax loss to the Treasury. The reinvested funds would still be subject to tax, but the tax would be deferred.

Changes in Depreciation Accounting, and the Investment Tax Credit

The present method of accounting for depreciation, based on historical costs, rather than on a more realistic replacement cost basis, severely affects the cash flows of small businesses. The value of the Investment Tax Credit is often lost to small businesses, and particularly to new small businesses because they have insufficient taxable income. While the Exchange has not developed recommendations for specific changes, we believe detailed study of how the Investment Tax Credit can meaningfully be extended to small businesses in warranted.

Tax Simplification

The Exchange strongly supports efforts by Congress to simplify the tax laws for small business. In particular, we welcome the initiatives that have been taken by the Select Committee on Small Business to flesh out comprehensive legislation to reduce the complexities of the Internal Revenue Code for the small entrepreneur.

Smaller businesses often do not have access to the kind of accounting and tax-planning expertise available to larger corporations. As a result, they are not always able to make full use of favorable tax provisions and may end up paying higher taxes than they should. Obviously, this drains needed resources from a small

company, and increases its competitive disadvantage vis-a-vis larger corporations. In any case, the bureaucratically imposed paperwork burdens weigh particularly heavily on smaller businesses.

Regulatory Reform

In many cases, Federal and State regulatory agencies develop guidelines and standards based solely upon practices among the larger corporations in the particular industry. For example, Business Week reported that the Food and Drug Administration recently proposed new food and storage regulations after checking only with the industry's largest manufacturer. Fortunately, the Small Business Administration was able to intervene on behalf of the industry's smaller companies, and the FDA is now modifying its rules.[10/]

While the SBA does what it can to protect small business from excessive or ill-conceived regulation, a greater level of protection is required. Congress might well give thought to requiring regulatory agencies to submit "Small Business Impact Statements" to the SBA, so as to insure that future and existing regulations are equitable to all sectors of the economy.

10/ "Small Business, The Maddening Struggle to Survive," Business Week, June 30, 1975, p. 101.

Conclusion

If small business is to prosper in the years ahead, then greater emphasis will have to be given to the promotion of risk-taking activity. The Exchange hopes its suggestions for small business will stimulate further thinking and result in concrete steps to improve the environment for investment in new, innovative business ventures.

As a first step, the Federal government must get its own fiscal house in order, so that over the longer term,monetary policy can be accommodative to the needs of business. At the same time, measures should be taken to eliminate unnecessary regulation and controls which stifle initiative and suppress equilibriating market forces.

The United States has always been a nation dedicated to the individual spirit. A land where men can dare to dream, and then set to work to make their dreams come true. The successful small businessman is the personification of this ideal.

The small businessman epitomizes the spirit of the American enterprise system. It may be hoped that the current hearings of the Joint Economic Committee -- and subsequent legislation -- will help to restore small business to its rightful importance in the U.S. economy.

THE CAPITAL NEEDS AND SAVINGS POTENTIAL OF THE U.S. ECONOMY

PROJECTIONS THROUGH 1985

New York Stock Exchange, Inc.

September, 1974

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INTRODUCTION

As the twin ogres of escalating inflation and soaring interest rates have tightened their grip on the U.S. economy, leading business, government and academic economists have made some dire predictions about what lies ahead for American business if the nation fails to develop and implement adequate corrective measures. Those predictions have flowed from a number of diverse statistical estimates and projections -- some of them based on solid, authoritative research, others seemingly no more than guesses and intuitive musings. One thing is certain: the problems are real. President Ford has identified inflation and its attendant ills as the nation's major domestic problem, and has made the fight against inflation the highest priority task of the new national Administration.

At the New York Stock Exchange, we have become increasingly concerned about the supply and allocation of investment capital. And our concerns have deepened with the realization that a capital shortage is no longer a threat for the future, but a fact of the present, as inflationary pressures come to bear on the capital markets.

To develop a clearer understanding of the dimensions and implications of this problem, our research economists undertook a broad survey and study of the capital needs and savings potential of the U.S. economy through 1985. The study sought to develop realistic projections of capital supplies and demands in the economy over the next dozen years.

The basic findings can be expressed in this very simple bit of arithmetic:

$$\begin{array}{r} \$4,050,000,000,000 \\ -\ \underline{4,700,000,000,000} \\ \$\ (650,000,000,000) \end{array}$$

Stated plainly, this means that the present estimated saving potential in the U.S. economy through 1985 -- from all domestic sources -- is something over $4 trillion. Over the same period, capital demands are likely to reach a cumulative total of $4.7 trillion. That leaves an estimated capital gap of $650 billion.

Those figures are not very reassuring. They confirm the apprehensions of others, and they underscore the urgency of the problems confronting the American business community and the American people.

But it is our hope that while these projections present a harsh and disturbing picture, they also give us a clear opportunity to assess the prospective implications of the emerging capital problem -- and to do something about it before it is too late.

The degree of intensity with which American business, American labor, American government -- and the American people -- attack this problem really holds the key to whether or not today's projections will become tomorrow's disruptions.

James J. Needham
Chairman

THE CAPITAL NEEDS AND SAVINGS POTENTIAL OF THE U.S. ECONOMY PROJECTIONS THROUGH 1985

This report of the Capital Needs and Savings Potential of the U.S. Economy Through 1985 is divided into three sections. Section I presents the New York Stock Exchange's "Base Case" projections of investment and saving flows for the period 1974-1985. Section II develops alternative scenarios to test the sensitivity of the base case conclusions to changes in parameter values. Section III discusses the implications of a major investment capital shortfall and offers a number of general policy recommendations for bridging the gap.

METHODOLOGY: AN OVERVIEW

To assess the adequacy of future saving to finance anticipated investment, separate projections were made of gross private domestic investment, business and personal saving, and net government requirements for funds. These estimates took the form of *ex ante* forecasts of saving and investment flows -- i.e., the projected values represent *desired* levels of investment and saving rather than *actual* or (*ex post*) values of those flows. This distinction is of critical importance. *Ex post* saving and investment must be equal at every point in time. *Ex ante*, the flows need not be equivalent, since corporations, households and other sectors of the economy carry out investment and saving planning independently of one another.

The study's emphasis on ex ante saving and investment requirements precluded the use of econometric models, in which saving is always equated with investment, primarily through changes in interest rates.

The need to use non-econometric techniques sacrifices some rigor. this is especially true in gauging the impact of alternative assumptions of investment demand and government budgetary policy on the economy as a whole. Economic variables are linked together in a complex pattern of multiple feedback loops, and it is difficult to trace the interactions among the variables without a well-specified model of system behavior.

To help overcome this difficulty, a scenario approach was used to assess the impact of changes in key parameters on the balance between the demand and supply of funds. A "base case" scenario was constructed, in which a "most likely" projection of investment and saving flows was detailed. Alternative scenarios were then developed to test the stability of the "base case" conclusions. The emphasis was placed, not so much on the precise values of saving and investment flows but on the more important issue of the relationship of those flows to each other -- and, inferentially, to the economy as a whole.

I. BASE CASE SCENARIO

A. THE DEMAND FOR FUNDS

General Methodology

Gross Private Domestic Investment (GPDI) and net government financing operations (deficit financing and net borrowing from the public) comprise the total domestic demand for funds in the economy. The value of Gross Private Domestic Investment in the 1974-1985 period was derived by aggregating estimates of business plant and equipment expenditures, residential construction and investment spending by farms, non-business and non-profit institutions (including investment in inventories.) Estimates of the government sector were broken out between state and local government deficit financing and the net financing needs of the Federal government. It should be borne in mind that these projections represent desired levels of capital spending -- what industry and knowledgeable observers believe will be required in the 1974-1985 period.

The projections are consistent with an 8.6% annual rate of growth in Gross National Product, (5% annual rate of inflation, 3.6% annual rate of real growth).

1. The Components of Gross Private Domestic Investment

a) Plant and Equipment Spending

The "base case" projection of plant and equipment spending (which includes outlays for modernization and new capacity) was de-

rived from specific industry forecasts and from projections made by other respected research organizations.[1/] The various estimates were adjusted to insure comparability, and then consolidated to form a consensus projection of future capital requirements.

The industries selected were those included in the Department of Commerce series on new plant and equipment spending. For projection purposes, the industries were grouped into five broad categories:

1) The energy sector -- mining,[2/] petroleum, electric and gas utilities.
2) Basic material processors -- iron and steel, nonferrous metals, stone, clay, glass, rubber, paper, and chemicals.
3) Transportation and transportation equipment manufacturers.
4) Communications and services.
5) All other.

Table 1 provides the consensus projection of growth rates in each of these categories. These rates (computed using 1973 as a base, the latest year for which complete data are available) reflect an assumed slowdown in the pace of new plant and equipment spending

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1/ Sources will be furnished upon request.
2/ The Department of Commerce does not break out mining data by commodity category. It is assumed that mining plant and equipment spending relates solely to the energy sector.

during the latter part of the estimating period, as it is unlikely that any investment boom would continue at a constant rate over a twelve-year interval.

Table 1

Average Annual Rate of Growth in
New Plant and Equipment Spending
1961-1973 (actual)
1973-1985 (projected)

	1973-1985	1961-1973
Energy Sector	12.7%	9.4%
Basic Materials	10.7	9.0
Transportation & Transportation Equipment	9.6	7.3
Communications & Services	8.4	8.8
Other	9.9	9.4
Total Plant & Equipment Spending	10.3%	8.9%

As Table 1 indicates, the energy and basic materials sectors will account for the greatest increase in capital spending.

On a cumulative basis, the energy sector will require roughly $820 billion in the 1974-1985 period. Electric utilities alone will require approximately $400 billion between 1974 and 1985 for increased generation, transmission and distribution facilities (assuming present environmental regulations).[3/] The other energy industries (including gas utilities, petroleum, coal, synthetic fuels and nuclear) will need to spend in the range of $420 billion for primary energy needs, downstream petroleum investment (including

3/ "24th Annual Electrical Industry Forecast," Electrical World, September 15, 1973, p. 53.

tankers and environmental protection equipment) and developmental costs for full-scale synthetic gas and oil shale production.[4/] The likely imperatives of "Project Independence" suggest, however, that the latter estimate is probably conservative.

The basic materials industries will spend nearly $330 billion through 1985. The huge increase in capital spending will be needed to overcome the serious shortages of capacity now limiting output in the iron and steel, aluminum, paper, cement, glass and other industries.

The transportation sector (including transport equipment industries) will require $225 billion through 1985. This sum reflects growing concern over the nation's mass transit needs. High energy costs and public concern for improvements in environmental quality have prompted proposals to upgrade the nation's aging railroad system and to develop viable alternatives to highway transportation.

Significant increases in capital outlays will also be registered by the communication and services sector and by "other" manufacturing industries (including electrical and non-electrical machinery, food, textiles, and miscellaneous durable and non-durable manufactures). These sectors will require approximately $770 and $420 billion, respectively, in cumulative capital outlays to 1985.

4/ Forecasts for the petroleum and related energy industries vary widely. The figures used in this report are derived from "Energy Financing," a March 7, 1974 research study issued by Irving Trust Company; a revised National Petroleum Council estimate of future capital needs (released in 1973); and projections of electric utilities capital requirements presented in Electrical World, September 15, 1973.

b) Residential Construction

The expected demand for new housing is related in large part to demographic factors. In the 1974-1985 period, the distribution of the U.S. population will shift toward a greater concentration in the 20-35-year age bracket, a group which has the highest rate for marriages and household formation. Conservative estimates suggest that by 1985, 3 million housing units a year may be required to meet the increased demand for housing. Included in this total are single-family and multi-family dwellings and mobile homes. An annual rate of 3 million housing starts by 1985 implies a 3.3% annual growth rate in housing starts over the period -- somewhat higher than the 2.6% annual growth rate during 1962-1973.

In terms of dollars, assuming that construction costs advance in line with general inflation rates,[5/] nearly $1.1 trillion will be required to meet America's housing needs.

c) Capital Spending on Inventories and by Farm and Non-Profit Institutions

Investment spending in this sector should amount to $850 billion in the 1974-1985 period. This total includes $206 billion in cumulative farm expenditures (based on historical rates of investment), $83 billion in inventory investment (based on recent average values of the change in inventories of $6.9 billion per year), and $562 billion in capital spending by private educational institutions, hospitals and related non-profit organizations (again, predicated

5/ Five percent per annum, except in the case of multi-family units, where costs were assumed to rise at a 4% annual rate, reflecting greater use of modular construction techniques and related innovations.

on historical data, modified to allow for reduced capital demands by colleges and universities, and a slowdown in the rate of hospital construction during the estimating period). This estimate should not be regarded as anything more than an order of magnitude projection, based on the diverse elements included within this "catch-all" category.

* * * * *

Aggregating the components of Gross Private Domestic Investment indicates that $4.5 trillion in private investment will be required over the 1974-1985 period (Table 2). The percentage of Gross National Product devoted to capital formation would rise from 15.6% in 1973 to an average of 16.4% over that period. The average over the preceding 12 years was 15.3%. In constant 1973 dollars, cumulative Gross Private Domestic Investment equals approximately $3.2 trillion. This sum is still roughly 1.5 times the $2 trillion spent in the preceding twelve-year period (also stated in terms of 1973 dollars). Thus, even abstracting to account for the effects of inflation, the projected volume of domestic investment will clearly be enormous.

Table 2

Projections of Gross Private Domestic Investment
Cumulative, 1974-1985

	Current $	1973 $
Plant and Equipment Spending	$2,568	$1,799
Energy	824	571
Basic Materials	328	230
Transportation and Transport Equipment	225	158
Communications and Services	772	548
Other	419	292
Residential Construction	1,085	771
Non-Profit, Agriculture, and Change in Inventories	850	601
Total Gross Private Domestic Investment	$4,503	$3,171

2. Government Financing Requirements

a) The Federal Sector

The Federal government's demand for funds is far too erratic to permit meaningful projections. Existing studies offer little practical guidance. For example, a recent study by the Brookings Institution projected the Federal budget to be in surplus by $93 billion (assuming a 5% rate of inflation and no new spending plans) in 1980.[6/] However, as new programs and changes in existing programs appear quite likely -- especially in the energy sector and for a national health insurance program -- the actual 1980 surplus could be far less than $93 billion. Indeed, the Federal budget may even be in deficit, depending on Congressional and Executive action --

6/ Barry M. Blechman, et. al., Setting National Priorities, The 1975 Budget, The Brookings Institution, Washington, D.C., 1974, p. 253.

a possibility noted in the Brookings analysis. Historical experience shows government surpluses to be a rarity and to assume a surplus in the years ahead would be overly optimistic.

In view of these considerations, and with full recognition of the uncertainties involved, the Federal deficit is assumed to average $3.5 billion a year over the 1974-1985 period. This rather conservative assumption is based on the average Federal deficit during the non-war years of 1954-1963. The relatively large deficits during the late 1960s cannot be viewed as "most likely," as they reflect U.S. involvement in Viet Nam.

In addition to budgetary deficits, the off-budget demands of sponsored credit agencies have been growing apace in recent years, exceeding $19 billion in 1973.[7/] This borrowing competes directly with private sector demands and represents a significant share of total credit market borrowing (10% in 1973). A Federal Financing Bank has recently been established to coordinate agency borrowing. And while it is too early to judge its impact, this new institution does offer the possibility of more rational government use of the credit markets. Again recognizing the substantial element of uncertainty involved, agency borrowing is assumed to average $8.6 billion a year during 1974-1985. This figure represents the average of such borrowing during the 1968-1973, prior to which credit agency borrowing was not a significant factor.

7/ To some extent, Federal agency borrowing substitutes for private borrowing. This, however, does not materially affect our conclusions. Even if all Federal agency borrowing were excluded, the projected savings gap would still be huge.

b) State and Local Government Financing Requirements

State and local governments have been running a sizeable surplus recently, but have been borrowing heavily (to the tune of $10-15 billion a year) to finance capital projects. Their net demands on the credit markets are assumed to average out to $2.5 billion a year over the next ten years. This estimate is based on a Tax Foundation study[8/] which estimated that state and local governments will run a cumulative surplus of about $78 billion in the 1974-1980 period, or approximately $11 billion a year, while debt requirements in the same period are expected to average under $14 billion a year. The difference of about $2.5 billion represents net credit demands. The 1974-1980 forecast is assumed to hold through 1985.

* * * * *

Table 3 indicates that combined Federal and state and local financing requirements will cumulate to $175 billion over 1974-1985.

Table 3

Governmental Demand for Funds
Cumulative, 1974-1985
(Billions of Dollars)

Financing Federal Deficits	$ 42
Net Federal Credit Agency Borrowing	103
Net State and Local Government Financing Requirements	30
Total Governmental Demands for Funds	$175

8/ The Financial Outlook for State and Local Government to 1980, Tax Foundation, Inc., New York, 1972, p. 96

B. THE SUPPLY OF SAVINGS

Business saving (capital consumption allowances and retained earnings adjusted for changes in inventory valuation), personal saving, and net foreign investment inflows constitute the sources of savings available to the economy.[9]

1. Business Saving

The projected value of business saving was derived from a regression of such saving on gross national product, using data from 1950-1973 (in order to provide sufficient observations over all phases of cyclical activity). The estimating equation is provided below:

Business Saving = 3.52459 + .10498 GNP

The coefficient of the GNP variable was highly significant ("t" value = 29.775) and the coefficient of determination ($\bar{R}^2$) was an encouraging .976. For forecasting purposes, GNP was assumed to grow at 8.6% per annum, consistent with the GNP growth rate used in the projections of capital spending. It was also implicitly assumed that profit margins would not increase much beyond present levels, that accounting procedures (especially treatment of depreciation costs) would not change significantly and that corporation taxes would remain essentially unchanged.

9/ The national income accounts do not include net increases in the money supply as a source of saving, as saving is defined in the accounts to equal income less spending.

The regression-based forecast indicates that more than $2.9 trillion will be saved by the business sector over the 1974-1985 period.

While any assumption that historical trends will continue should automatically be suspect, the stability of the relationship between business saving and GNP is quite pronounced. It has never fallen below 9.9% (reached only in the recession years of 1953 and 1970) and has only risen above 12% during the early years of the Viet Nam War (1964-1966).

Capital consumption allowances will account for the major portion of the nearly $3 trillion in business saving, cumulating to about $2.4 trillion over 1974-1985. The significant increase in the stock of capital projected for the period would necessarily generate large additional depreciation charges. The actual value of these write-offs was estimated by assuming that the capital consumption allowance/GPDI ratio would average 51.75% over the period. This percentage is below historic levels and reflects the assumed higher rate of growth in GPDI relative to the growth in depreciation charges.

Retained earnings were treated as a residual element in this analysis and are expected to accumulate to more than $560 billion. The relatively low growth rate projected over the period reflects the downward adjustment for inventory profits in the historical data. It should be noted that retained earnings in 1973 (even

after adjustment for inventory profits) should not be used as a base for future projections. Cyclical factors and dividend controls made total retentions in 1973 far higher than would ordinarily be the case (i.e., if corporate retentions are viewed over the entire business cycle).

2. Personal Saving

Personal saving represents a sizeable flow of funds to the capital markets -- nearly $55 billion in 1973. As a percent of GNP, personal saving ranged between 3.4% and 5.8% during 1960-1973. At the close of 1973, however, the personal saving rate was 4.25%, well below the 5.0% average of the preceding five years.

Personal saving is expected to rise from $54.8 billion in 1973 to $135 billion by 1985, a cumulative total of more than $1.1 trillion. These projections assume that the ratio of personal saving to GNP will decline smoothly over the period -- from 4.25% in 1973 to 3.9% in 1985 (based, in part, on shorter-term projections made by the Brookings Institution). The expected decline in the saving/GNP ratio is predicated on: 1) the shifting age distribution of the U.S. population toward the low-saving 20-35 age bracket, 2) mandated increases in social security contributions, which tend to be regressive, and 3) the possibility that the present high levels of inflation may change the historic propensity of consumers to maintain a constant real level of savings in relation to income. This does not imply an expectation that current rates of inflation will

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persist but, rather, that traditional consumer saving habits may be altered by the recent severe erosion of real household wealth.

3. Foreign Investment Flows

In addition to domestic sources of savings, an increasing flow of funds should become available from foreign sources. The greatest potential for such inflows clearly lies with the Arab states, which are expected to accumulate more than $500 billion as an investable surplus in the 1974-85 period. While a major portion of these funds will no doubt be recycled to other nations to finance their oil purchases, a significant volume should still be available for investment. The size and liquidity of the New York capital markets should attract a large share of these oil revenues, with investment probably being concentrated in government and high-grade corporate debt securities.

Unfortunately, however, no realistic basis exists from which to project the future volume of net foreign inflows of capital. Political considerations alone make projections extremely unreliable. Thus, while it may be hoped that sizeable foreign inflows can add to the pool of available savings, prudence dictates against relying on them.

C. A CAPITAL SHORTFALL

When the projections of ex ante demand and supply of capital funds are offset, it is clear that a cumulative saving gap of nearly $650 billion is in prospect. This capital shortfall, aver-

aging $53.8 billion a year over the 1974-1985 period, represents approximately 13% of the average demand for funds over the period (Table 4).

Table 4

Sources and Uses of Funds
Cumulative, 1974-1985
(Billions of Dollars)

Sources of Funds		
Business Saving		$2,923
Capital Consumption Allowances	$2,359	
Corporate Retained Earnings	564	
Personal Saving		1,109
Total Sources of Funds		$4,032
Uses of Funds		
Gross Private Domestic Investment		$4,503
Plant and Equipment	$2,568	
Residential Construction	1,085	
Other	850	
Financing Federal Deficits		42
Net State and Local Government Financing Requirements		30
Net Sponsored Credit Agency Borrowing		103
Total Uses of Funds		$4,678
Saving Gap		($ 646)

It should be stressed that this "base case" scenario presents a "most likely" outcome, based upon reasonable assumptions of future capital demands and savings availability.

However, from a policy viewpoint, the precise dimensions of a saving gap is not the issue. Whether the cumulative gap is $400 billion or $600 billion or $800 billion, the problem -- and the policy implications -- remain the same.

It is more important to know whether a different set of "reasonable" assumptions would develop projections that would eliminate the prospective gap, or reduce it to inconsequential or manageable proportions. The following section of this report demonstrates that this does not appear to be possible.

II. ALTERNATIVE SCENARIOS

The alternative scenarios presented here assume no shifts in tax policies and no major changes in the general business climate over the 1974-1985 period.

A. Alternative #1: Higher Saving Flows

This scenario assumes that the base case projections may have underestimated business and personal saving. To adjust for this possibility:

1) Corporate capital consumption allowances were assumed to equal 54.25% of GPDI (based on the average percentage during the major expansions of the 1962-73 period) as opposed to the base case level of a 51.75% average.

2) Retained earnings (adjusted for inventory valuation) were assumed to equal 10% more than base case estimates (an arbitrary, but sizeable shift).

3) Personal saving rates were assumed not to fall, as in the base case, but to remain at the 1973 level of 4.25% of GNP. The rate of growth of nominal GNP was assumed to be 9.2% rather than the 8.6% rate used in the base case. This higher rate reflects the possibility that the projected levels of GPDI are consistent with a substantially higher rate of real economic growth than the 3.6% rate assumed in the base case scenario.

With these modifications (all other factors remaining the same) a sizeable, albeit reduced saving gap of $396 billion is still projected for the 1974-1985 period (Table A1).

Table A1

Alternative #1 - High Saving - Base Case Investment
Cumulative, 1974-1985
(Billions of Dollars)

	Base Case	Alternative #1
Gross Private Domestic Investment	$(4,503)	$4,503
Add		
Depreciation Allowances	2,359	2,443
Retained Earnings	564	620
Personal Saving	1,109	1,219
Private Saving Gap	$(471)	$(221)
Add		
Government Demand for Funds	(175)	(175)
"Total" Saving Gap	$(646)	$(396)

If cumulative governmental demand for funds is assumed at 50% of base case levels (i.e., at $87.5 billion) a saving gap of more than $300 billion still occurs.

In this scenario, the private saving gap is less than 50% of the base case projection. However, the assumptions upon which this "revised" gap is based are not particularly realistic. While the adjusted retained earnings projections appear to be reasonable, the depreciation to GPDI ratio is unlikely to remain constant at 54.25% when capital expenditures are increasing at a faster rate than depreciation charges. It is also doubtful, based upon previously noted demographic factors, that the personal saving/GNP ratio would

remain at current levels. The 9.2% growth rate assumption is similar ly extreme, given the general agreement in long-term econometric models as to the relationship between levels of capital expenditure and gross national product. Similarly, it is unlikely that government demands would total only $87.5 billion through 1985 -- an eventuality for which there is simply no historical precedent.

B. Alternative #2: Lower Investment and Higher Saving

This scenario goes one step beyond Alternative #1, assuming that the base case projections of aggregate GPDI were overstated, while saving flows were understated, as in the previous scenario. To show the implications of such a set of assumptions:

1) The GPDI/GNP ratio was assumed at a constant rate of 16% in the 1974-1985 time-frame (it should be noted that every econometric model reviewed in the course of this study assumed a GPDI/GNP ratio above 16%). GNP was assumed to increase at 8.6% per annum, as in the base case (even though a lower GPDI/GNP ratio suggests that a slower rate of growth would be more appropriate).

2) Capital consumption allowances were computed at 54.25% of the lower GPDI estimate.

3) Retained earnings were assumed to cumulate to $620 billion, based on the Alternative #1 assumptions.

4) Personal saving was computed at 4.25% of nominal GNP.

The lower level of investment spending assumed in this

scenario suggests that the Alternative #1 assumption of a 9.2% rate of growth in nominal GNP would be too high. While econometric studies suggest that the base case rate of 8.6% would also be excessive, this rate is used for this scenario.

Table A2 shows that even with these assumptions, a significant saving gap of $404 billion develops. Again, even if the base case assumption regarding government spending is halved, the projected saving gap is still of major proportions.

Table A2

Alternative #2 -- Low Investment and High Saving
Cumulative, 1974-1985
(Billions of Dollars)

	Base Case	Alternative #2
Gross Private Domestic Investment	$(4,503)	$(4,406)
Add		
Depreciation Allowances	2,359	2,388
Retained Earnings	564	620
Personal Savings	1,109	1,169
Private Saving Gap	$(471)	$(229)
Add		
Government Demand for Funds	(175)	(175)
"Total" Saving Gap	$(646)	$(404)

C. Alternative #3: High Investment and High Saving

The base case scenario was somewhat conservative in its projections of Gross Private Domestic Investment. For example, a number of respected research groups have estimated that the energy sector would require $900 billion in capital funds in the 1974-85 period, as compared with the $820 billion used in the base case

analysis. (This higher estimate assumed the same rate of inflation -- 5% per annum -- as the base case study.) To adjust for any possible underestimation of capital demands, the following assumptions were made:

1) Energy investment was assumed to cumulate to $900 billion in the 1974-1985 period.

2) Base case projections for other plant and equipment sectors were increased by 5% in each year (a relatively small upward adjustment).

3) Residential construction expenditures were recalculated assuming 3.2 million housing starts by 1985 instead of 3.0 million as in the base case. In addition, the 1% "technology" factor used in computing the inflation rate in residential construction costs was not applied here (all costs were postulated to increase at 5% per annum).

4) Non-business, non-profit capital investment was also increased by 5% in each forecasting period.

With these new assumptions, Gross Private Domestic Investment rises from $4,503 billion in the base case to $4,785 billion (Table A3).

Table A3

Alternative #3 -- Gross Private Domestic Investment
Cumulative, 1974-1985
(Billions of Dollars)

		Base Case	Alternative #3
Plant and Equipment Spending		$2,568	$2,731
of Which	Energy	(824)	(900)
	Transport	(225)	(236)
	Basic Materials	(328)	(345)
	Communication & Services	(772)	(811)
	Other	(419)	(439)
Residential Construction		1,085	1,161
Other		850	893
Gross Private Domestic Investment		$4,503	$4,785

On the saving side, it was assumed that:

1) Depreciation allowances would be calculated using the higher (and somewhat unrealistic) rate of 54.25% of GPDI.

2) Retained earnings would be computed assuming a 10% increase over base case levels (higher plant and equipment investment being associated with higher levels of retentions).

3) Personal saving would be estimated as in Alternative #1, on the basis of a 9.2% annual rate of growth in nominal GNP, with the personal saving/GNP ratio assumed at 4.25%. As previously indicated, this percentage probably overstates the volume of personal saving that will accumulate in the forecasting period.

Offsetting the projections of GPDI with estimated saving flows provides a saving gap of $525 billion (Table A3a). As before, changing assumptions regarding governmental financing needs will increase or reduce the total saving gap.

Table A3a

Alternative #3 -- High Investment, High Saving
Cumulative, 1974-1985
(Billions of Dollars)

	Base Case	Alternative #3
Gross Private Domestic Investment	$(4,503)	$(4,785)
Add		
Depreciation Allowances	2,359	2,596
Retained Earnings	564	620
Personal Savings	1,109	1,219
Private Saving Gap	$(471)	$(350)
Add		
Government Demand for Funds	(175)	(175)
"Total" Saving Gap	$(646)	$(525)

D. Alternative #4: Increased Inflation

The base case scenario assumed a 5% annual rate of inflation in the 1974-85 period. To test the impact of higher inflation on the saving gap, the base case estimates were recomputed assuming a 6% rate of inflation (the rate of growth of nominal GNP increasing from 8.6% to 9.6%). The results of this computation are provided in Table A4.

Table A4

Alternative #4 -- Increased Inflation
Cumulative, 1974-1985
(Billions of Dollars)

	Base Case	Alternative #4
Gross Private Domestic Investment	$(4,503)	$(4,833)
Add		
Depreciation Allowances	2,359	2,536
Retained Earnings	564	609
Personal Savings	1,109	1,182
Private Saving Gap	$(471)	$(506)
Add		
Government Demand for Funds	(175)	(186)
"Total" Saving Gap	$(646)	$(692)

As shown in Table A4, higher inflation rates would only serve to widen the saving gap, though saving flows would also rise, based upon increases in the capital base and in the level of nominal income.

E. Other Scenarios

The preceding four scenarios illustrate that the base case conclusion of a sizeable cumulative saving gap stands up to fairly severe changes in parameter values. While it would certainly be possible to construct sets of assumptions that would eliminate the gap, the alternative scenarios presented here suggest that the reasonableness of more extreme scenarios would be open to serious question. And while it might be argued that the majority of business economists have overstated the nation's capital needs, it is extremely unlikely that the best-informed experts have seriously erred in their own areas of expertise.

The most reasonable conclusion from the alternative scenarios presented here is that they confirm the reasonableness of the base case projection of a sizeable capital shortfall over the period to 1985.

III. IMPLICATIONS AND POLICY RECOMMENDATIONS

The saving gap or capital shortfall projected in the base case scenario represents a theoretical imbalance between investment capital demand and investment capital supply. The gap itself will never actually show up; rather, it will be evidenced *ex post*, or after the fact, by high interest rates -- brought about by intensified competition for an inadequate supply of savings -- and reduced credit availability. The projected shortage of capital will have a particularly severe impact on domestic business activity, on the position of the U.S. in international economic affairs and, ultimately, on the standard of living and quality of life in America.

A. IMPLICATIONS OF A CAPITAL SHORTFALL

1. Domestic Business Implications

Housing and other construction will be particularly hard hit by a capital shortfall. Skyrocketing interest rates have already severely constrained new housing starts. If present trends continue, the likely results may include decreased square footage in new homes and apartments and lower construction standards. Millions of Americans who dream of a home in the suburbs will have to forego their hopes and aspirations. Indeed, the very quality of life may be impaired, as the lack of suitable housing facilities leads to even more urban congestion and decay.

Small and medium-size businesses will find it increasingly difficult to obtain necessary financing. High interest charges will

often preclude the possibility of long-term financing, forcing them to rely on short-term borrowing -- primarily through commercial banks -- to finance capital investment. But borrowing short for long-term purposes is not normally advisable, and bankers and other lenders are unlikely to continue to satisfy the demand -- at any price -- over an extended period. Moreover, as credit availability declines, lenders will increasingly put their funds with larger, "safer" borrowers with whom they have long-standing customer relationships. The largest and safest borrower, of course, is the Federal government. To the extent that funds are directed into government issues, additional strains will be placed on the private sector (as interest rates increase because of the flow of funds into such issues). The government could even become a center for the allocation of funds to business and consumers if Federal borrowing increased significantly beyond expected levels.

Even larger companies will feel the pinch. This is especially likely in the utility sector, where expansion plans are already being cut back because of financing problems. In addition to raising the possibility of frequent brownouts and blackouts, reduced capital spending in the energy sector would soon impact on other areas of the economy, notably in the construction and electrical machinery industries.

Overall, the capital markets may be unable to meet the essential financing needs of American industry. Along with a decline in bond financing, commercial paper may become unavailable as a source of

funds to all but the major Aaa corporations. As lenders become increasingly wary, they will be likely to shy away from buying "high risk" paper unless the creditworthiness of the borrower is beyond question. High rates of interest may adversely affect stock prices as investors shun equities because of the higher returns available elsewhere with less risk. Price-earnings ratios would continue under pressure. And since, with low P/E ratios, corporations cannot float new stock without diluting the earnings of existing shareholders, it would become increasingly difficult to market new equity issues. (At a P/E ratio of 5, for example, a company would have to earn 20% on new equity capital to prevent earnings dilution.) If inflationary fires are dampened, a new equilibrium should be achieved between return on equities and interest rates, permitting stock values to resume their historic upward pattern. But the adjustment period could be prolonged.

Slow growth in stock prices could also increase pressures for higher dividend payouts. The danger here, of course, is that higher payouts would reduce retained earnings which constitute an important part of the internal funds available for corporate reinvestment.

2. International Implications

Reduced levels of capital investment, necessitated by a shortage of investment capital, may impede both the growth of the U.S. capital base and the corporate sector's ability to produce. America's position as the major world economic and military power could

be endangered -- particularly vis-a-vis the Eastern-bloc nations where government can tightly control the allocation of resources.

If investment projects are delayed or scrapped because of the unavailability of capital funds at reasonable rates, the nation's over-all productivity may decline, placing American exports at a marked disadvantage in world markets. Competitors with more efficient plant and equipment will be able to underprice U.S. goods. The impact on the nation's balance of payments would be particularly grave in light of the anticipated need to import substantial amounts of energy resources (and without sufficient energy resources, U.S. industry may be unable to produce up to expectations).

If stock prices remain depressed because of high interest rates and sluggish growth prospects, there may be increasing foreign interest in acquiring U.S. corporations. While this need not be alarming (especially as U.S. companies have invested heavily overseas, often by purchasing foreign facilities) domestic security and related implications must be considered. Especially in an era of capital scarcities, foreign investors, consistent with the national interest, should be accorded a welcome reception.

3. Implications for the American People

Slower growth at home, because of decreased investment spending, will mean higher levels of unemployment and reduced potential for advancement. This will place greater strains on already over-burdened social service facilities, particularly in the central cities. Minority groups will be particularly affected, as upward mobility

becomes more difficult in a constrained economic environment.

Increased unemployment may permanently drive many skilled workers out of their specialties, reducing the available pool of skilled labor. Educational attainment may also decline, with dim economic prospects deterring millions from seeking college educations and advanced training. The long-term implications here are literally incalculable.

Declines in productivity, resulting from a shortage of capital, may further fuel inflationary fires. Prices will continue their upward climb as demand presses against inadequate supply capabilities.

The personal financial security of millions of Americans may also be endangered. Today, billions of dollars in pension funds are invested in common stocks. The recent malaise in the equity markets has reduced the value of pension fund portfolios so that employers are being forced to increase their contributions significantly above planned levels. Continued sluggishness in stock prices could exacerbate the drain on existing pension fund reserves.

In sum, the social fabric of this nation may be weakened if the economy cannot rise to meet the expectations of the American people. Fewer job opportunities, increased pressure on social services, reduced housing activity, and continued inflationary pressures will combine to lower standards of living and the overall quality of life. The Federal government may be unable to fill the vacuum. Declining tax revenues (resulting from reduced economic growth) will hamper the ability of government to meet the needs for mass transit,

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public housing, health care, urban renewal, energy research, and a host of other high-priority programs. The squeeze on Federal revenues will tighten as reduced levels of economic activity require increased expenditures for income maintenance programs.

B. POLICY RECOMMENDATIONS

While the purpose of this report is to identify the dimensions of the prospective capital shortfall, rather than to suggest ways of avoiding it, a number of observations may still be appropriate.

The prospect of a savings shortfall suggests two distinct policy alternatives. One, which could be labeled a policy of benign neglect, would allow the economy to adjust to the shortage of capital through higher interest rates and slower economic growth. The implications of such a policy have already been discussed. The second option envisages the market mechanism playing a major role in closing the prospective capital gap in an environment of brisk economic activity -- by encouraging saving and productive investment, discouraging excessive current consumption, and reducing existing roadblocks to foreign capital investment in the United States, subject to appropriate safeguards with respect to ownership of U.S. productive facilities.

Obviously, the first step in stimulating an economic environment in which saving flows will be adequate to meet projected investment needs, will be for government to bring inflation under control. To begin with, Federal expenditures should be significantly cut back;

non-essential spending should be deferred, and marginal programs should be eliminated. These reductions should apply across all sectors of the budget, including non-essential defense spending. If inflation is not brought under control, rising prices will continue to eat awry at the purchasing power of available savings.

To increase the flow of saving, especially by the business sector, a sweeping reform of U.S. tax laws is essential. Specifically, corporate tax rates should be adjusted to permit increased accumulation of funds for capital purposes, and current capital gains taxation should be modified by:

1) Creating incentives for individuals to realize -- and reinvest -- gains that are now "locked in" by tax considerations.
2) Liberalizing the entire capital gains tax structure to promote risk-taking and to stimulate additional saving.
3) Eliminating the distinction between long-term and short-term capital losses, and providing unlimited deductibility for losses.
4) Allowing for complete tax exemption for reasonable amounts of capital gains.

The double taxation of dividends should be ended. As a first step, the dividend exclusion from Federal income taxes should be increased.

The treatment of depreciation should be modified to reflect higher replacement costs resulting from inflationary trends, and

to encourage quicker replacement with more efficient equipment. By using an "original cost" basis, depreciation charges cannot be sufficient to provide for the replacement of existing capital. As a result, the capital base is eroded as business ends up paying a higher effective tax rate because corporate profits are artifically bloated by the understatement of depreciation expenses.

The investment tax credit should not be used as a counter-cyclical control device, but should be incorporated into the tax structure as a permanent incentive for capital investment. Further, the allowances granted under the program should be raised to provide additional after-tax dollars for investment purposes.

It is fully recognized that these tax changes may reduce the revenues available to the Federal government in the short run. But higher investment spending and national output will, in turn, generate additional tax revenues. Moreover, if public expenditures are cut back to match any reduction in taxes, there is no reason to expect that the shortfall in tax receipts would result in increased deficit financing.

Business and government must also cooperate to use what capital is available more efficiently. To this end, excessive regulation and restrictive controls (especially in the utility industry) should be relaxed. If necessary, environmental standards should be modified, with target dates deferred, so that capital funds may be used temporarily to increase productive capacity.

To attract additional foreign capital, the withholding tax on income from foreign-held securities should be repealed. This particularly applies to the Arab states, with which the U.S. does not have tax treaties. While increased inflows of foreign capital would help bridge the saving gap, such flows require continual monitoring to insure compatibility with domestic economic objectives.

Clearly, national policy must be directed toward increasing the ability of the economy to generate higher rates of saving. But this cannot be accomplished without at least some discomfort. Americans must be willing to make some relatively small sacrifices today -- chiefly by cutting back somewhat on current consumption -- to help assure that future generations will enjoy higher living standards and a better quality of life.

INTRODUCTION

The outlook for equity capital financing in the United States, as of late February 1975, is both encouraging and unpromising.

For the short term, the prospects for improving the scope and quality of equity financing appear reasonably good -- there really is no place to go but up. Declining interest rates and hopes of an eventual economic upturn have given many investors reasons to step up their trading activity. And that can only be a good sign for future public interest in new stock offerings.

Unfortunately, short-term improvement can mask a full range of more fundamental, longer-range problems. And these represent a very serious potential threat to the health of American business.

A major study published by the New York Stock Exchange in the fall of 1974 estimated that business enterprises would account for about $3 trillion of the private sector's $4.5 trillion aggregate capital requirements through 1985. We also estimate that some $800 billion of the total will have to be obtained externally -- from one-quarter to one-half of it from new equity financing.

That translates roughly into an average of $20-$35 billion a year in new equities -- more than American business has ever generated through new equity offerings in a single year.

In the present study, the Exchange's research economists have delineated recent historical trends in corporate financing, showing both an unmistakable, accelerating movement away from internal fi-

nancing and a rapidly intensifying reliance on debt -- especially short-term debt -- to finance capital needs.

The situation is exacerbated by the sharp impact of inflation on corporate profits, and by a tax structure that actually penalizes corporations for not going heavily into debt.

Rising debt/equity ratios, diminishing interest coverage, a dramatic fall-off in new stock underwritings and adverse movements in a host of other key indicators all point to an increasingly bleak picture that could get worse.

The data presented in this study strongly suggest that current public and governmental attitudes toward corporate profitability and the tax structure are inconsistent with the realities of corporate finance.

The Exchange hopes this study may contribute to a better understanding of the capital problems facing U.S. business -- and that it may help stimulate major, necessary changes in national economic and tax policies.

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THE NEED FOR EQUITY CAPITAL

This research report focuses on the equity capital needs of America's corporations. Its basic conclusion is that the level of equity financing will have to increase significantly -- far above historic levels -- if the corporate sector is to maintain its financial strength and its economic vitality.

The report first highlights the enormous capital needs facing the U.S. economy. It indicates that corporations may have increasing difficulty meeting these needs, in light of their growing dependence on external debt financing. The study goes on to point out that the ability of corporations to finance new equity issues has been constrained at the very time when it is clearly needed the most -- and suggests that the deterioration in real corporate profitability must be reversed if the long-term equity picture is to improve.

I. The Future Capital Needs of the American Economy

The capital needs of the American economy are expected to grow enormously over the next decade. Estimates prepared by the NYSE, as well as projections made by others, suggest that upwards of $4.5 trillion in capital spending will be required over the 1974-1985 period. Table 1, provides a breakdown of these requirements, with particular emphasis on business plant and equipment expenditures.

Table 1

PROJECTIONS OF GROSS PRIVATE DOMESTIC INVESTMENT
Cumulative, 1974-1985

	1974-85 in Current $	1974-85 in 1973 $	1962-73 in 1973 $
Plant and Equipment Spending	$2,568	$1,799	$ 939
Energy	824	571	241
Basic Materials	328	230	125
Transportation and Transport Equipment	225	158	109
Communications and Services	772	548	329
Other	419	292	135
Residential Construction	1,085	771	509
Non-Profit, Agriculture, and Change in Inventories	850	601	400
Total Gross Private Domestic Investment	$4,503	$3,171	$1,848

Source: The Capital Needs and Savings Potential of the U.S. Economy: Projections Through 1985, New York Stock Exchange, September 1974.

These projections are predicated on a 3.6% annual real growth rate and a conservative 5% annual average inflation rate to 1985. The table indicates that the projected cumulative capital needs far exceed similar spending in the 1962-1973 period, even when all flows are converted to constant dollar terms.

The NYSE has projected that the economy will be hard put to meet its capital needs -- that there will be a sizeable capital gap -- unless decisive actions are taken to increase the flow of saving to the economy. The concept of a "capital gap" is particularly relevant to the corporate sector. As documented in this report, industry's accelerating search for financing has created conditions which

may not be sustainable. Without fresh infusions of equity capital, business may well be unable to fund its investment objectives.

II. The Changing Composition of Business Financing

A. Greater Reliance on External Funds

Non-financial corporate business has sharply increased the proportion of external funds in its financing operations. As shown in Table 2, the ratio of external to internally generated funds (depreciation plus retained earnings) has risen almost steadily from 29% in 1950 to 85% in 1974.

Table 2

PERCENT OF EXTERNAL TO INTERNAL SOURCES OF FUNDS
1950-1974
(Corporate Non-Financial Sector)

	Percent
1950	29%
1955	32
1960	35
1965	35
1966	41
1967	52
1968	48
1969	68
1970	72
1971	66
1972	72
1973	77
1974*	85

* Average, 1st and 2nd quarters, seasonally adjusted, at an annual rate, 1974.

Sources: Supply and Demand for Credit in 1974, Salomon Brothers.
Flow of Funds, Board of Governors of the Federal Reserve System, 1950-1974.

This growing dependence on external financing is also seen in the declining ratio of internal funds to capital expenditures (Table 3). The ratio has declined sharply from 82.3% in 1968 to 63.3% last year. The ability of corporations to finance their investment needs "in-house" has been severely eroded in the past seven years.

Table 3

GROSS INTERNAL FUNDS AS A PERCENT OF CAPITAL EXPENDITURES
Non-Financial Corporate Business
1960-1974
(Billions)

	Gross Internal Funds	Capital Expenditures	Percent
1960	$34.4	$38.7	88.9%
1961	35.6	36.3	98.0
1962	41.8	43.6	95.9
1963	43.9	45.2	97.1
1964	50.5	51.6	97.9
1965	56.6	62.3	90.9
1966	61.2	76.5	80.0
1967	61.4	71.4	86.0
1968	61.7	75.0	82.3
1969	60.7	83.7	72.5
1970	59.4	84.0	70.7
1971	68.0	87.2	78.0
1972	78.7	102.5	76.8
1973	84.6	121.5	69.6
1974*	83.7	132.3	63.3

* Average 1st and 2nd quarters, seasonally adjusted, at an annual rate.

Source: Flow of Funds, Board of Governors of the Federal Reserve System, 1960-1974.

B. The Trend Toward Debt

In raising external capital, non-financial corporations have turned increasingly toward debt. Debt/equity ratios for manufacturing companies, for example, have risen sharply since 1964. Table 4 provides data on this shift and indicates that particular industry groupings have undergone significant changes in their debt positions. For example, debt/equity ratios in 1964 ranged from 16.3% to 46.0% -- and only four industry groups of the 20 groups in the table, had ratios over 40.0% (lumber, leather products, apparel and miscellaneous manufacturing). In 1973 the range was 25.5% to 67.8%, and 16 of the 20 had ratios of over 40%. Nine industry groups had debt/equity ratios of over 50% and five of those had ratios of over 60% (miscellaneous manufacturers, tobacco, apparel, lumber and wood products, rubber and plastics).

Table 4

DEBT/EQUITY RATIO BY INDUSTRY (%)
All Manufacturing Corporations
1964, 1973, 1974

	1964	1973	1974 (est)*
All Manufacturing Corporations	25.4%	43.9%	42.0%
Durables			
Transportation Equipment	17.0	38.1	35.5
Motor Vehicles and Equipment	10.7	24.9	19.2
Aircraft and Parts	31.5	62.5	58.5
Electric Machinery, Equipment and Supplies	29.6	54.1	54.4
Other Machinery	26.3	41.6	38.2
Metal Working Machinery and Equipment	18.1	40.1	n.a.
Other Fabricated Metal Products	27.9	46.1	n.a.
Primary Metals	26.3	53.2	48.5
Primary Iron and Steel	24.1	51.1	45.0
Primary Non-Ferrous	30.3	56.2	53.5
Stone, Clay, Glass	22.9	41.9	46.7
Furniture and Fixtures	26.5	42.7	n.a.
Lumber and Wood Products	46.0	63.3	n.a.
Instruments and Related Products	21.2	25.5	24.6
Miscellaneous Manufacturing	46.0	67.8	n.a.
Other Durable Manufactures	n.a.	n.a.	62.5
Non-Durables			
Food and Kindred Products	31.5	54.1	56.1
Tobacco Manufacturers	26.1	64.7	67.6
Textile Mill Products	32.4	55.4	58.0
Apparel and Other Finished Products	40.9	63.4	n.a.
Paper and Allied Products	27.2	50.3	48.8
Printing and Publishing (ex. Newspapers)	31.1	39.1	37.9
Chemical and Allied Products	26.5	39.6	36.6
Basic Chemicals	33.8	48.2	42.5
Drugs	10.1	27.4	23.9
Petroleum Refining and Related Industries	16.3	28.9	22.2
Petroleum Refining	16.0	28.8	n.a.
Rubber and Miscellaneous Plastics	34.5	61.5	79.4
Leather and Leather Products	41.0	48.5	n.a.
Other Non-Durable Manufactures	n.a.	n.a.	58.5

* Data through the first half of 1974. In 1974 the FTC altered its method of data collection. Thus, the 1974 D/E ratios should not be compared directly with the 1973 ratios, as the underlying data bases are not identical.

Source: FTC/SEC, Quarterly Report of Manufacturing Corporations, 1964, 1973, 1974.

For non-manufacturing sectors a similar shift is also observable. While post-1971 data have not been published, latest IRS statistics show that the ratio of long-term debt to net worth increased markedly between fiscal 1965 and 1971 (Table 5). These ratios would show an even higher rate of change if current statistics were available.

Table 5

LONG-TERM DEBT AS A PERCENT OF NET WORTH
Fiscal 1965 & Fiscal 1971

	Fiscal 1965	Fiscal 1971*	% Change
Selected Industrial Divisions	38.3%	48.2%	25.9%
Agriculture, Forestry and Fishing	46.8	79.1	69.0
Wholesale and Retail Trade	23.7	32.2	35.9
Transport, Communication, Electric and Gas Utilities and Sanitary Services	76.5	94.4	23.4
Mining	27.3	31.1	13.9
Contract Construction	39.2	43.9	12.0
Services	88.7	92.1	3.8
Finance, Insurance and Real Estate	42.8	42.1	-1.6

* Latest available data.

Source: IRS, Statistics of Income, 1970 Corporation Income Tax Returns.

For non-financial corporations, all classes of debt have increased markedly over the 1968-1974 period (Table 6). Most significantly, short-term borrowings have skyrocketed. The ratio of short-term debt outstanding to corporate bonds outstanding has risen from 73.3% in 1968 to an alarming 99.7% in 1974 (Table 7).

Table 6

ANNUAL NET INCREASE IN DEBT OF NON-FINANCIAL CORPORATIONS
1968-1974
(Billions)

	Mortgage Debt	Long & Short Term Bank Loans	Net New Bond Issues
1968	$ 5.7	$ 9.7	$12.9
1969	4.6	11.6	12.0
1970	5.2	5.7	19.8
1971	11.4	4.8	18.8
1972	15.6	13.9	12.2
1973	16.1	30.6	9.2
1974*	12.5	32.9	14.3

* Average 1st and 2nd quarters, seasonally adjusted data at an annual rate.

Source: Flow of Funds, Board of Governors of the Federal Reserve System, 1968-1974.

Table 7

SHORT-TERM DEBT OUTSTANDING AS A
PERCENT OF CORPORATE BONDS OUTSTANDING
1968-1974
(Billions)

	Short-Term Debt	Corporate Bonds	Percent
1968	$ 99.4	$135.6	73.3%
1969	118.3	147.6	80.2
1970	126.8	167.3	75.8
1971	131.5	186.1	70.6
1972	147.0	198.3	74.1
1973	179.3	207.5	86.4
1974*	221.2	221.8	99.7

* Average 1st and 2nd quarters, seasonally adjusted data at an annual rate.

Source: Flow of Funds, Board of Governors of the Federal Reserve System, 1968-1974.

III. Implications of the Shift to Debt

Rising levels of debt, especially short-term indebtedness, have increased the vulnerability of corporations to swings in corporate earnings. They have forced many corporate managers to devote a disproportionate amount of their activities to managing their companies' debt position rather than concentrating on the real business of the firm. The huge overhang of fixed interest payments is particularly worrisome in the present period when corporate profits are expected to fall from their 1974 levels.

Measures relating to debt-carrying capacity have shown a marked deterioration since the mid-1960's. This is especially true in the case of interest coverage (pre-tax corporate profits of non-financial corporations plus interest payments divided by interest payments) and the ratio of liquid assets to short-term debt (Tables 8 and 9). Such sharp downward movements in key financial indicators indicate that corporations may be approaching their borrowing limits.

Table 8

INTEREST COVERAGE*
1955-1974

	Coverage Ratio
1955	27.3
1960	14.4
1965	11.8
1966	11.0
1967	9.0
1968	8.6
1969	6.9
1970(e)	4.7
1971(e)	4.8
1972(e)	5.3
1973(e)	5.7
1974(e)	6.0

* Pre-tax corporate profits of non-financial corporations plus interest payments divided by interest payments.

(e) Estimated by the Department of Commerce, based on 1970/71 IRS data.

Source: Survey of Current Business, U.S. Department of Commerce.

Table 9

LIQUID ASSETS OUTSTANDING TO
SHORT-TERM DEBT OUTSTANDING
1968-1974
(Billions)

	Liquid Assets	Short-Term Debt	Percent
1968	$76.7	$ 99.4	77.2%
1969	78.9	118.3	66.7
1970	77.8	126.8	61.4
1971	88.4	131.5	67.2
1972	99.5	147.0	67.7
1973	106.4	179.3	59.3
1974*	123.1	221.2	55.6

* Average 1st and 2nd quarters, seasonally adjusted data at an annual rate.

Source: Flow of Funds, Board of Governors of the Federal Reserve System, 1968-1974.

The debt statistics outlined in this report do not tell the full story. Off-balance-sheet financing, through leveraged leasing and other techniques, has also increased the vulnerability of corporations. Such financing has grown from approximately $50 billion in 1970 to an estimated $85 billion in 1974, according to the American Association of Equipment Lessors. Long-term leases carry fixed charges that must be paid, just as the interest on a bond issue must be paid. While not considered as debt, the effect is the same -- a drain on the cash position of the firm. When profits fall, the corporation may experience an enormous cash squeeze that can reduce managerial flexibility and possibly endanger the firm's ability to survive.

IV. The Need for Equity Capital

If corporations are to reverse their dangerous drift toward increasing debt, they must obtain fresh infusions of equity capital.

A. Decline in Stock Offerings

Unfortunately, at the very time when equity is needed the market for new issues has evaporated. The number of common stock underwritings has fluctuated from a record high of 1,792 in 1969 down to a mere 154 last year (Table 10). In terms of value, new issues of corporate stocks have fallen precipitously, from a high of $15.2 billion in 1972 to $7.6 billion in 1974 (Table 11). This 50% drop compares with the relative strength in new debt issues over the same period. In terms of net issues (new issues less redemptions) the picture is equally bleak, with net stock issues falling 78% between 1971 and 1974 (Table 12). Note that equity's percent of new issues, expressed either in terms of gross or net issues has fallen sharply in recent years.

Table 10

NUMBER OF COMMON STOCK UNDERWRITINGS
1965-1974

	Number of Underwritings
1965	367
1966	316
1967	469
1968	1,099
1969	1,792
1970	778
1971	1,128
1972	1,383
1973	411
1974*	154

*Preliminary

Source: Investment Dealers Digest, 1967-1974.

Table 11

NEW ISSUES OF CORPORATE SECURITIES
All Industries
1964-1974
(Millions)

	Debt	Percent	Stock	Percent	Total
1964	$10,715	74.1%	$ 3,748	25.9%	$14,463
1965	12,747	79.9	3,205	20.1	15,952
1966	15,629	78.9	4,169	21.1	19,798
1967	21,299	82.0	4,664	18.0	25,963
1968	19,381	76.2	6,057	23.8	25,438
1969	19,523	67.7	9,318	32.3	28,841
1970	29,495	76.2	9,213	23.8	38,708
1971	31,917	68.4	14,769	31.6	46,686
1972	27,065	64.0	15,242	36.0	42,307
1973	21,501	64.1	12,057	35.9	33,558
1974*	37,300	83.1	7,600	16.9	44,900

* Estimated, first three quarters, at an annual rate.

Source: SEC, Statistical Bulletin, 1964-1974.

Table 12

ANNUAL NET CHANGES IN CORPORATE SECURITIES
All Industries
1964-1974
(Millions)

	Debt	Percent	Stock	Percent	Total
1964	$ 6,637	82.3%	$ 1,431	17.7%	$ 8,068
1965	8,098	100.5	-37	-0.5	8,061
1966	11,088	90.5	1,169	9.5	12,257
1967	15,960	87.6	2,267	12.4	18,227
1968	13,962	106.9	-900	-6.9	13,062
1969	13,755	74.4	4,727	25.6	18,482
1970	22,825	77.0	6,801	23.0	29,626
1971	23,728	63.8	13,452	36.2	37,180
1972	19,062	59.4	13,018	40.6	32,080
1973	12,691	58.3	9,064	41.7	21,755
1974*	22,600	87.9	3,100	12.1	25,700

* Estimated, first three quarters, at an annual rate.

Source: SEC, Statistical Bulletin, 1964-1974

The basic reason for the decline in new stock issues is that stock prices have fallen to such low levels (below book value in many cases) that companies cannot issue new stock without diluting the earnings of existing shareholders. At current P/E's, a corporation must earn approximately 14% on new capital in order to protect shareholder interests. Such high returns may not be attainable. Also, if the investor expects the company will have to engage in a succession of new stock issues in the future, at similar P/E ratios, he may be unwilling to buy the stock at less than book value. The lower the price at which the stock sells today, the

lower will be the price relative to book equity per share of future sales, and the greater the subsequent dilution of earnings per share.[1/]

B. The Role of Corporate Profitability

A basic factor behind the relatively poor yields on stocks is the alarming fall-off in "real" corporate profitability. While reported profits have risen sharply since 1970, the rise has been mainly in the form of transitory inventory gains. Subtraction of these "phantom" profits confirms that corporate returns have shown only minimal growth since 1972 (Table 13).

Table 13

CORPORATE PROFITS BEFORE TAXES
All Industries
1966-1974
(Billions)

	Pre-Tax Profits	Inventory Valuation Adjustment	Pre-Tax Profits Less IVA
1966	$ 84.2	$- 1.8	$ 82.4
1967	79.8	- 1.1	78.7
1968	87.6	- 3.3	84.3
1969	84.9	- 5.1	79.8
1970	74.0	- 4.8	69.2
1971	83.6	- 4.9	78.7
1972	99.2	- 7.0	92.2
1973	122.7	-17.6	105.1
1974 (est.)	143.8	-37.4	106.4

Source: Economic Indicators, December 1974.

1/ Herman G. Roseman, "Utility Financing Problems and National Energy Policy," Public Utilities Fortnightly, September 12, 1974, pages 6-7.

The picture is even less encouraging when adjustment is made for the underdepreciation of corporate assets. Corporations now depreciate on the basis of historical cost. However, with high inflation rates, replacement costs have skyrocketed. As a result, business is not allocating sufficient funds to maintain its capital base.

The situation is further exacerbated by the fact that taxes on corporate profits are based on these overstated profits. As Table 14 indicates, corporations have been paying effective tax rates in excess of 65%, if taxes paid are related to the real value of corporate earnings.

Table 14

EFFECTIVE TAX RATES ON PRE-TAX CORPORATE PROFITS*
1965-1974

	Profits As Reported	Profits Adjusted for IVA and Underdepreciation
1965	42%	43%
1966	42	44
1967	43	46
1968	47	55
1969	49	58
1970	50	62
1971	46	58
1972	47	58
1973	48	66
1974 (est.)	48	67

* Includes Federal and State Taxes

Source: Terborgh, G. "Inflation and Profits," Financial Analysts Journal, May-June, 1974, page 22.

It is little wonder then that corporations have been forced to the credit markets. With real profits lagging and dividend payouts rising, there is literally nothing left to plow back into the business. Table 15 shows dramatically the effect of declining real profits -- in 1974 business actually paid a portion of its dividends out of existing capital.

Table 15

RETAINED EARNINGS
Non-Financial Corporations
1960-1974
(Billions)

	Adjusted*	Reported
1960	$7.5	$9.0
1961	7.4	8.9
1962	12.5	11.1
1963	12.4	11.9
1964	18.1	16.8
1965	22.2	19.9
1966	22.0	22.7
1967	17.8	18.4
1968	15.4	17.1
1969	7.2	13.3
1970	1.9	9.6
1971	6.6	14.1
1972	11.7	20.8
1973	11.5	31.3
1974(est.)	-5.2	35.2

* Profits adjusted for IVA and underdepreciation of corporate assets.

Sources: "Profitability and Investment," The Morgan Guaranty Survey, Morgan Guaranty Trust Co., September 1974. Survey of Current Business, 1961-1974.

These statistics boil down to the basic fact that the actual returns to the corporate sector are simply inadequate to attract new equity investment. As seen in Table 16 the "adjusted" after-

tax return on the capital assets of non-financial corporations stood at a woeful 4.8% in 1974. With such meager returns, it is little wonder that equity markets have been so depressed.

Table 16

AFTER-TAX RATE OF RETURN ON
NON-FINANCIAL CORPORATE CAPITAL ASSETS
1965-1974

	Adjusted* After Tax Rate of Return	Unadjusted After Tax Rate of Return
1965	10.0%	10.0%
1966	9.9	10.0
1967	8.8	8.7
1968	7.9	8.3
1969	6.4	7.3
1970	5.4	6.3
1971	5.6	6.5
1972	6.2	7.2
1973	6.1	8.3
1974 (est.)	4.8	9.0

* Profits adjusted for IVA and underdepreciation of corporate assets.

Source: "Profitability and Investment," The Morgan Guaranty Survey, Morgan Guaranty Trust Co., September 1974, page 10.

V. Conclusion

The NYSE has estimated that roughly $250 billion in net equity financing will be needed in the decade ahead. This projection is in line with estimates made by Henry Kaufman, partner of Salomon Brothers, who recently noted that "there will have to be quite a few years...in which the net volume of new equity flotations will have to exceed $20 billion if credit quality deterioration is to be arrested."[2/] It ought be noted the amount of equity financing implied in these figures dwarfs postwar flotations, which peaked at $13.5 billion, net, in 1971.

The recent lowering of interest rates and rebound in stock prices, while most welcome, should not obscure the long-term difficulties facing the equity markets. The statistical materials presented in this report demonstrate that the alarming increases in corporate debt, and decline in real profitability, are fundamental problems that will have to be resolved if we are to meet the economic challenges of the future.

2/ Henry Kaufman, "Financial Roadblocks to a New Economic Expansion," a speech before the 25th Anniversary Investment Seminar of the New York Bankers Association, November 22, 1974.

The Need for Equity Capital

A Summary ...

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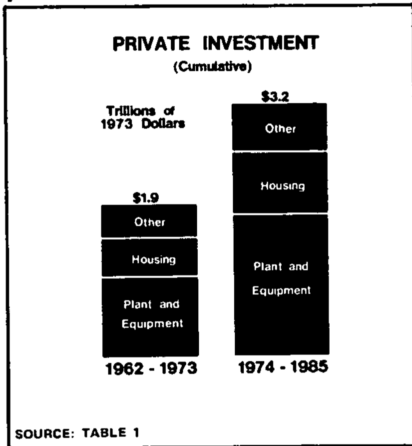

Prospective capital needs are enormous at the very time when...

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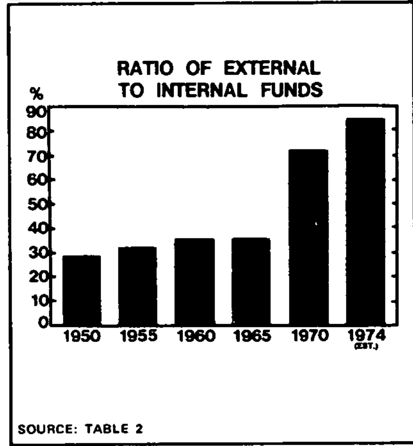

corporations are relying more heavily on external capital...

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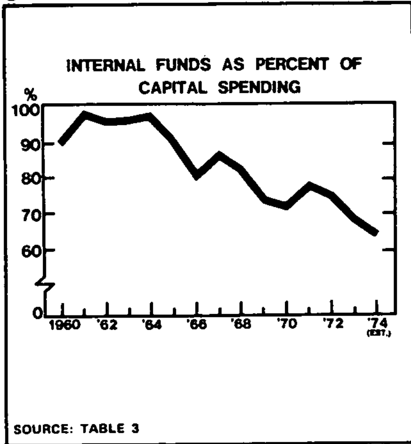

and less heavily on internal funds -- especially to finance capital investment.

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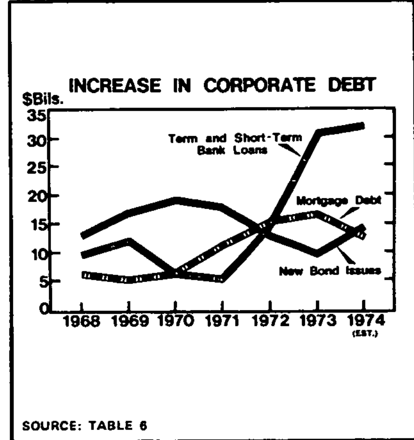

The level of debt has risen sharply...

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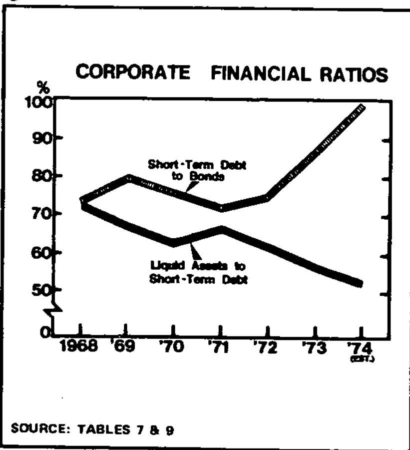

placing new strains on corporate financial capacity.

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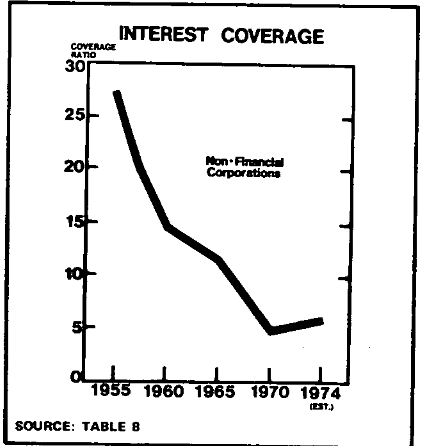
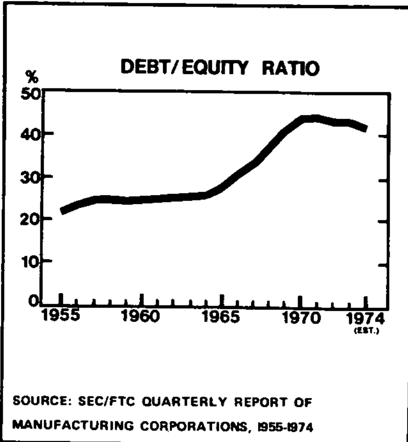


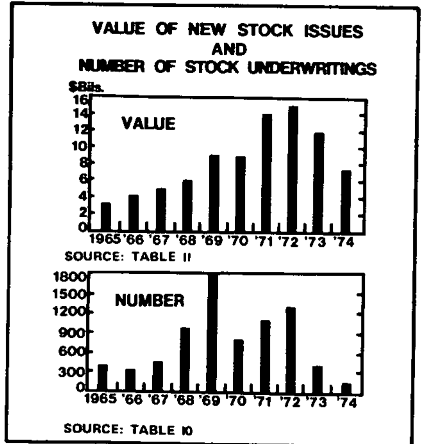
This is seen especially in falling interest coverage...

7



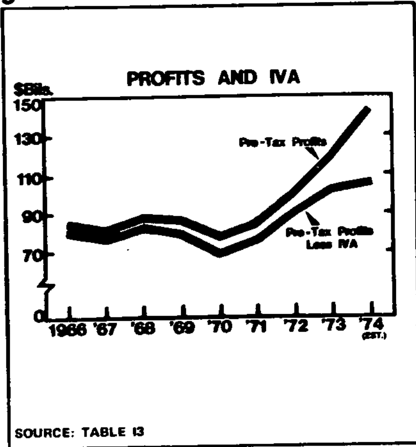
and rising debt/equity ratios.

8



While debt has been increasing, new stock issues have fallen and the number of new stock underwritings has plummeted.

9



The fall-off in new stock issues is related to reduced growth of real profits...

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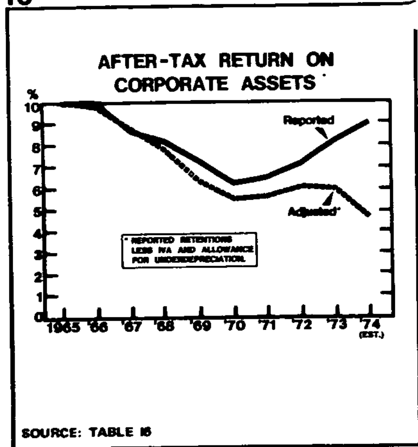
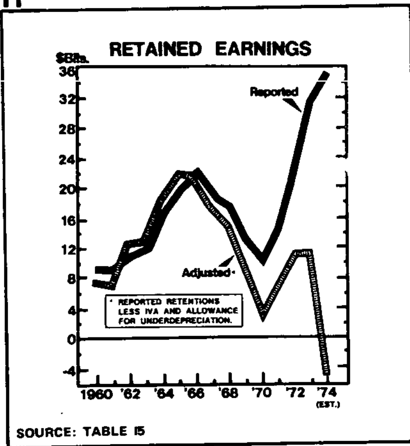


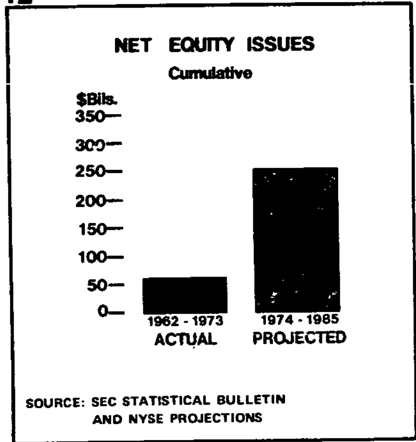
which is reflected in the sharp decline in real rates of return.

11



Decreasing real profitability has resulted in negative retentions in 1974.

12



Unless sufficient new equity is forthcom. .g, the economy may have serious difficulty in meeting its investment objectives.

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Introduction

The New York Stock Exchange has spearheaded a major campaign to alert U.S. business and government leaders to the prospect of a major shortage of investment capital in the years ahead. The present research study is the third in a series of statistical analyses relating to this problem. Its findings imply an urgent need to develop ways and means of encouraging large numbers of individual Americans to become net purchasers of corporate stocks in the decade ahead.

Our initial report, published in September 1974, estimated that business enterprises would require some $3 trillion of the private sector's projected aggregate capital requirements of $4.5 trillion through 1985.

The second report, issued in February 1975, estimated that of some $800 billion that U.S. corporations will have to raise externally, at least $250 billion will need to come from new equity financing.

The present study relates corporate equity requirements to the prospective sources of equity capital through 1985 -- institutional investors, foreign investors, and U.S. households. It suggests that in the absence of specific measures to improve the equity investment climate in the United States, net equity purchases will fall short of the goal by an average of some $7 billion a year.

Essentially, the task of accumulating enough capital means that people must save more and consume less. In a society accustomed to perhaps more than its share of material self-indulgence, that suggests a reversal of form approaching the revolutionary.

It implies major changes in national priorities; changes in budget and monetary policies; changes in the tax structure.

It is impossible to overstate the dimensions of the stakes involved in the national quest for capital sufficiency. Success or failure will play a key role in determining whether or not the nation will be able to generate adequate employment opportunities for its work force; whether or not we will be able to meet our national energy goals; whether or not 210 million Americans will have adequate housing and mass transit; whether or not American business and industry can maintain the standards of excellence essential to keeping America fully competitive in world markets.

That is the underlying message of this series of reports on America's investment capital prospects -- a message that underscores the urgent need for a major reassessment of public policy toward capital investment.

Now.

Chairman

DEMAND AND SUPPLY OF EQUITY CAPITAL PROJECTIONS TO 1985

Overview

This study is the third in a series of NYSE research reports on the U.S. capital markets. The first study, "The Capital Needs and Savings Potential of the U.S. Economy" drew attention to the possibility of a significant shortage of investment capital in the decade ahead. The second study, "The Need for Equity Capital" discussed the growing reliance of corporations on debt financing and spotlighted the disturbing secular decline of real corporate profitability. The report indicated that fresh infusions of new equity capital will be required if the credit deterioration evidenced over the past decade is to be corrected.

The present study extends this view by quantifying the future demand and supply of equity capital. Specifically, the report projects corporate demands for equity through 1985 and relates these projections to expected sources of supply -- from institutions, foreigners, and "households". The major conclusion is that corporations will be hard-pressed to market the amount of equity capital that they will need in the next decade, unless incentives are provided to stimulate individual demand for corporate stocks.

Section I projects corporate equity requirements over the next decade. Section II estimates the net acquisition of equities

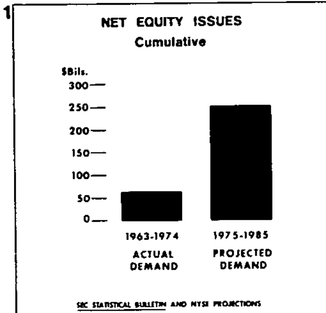
by institutions, foreigners and "households". Section III discusses the implications of these projections, both to the capital markets and to the economy as a whole.

A chart summary, highlighting the major conclusions of this study, precedes the text.

- 3 -

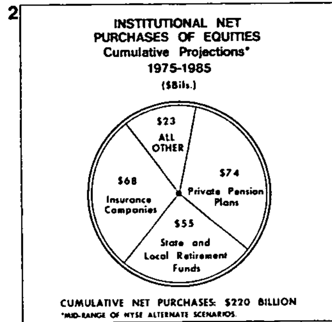
DEMAND AND SUPPLY OF EQUITY CAPITAL
A Summary ...

1



Corporate demand for new equity will dwarf historic levels, cumulating to $250 billion in the decade ahead.

2



Institutions will be the major source for equity capital.

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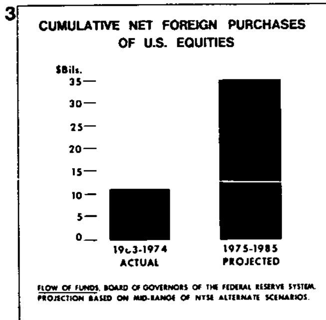

Foreigners will substantially increase their net purchases of equities.

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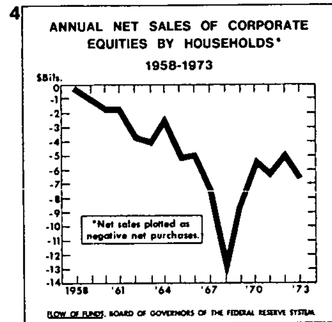

Households, however, will continue to be net sellers, as in the past.

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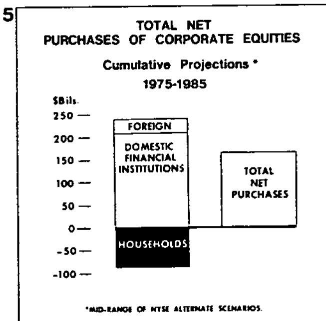
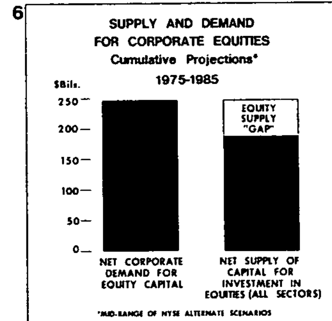


Total supply of equity will cumulate to only $175 billion.

6



Comparing net demand and supply of equity capital shows a cumulative gap of $75 billion through 1985, or about $7 billion a year.

I. Projections of Corporate Demand for Equity Capital

The effort to project net corporate equity issues through 1985 was necessarily subject to a wide range of inhibiting factors. For example, the variability of the dollar value of net equity issues precluded the use of trend analysis to project these flows directly (see Table A-1, Statistical Appendix). Moreover, significant changes in the economic environment made it inappropriate to rely on long-term historical data in projecting out to 1985. Inflation experienced during 1968-75 bears little resemblance to the marked price stability of the immediately preceding period; thus, any trend analysis that included the early to mid-sixties would inevitably be biased downward.

A. Underlying Assumptions

1) Capital needs in the next decade will be enormous.

In the 1974-85 period, corporations will have to finance roughly $2.5 trillion in fixed investment.[1/] In constant 1973 dollars, this sum is nearly double the spending on capital investment in the preceding twelve year period. Included here are capital expenditures in the energy sector, and for plant and equipment in the basic materials processing, transportation equipment, communications and service industries (see Table A-2).

1/ These capital spending projections are drawn from an Exchange study, "The Capital Needs and Savings Potential of the U.S. Economy: Projections to 1985". It is available on request to the Research Department.

2) <u>The trend toward external financing may abate somewhat, if corporate profits improve in the next decade.</u>

As shown in Table A-3, the ratio of external to internal sources of funds has risen sharply since the mid 1960s. This trend is directly related to the decline in the real value of corporate retained earnings. Inflationary pressures have dramatically cut into the purchasing power of corporate profits -- as shown in Table A-4. If inflation stabilizes over the next decade, and corporations regain some measure of profitability, the pressures for increased levels of external financing should be dampened.

However, the level of profitability is unlikely to return to the halcyon days of the early 1960s, when internal funds represented 95% of capital expenditures (Table A-5). Indeed, a return to a 75% level would represent a major improvement. Thus, there should still be a significant demand for outside financing in the years ahead.

3) <u>Regardless of increases in internal funds, present debt/equity ratios and other financial measures suggest that continued expansion of relative debt burdens may not be possible.</u>

Table A-6 indicates that corporate debt burdens -- particularly short-term indebtedness -- have increased markedly. However, even more disturbing than these raw figures is the alarming deterioration in key barometers of corporate creditworthiness. Table A-7 shows that debt equity ratios have soared by 88% since 1964; Table A-8 charts the decline of interest coverage from 11.0 in 1966 to 6.0 in 1974.

Recent capital market activity suggests that lenders have shaken off the blinders of the early-to-mid 1960s, when rising debt burdens were expected to be readily financed by continuously rising corporate profits. However, the inflation of the past eight years, combined with the appearance of a long and steep recession, has made lenders extremely cautious about granting credit without regard to the equity base of the borrowing corporation.

B. Looking to the Future

In light of these underlying assumptions, the Exchange's projections to 1985 assume that corporations will need to use equity in considerably greater proportions than in the past. However, because of the uncertainties involved in estimating the magnitude of equity financing that might be required, it was assumed that at a minimum, corporations would finance 10% of their future capital expenditures by means of equity -- the proportion recorded during 1970-73 (Table A-9). This implies net equity issues cumulating to approximately $250 billion through 1985.[2/]

While it may be regarded as somewhat arbitrary, this assumption provides a reasonable estimate of future equity requirements.

2/ NYSE projections of expenditures on new plant and equipment cumulate to nearly $2.5 trillion over the next decade. Ten percent of this sum equals $250 billion. These capital spending projections are fully detailed in "Capital Needs and Savings Potential of the U.S. Economy: Projections to 1985", New York Stock Exchange, September 1974.

The clear need to redress current debt/equity imbalances suggests that many corporations may find an even higher rate of equity financing appropriate. Indeed, if manufacturers alone were to build up their equity merely to restore the debt/equity ratio to the average level of 1961-65, they would need more than $250 billion of additional equity to redress their balance sheets -- without financing any additional growth.

II. Supply of Equity Capital

Three major groups of investors supply equity capital to corporations: financial institutions, foreigners, and "households", which include non-profit organizations, personal trusts and individuals.

A. Institutional Supply of Equity Capital

Institutional net purchases of corporate equities have been growing apace since the late 1960s (excluding 1974, a disastrous year for the equity markets in general and for new stock issues in particular). As shown in Table A-10, private non-insured pension plans, state and local retirement funds and life insurance companies -- among the major institutional purchasers -- sharply increased their net purchases of corporate stocks.

The substantial upward thrust of institutional net purchases of equities in the late 1960s and early 1970s make forecasting particularly difficult. It simply cannot be assumed that such rapid growth rates will continue, or that particular ratios

will remain at their recent levels. Accordingly, the projections of institutional net purchases described below are highly judgmental and must not be viewed as precise point forecasts.

Net purchases of equities were projected via a two-step procedure. First, an estimate was made of future net acquisitions of financial assets. Regression and judgmental methods were used in these projections (Table A-11). Then, based on probable values for the ratio of net equity purchases to net financial asset acquisitions (Table A-12), future net stock purchases were calculated.

Two alternate scenarios were developed:

1) Scenario A, assuming a high value for the equity to net acquistions ratio, and
2) Scenario B, in which the percent of annual asset flows devoted to equities would be significantly lower than in recent periods.

The average of these alternate scenarios could be taken as a "mid-range" forecast. Table 1 shows the results of these calculations -- i.e., that financial institutions will purchase, net, between $190 and $253 billion in equities over the next decade.

Table 1

Projections of Institutional
Net Purchases of Corporate Equities
Cumulative, 1975-1985
(billions)

	Scenario A	Scenario B	Mid-Range
Private Non-Insured Pension Plans	$ 87	$ 62	$ 74.5
State - Local Retirement Funds	62	49	55.5
Life Insurance Companies	52	45	48.5
Property & Casualty Insurance Companies	24	15	19.5
Other Institutions*	28	19	23.5
TOTAL	$ 253	$ 190	$ 221.5

*Mutual Savings Banks, Open-End Investment Companies, Security Broker/ Dealers.

Source: NYSE projections.

The derivation of these forecasts is explained in greater detail below.

1) Private Non-Insured Pension Plans

a. Net Asset Acquisitions

Net asset acquisitions of private non-insured pension plans have been extremely stable over time, ranging narrowly between \$6.3 and \$7.7 billion annually in recent years. It was assumed that the average annual growth rate in net acquisitions over the past eleven years (5.5%) would hold for the next eleven years as well. This assumption may be on the high side, as many pension programs are presently undergoing considerable cash management

difficulties, with benefit disbursements rising at a higher rate than contributions and investment income. This could place extreme pressure on the level of annual asset acquisitions. Indeed, zero net acquisitions by the early 1980s are by no means inconceivable. It should be recognized, therefore, that to the extent net acquisitions may be overstated, there would be a correspondingly high estimate of net equity purchases.

b. Net Equity Purchases

Historically, private pension plans have been heavy net purchasers of corporate stocks. In 1971 and 1972, net stock purchases have exceeded 100% of their annual acquisitions of financial assets. However, this is unlikely to occur again in the decade ahead -- for several reasons.

First, the new pension reform law may sharply alter pension fund managers' equity purchasing activities. The law requires diversification in portfolio policy. If a pension plan predominantly invested in common stocks does not meet the yet to be interpreted provisions of the law, plan managers may be compelled to divest significant portions of their portfolios or reduce future net purchases of equity securities. The fiduciary requirements of the act, under which fund managers may be held personally liable for losses resulting from "improper handling of plan assets", may also cause fiduciaries to reexamine their equity exposure -- especially if high yields on fixed income securities continue to be available.

In addition, in rising markets, equities automatically increase as a percentage of total financial assets. As this occurs, pension plan managers probably will be reluctant to sharply increase the flow of new money into stocks.

With these factors in mind, Scenario A projects equity purchases at 70% of annual net acquisitions of financial assets, cumulating to $87 billion through 1985 -- a slightly lower percentage than the 72% rate in 1967-73 (excluding the abnormal years of 1971 and 1972).

Scenario B assumes that the enormous losses suffered by pension plans in the market slide of 1973-74 and the impact of the new pension reform law will sharply reduce the share of net equities purchased in the years ahead. If the relevant ratio is assumed to average 50% over the decade -- roughly equivalent to the rate during the more conservative 1960-66 period -- net purchases will cumulate to $62 billion. The possibility that the projections of net asset acquisitions may actually be overstated adds credibility to this projection.

2) <u>State and Local Retirement Funds</u>

a. <u>Net Asset Acquisitions</u>

As with the private pension plans, net acquisitions of financial assets by state and local retirement funds (SLRF) have risen at a steady pace. For purposes of estimation, these assets were assumed to continue growing at their 1965-73 rate, adjusted

slightly to reflect the rapid run-up in acquisitions in the past few years.[3/]

b. Net Equity Purchases

SLRF's have dramatically increased their proportionate annual acquisitions of equities. The percentage of net equity purchases to net asset acquisitions surged from an average of 7.8% during 1960-65 to 42.7% during 1970-73.

Scenario A assumes that the equity/acquisition ratio will average slightly more than 41% over the decade, implying cumulative net purchases of $63 billion. The rationale for selecting this percentage is essentially the same as in the projection of private pension plan net equity purchases. Scenario B assumes a somewhat lower percentage of net purchases to annual net asset flows, averaging 32% over the estimating period. Again, the impact of the 1973-74 market slide and the growing preference among the state and local governments for "preservation" over "performance" may result in a relatively smaller volume of net equity purchases -- $49 billion -- than might have otherwise been the case.

3/ Regression analysis was used to project the 1975-85 values of SLRF annual net acquisitions. The estimating equation was as follows:
Net Acq. (SLRF) = -41.63971 + .68680T
Where T = time, 1965-1973
The computed "t" statistic was 9.582 and the R^2 was .929.

3) Life Insurance Companies

a. Net Asset Acquisitions

Annual net asset acquisitions of life insurance companies have been expanding rapidly since 1970, rising from $9.9 billion in 1970 to $16.6 billion in 1973, an increase of 68% over three years. This rapid rise reflected a sharp increase in policy loans by policy holders, (to take advantage of interest rate differentials) and increased purchases of corporate debt instruments. (Such purchases amounted to $1.5 billion in 1970 and $5.9 billion in 1973.)

This rate of increase is not expected to be sustainable over the next decade; more likely is a return to historical growth rates averaging 5% over the decade (5.5% per annum through 1980 and 4.5% per annum thereafter, to 1985).

b. Net Equity Purchases

Equities as a percent of net asset acquisition have risen sharply since 1967.[4/] The ratio has varied between 28.7% and 18.5% in the 1969-73 period (with an average ratio of 22.3%).

Consistent with the rationale used in projecting net equity purchases for private pension plans and SLRFs, Scenario A assumes that 20% of future net asset acquisitions would be devoted to equities -- or $52 billion on a cumulative basis. Scenario B

4/ Increases in net equity purchases have been confined, primarily, to segregated investment accounts.

assumes a 15% rate, with flows cumulating to $45 billion. This lower rate (the average rate for 1967-69), while still historically high, takes into consideration the possibility that the rapid buildup of equities in life insurance portfolios might have been "too much" - "too fast", and that some slowdown (especially in light of recent book losses and the provisions of the pension reform law) might be in order. Both scenarios assumed that the volume of variable annuity and variable life insurance policies would not increase significantly in the foreseeable future.

4) Property and Casualty Insurance Companies

a. Net Asset Acquisitions

Annual acquisitions of financial assets by property and casualty (P & C) insurers have increased dramatically beginning in 1966 -- displaying a 14% annual rate of growth.

The current perilous financial plight of many P & C companies strongly suggests that this high growth rate will not be sustained over the next decade. A 6% rate of growth over the estimating period appears much more reasonable. This rate is somewhat lower than the long-term historical rate of approximately 7% and reflects the likelihood of reduced acquisitions in the years ahead.

b. Net Equity Purchases

Both scenarios anticipated that P & C insurers would reduce their rate of net equity purchases from the 38% level recorded

during 1971-73. The enormous losses incurred in recent years (in both investments and underwriting operations) clearly argue for a secular reduction in equity exposure.

Scenario A assumed that the equity-asset acquisition ratio would decline to 25% by 1985 -- a fairly minor shift judged against recent developments. In Scenario B, the ratio was assumed to fall to 18% by 1985, the average rate in the 1960-69 period. In dollar terms, cumulative net purchases were projected to range between $15 and $24 billion through 1985.

5. Other Financial Institutions

Mutual savings banks, open-end investment companies and security broker/dealers historically have been minor net purchasers of corporate equities.

Net equity purchases by these institutions are expected to remain small in relation to total institutional accumulations. Because of the small amounts involved, and the extreme variability of the data, only rough estimates of these flows were made. Net equity purchases by "other" institutions are expected to cumulate to between $19 and $28 billion.

B. Foreign Investment in U.S. Equities

Table 2 details the Exchange's projections of foreign net purchases of corporate equities through 1985. Again, two alternate scenarios were developed. On a cumulative basis, between $27 and $43 billion in equity capital is expected to be supplied

from foreign sources -- a mid-range average of somewhat over $3 billion a year. This compares with cumulative net equity purchases of only $10 billion in the preceding decade, or an annual average of under $1 billion.

Table 2

Cumulative Net Foreign
Purchases of Corporate Equities
1963-1974 Actual
1975-1985 Projected
(billions)

	Actual	1975-1985 Projected		
	1963-1974	Scenario A	Scenario B	Mid-Range
Net Foreign Equity Purchases	$ 10.5	$ 43	$ 27	$ 35

Sources: Flow of Funds, Board of Governors of the Federal Reserve System.
NYSE projections.

These projections are tentative and may be subject to considerable variation because of the uncertainty of estimating OPEC investment activity. While recent conjecture has suggested that foreign investment, led by a flow of petrodollars, could become a major factor in the U.S. securities markets, no one can realistically claim to do more than guess at the possible magnitude of the amounts. Indeed, current projections of the OPEC revenues are far lower than forecasts made only six months ago.

In the recent past, net foreign investment in U.S. equities has been minimal -- averaging only $1.7 billion a year during 1968-73. In 1974, a depressed year in the equity markets, foreign investment inflows dwindled to a net of only $0.3 billion. In the present active market, net foreign equity purchases are running at an annual average of roughly $4 billion. Clearly, not enough information is yet available to permit any definitive long-term conclusions.

C. Household Investment in Corporate Stocks

"Households" include -- in addition to individuals as members of households -- personal trusts and non-profit organizations serving individuals, such as foundations, private schools and hospitals, labor unions, churches, and charitable organizations.[5/] This sector has recorded substantial net sales of equities in every year since 1958 (Table A-13). In part, these sales reflect a liquidation of trusts and estates as well as a growing trend toward intermediation by individuals who have shifted from direct equity participation to indirect equity ownership through mutual funds and non-insured pension plans. However, they also reflect a general disenchantment with equity ownership on the part of many investors.

5/ Introduction to Flow of Funds, Board of Governors of the Federal Reserve System, Washington, D.C., February 1975, p.34. No separate breakouts are avilable for individuals, non-profit organizations or personal trusts.

In looking to 1985, households were assumed to continue as net sellers of common stock (Table 3). The specific projections were derived using the same methodology used in the forecasts of institutional net equity purchases; i.e., net acquisitions of financial assets by households were projected, and future equity purchases were then calculated as a percent of this "base figure". (See Tables A-14 and A-15).

Table 3

Projections of Household Net Sales of Corporate Equities*
Cumulative, 1975-1985
(billions)

Scenario A	Scenario B	Mid-Range
$ (108)	$ (48)	$ (78)

*Excludes mutual funds. Net sales are shown as negative net purchases.

Source: NYSE projections.

Scenario A assumed that households' net sales will average 4.5% of net household financial asset acquisitions -- a rate selected on the basis of 1970-74 data -- cumulating to $108 billion by 1985.

Scenario B assumed an annual net sales ratio of 2% of yearly net asset acquisitions -- the average percentage during 1955-59 -- selected to compensate for any possible "upward" bias in Scenario A. If anything, however, the 2% rate probably over-compensates,

as it implies cumulative net sales of only $48 billion -- far too low in light of recent history.

III. Implications

A. Putting the Pieces Together

Tables 4 and 5 draw together the Exchange's projections of the demand and supply of equity capital in the next decade. As shown in Table 4, net purchases of equities are expected to fall short of net corporate demands by between $62 and $81 billion over the estimating period. This amounts to a deficit of roughly $5.6 to $7.4 billion a year in the 11 years to 1985 (Table 5).

Table 4

Summary of NYSE Projections of the Supply and Demand of Equity Capital Cumulative, 1975-1985 (billions)

	Scenario A	Scenario B	Mid-Range
Net Supply			
Net Institutional Purchases	$ 253	$ 190	$ 221.5
Net Foreign Purchases	43	27	35.0
Net Household Purchases (Sales)	(108)	(48)	(78.0)
TOTAL Net Equity Purchases	$ 188	$ 169	$ 178.5
Net Demand	$ (250)	$ (250)	$ (250.0)
Equity "Shortfall"	$ (62)	$ (81)	$ (71.5)

Source: NYSE projections. Data are rounded to the nearest billion dollars.

Table 5

Summary of NYSE Projections of the Supply and Demand of Equity Capital Annual Averages 1975-1985 (billions)

	Scenario A	Scenario B	Mid-Range
Net Supply			
Net Institutional Purchases	$ 23	$ 17	$ 20
Net Foreign Purchases	4	2	3
Net Household Purchases (Sales)	(10)	(4)	(7)
TOTAL Net Equity Purchases	$ 17	$ 15	$ 16
Net Demand	$ (23)	$ (23)	$ (23)
Equity "Shortfall"	$ (6)	$ (8)	$ (7)

Source: NYSE projections. Data are rounded to the nearest billion dollars.

Again, it must be stressed that these projections should not be viewed as precise forecasts. However, what is implied in the results requires no qualification: U.S. industry will be extremely hard-pressed to finance its equity capital needs in the years ahead.

Obviously, the U.S. industrial plant will not grind to a halt because of a deficiency of equity capital. Perhaps less obvious is the likelihood that if corporations must accelerate their debt financing efforts to meet their operational and investment requirements, only the biggest and most seasoned companies can

reasonably expect to obtain needed funds. Smaller companies -- in some ways the innovative heart of the economy -- will be slowly squeezed out of the capital markets and, conceivably, out of existence, unless adequate sources of equity capital are available to them.

In the longer run, larger corporations also will reach the limits of their borrowing power. The situation could deteriorate to the point where large segments of U.S. industry would find it necessary to call on the Federal government to guarantee their loans or to purchase "equity participation" certificates. And that, of course, would effectively place the Federal government in the position of allocating capital to the private sector, with bureaucratic decision-making replacing the market mechanism. The ultimate adverse effects, in terms of reduced economic efficiency and diminished corporate ability to adopt rapidly to changing competitive conditions are incalculable.

B. Closing the Gap

Where can the needed equity capital be obtained? Institutions probably cannot be expected to increase their net purchases much beyond the Scenario "A" levels. Private pension and state and local retirement funds have sharply increased their equity positions in recent years, and are unlikely to allow equities to figure still more prominently in their annual asset acquisitions. Life insurance companies are in a similar position, having invested

heavily in equities since 1969. Also, as previously noted, if over-all market values rise over the next decade, equity holdings will automatically increase as a percentage of total assets. This factor alone could stem any major advance in institutional net purchases beyond forecasted levels.

The foreign sector cannot be relied upon to increase its net equity purchases much beyond the projected levels. While data are insufficient for any firm conclusions in this area, a major shift in the conservative investment strategies of the OPEC nations -- the largest potential foreign source for equity capital-- is unlikely. The oil producing states, particularly the Arab nations, favor government securities and short-term deposits over less liquid and higher risk corporate stocks. Moreover, it now seems doubtful that capital funds held by OPEC nations will reach the high levels predicted by some observers last year.

Clearly, then, the household sector -- and particularly the individual investor -- holds the key to overcoming the capital supply insufficiency implied by the projections developed in this study. The problem here is to find ways to bring the individual investor back into the equity markets -- to reverse his traditional role as a net seller of stocks and to encourage him to become a net purchaser.

The task of developing viable solutions to this problem is beyond the scope of this study. Elsewhere, however, the Exchange

has made a number of constructive recommendations for tax reform which could vastly increase the attractiveness of equities to individuals with investment capital. Those proposals include phasing out the double taxation of corporate profits allocated to dividends, liberalizing and rationalizing the entire capital gains tax structure, and eliminating the withholding tax on dividends and interest paid to foreigners.

Hopefully, the statistical materials and projections presented in this report will help focus the attention of business and government leaders on the urgent need for substantive changes in public policy aimed at achieving capital sufficiency in the decade ahead. The alternative -- a more or less rapid shift to some form of government-administered credit allocation -- could lead to undesirable changes in the nation's social, economic and political environment.

Table A-1

Net Equity Issues of
Non-Financial Corporate Business
1960-1974
(billions)

Year	Amount	Year	Amount
1960	$ 1.5	1967	$ 2.2
1961	2.2	1968	(1.5)
1962	0.4	1969	2.9
1963	(0.6)	1970	4.8
1964	1.3	1971	11.7
1965	(0.1)	1972	10.4
1966	1.1	1973	7.2
		1974	3.5

Source: Flow of Funds, Board of Governors of the Federal Reserve System.

Table A-2

New Plant and Equipment Spending
Cumulative Projections 1974-1985
(billions)

	1974-85 in Current $	1974-85 in 1973 $	1962-73 in 1973 $
Total Plant & Equipment Spending	$ 2,568	$ 1,799	$ 939
Energy	824	571	241
Basic Materials	328	230	125
Transportation & Transport Equipment	225	158	109
Communications & Services	772	548	329
Other	419	292	135

Sources: Survey of Current Business, U.S. Department of Commerce.

The Capital Needs and Savings Potential of the U.S. Economy: Projections to 1985, New York Stock Exchange, September 1974.

Table A-3

Percent of External to Internal Sources of Funds
Corporate Non-Financial Sector
1950-1974

Year	Percent
1950	29%
1955	32
1960	35
1965	35
1966	41
1967	52
1968	48
1969	68
1970	72
1971	66
1972	72
1973	77
1974	85

Sources: Supply and Demand for Credit in 1974, Salomon Brothers.

Flow of Funds, Board of Governors of the Federal Reserve System.

Table A-4

Retained Earnings
Non-Financial Corporations
1960-1974
(billions)

Year	Adjusted*	Reported
1960	$ 7.5	$ 9.0
1961	7.4	8.9
1962	12.5	11.1
1963	12.4	11.9
1964	18.1	16.8
1965	22.2	19.9
1966	22.0	22.7
1967	17.8	18.4
1968	15.4	17.1
1969	7.2	13.3
1970	1.9	9.6
1971	6.6	14.1
1972	11.7	20.8
1973	11.5	31.3
1974(est.)	(5.2)	35.2

*Adjusted for inventory valuation and underdepreciation of corporate assets.

Sources: "Profitability and Investment", _The Morgan Guaranty Survey_, Morgan Guaranty Trust Co., September 1974.

Survey of Current Business, U.S. Department of Commerce.

Table A-5

Gross Internal Funds as a Percent of Capital Expenditures
Non-Financial Corporate Business
1960-1974
(billions)

Year	Gross Internal Funds	Capital Expenditures	Percent
1960	$ 34.4	$ 38.7	88.9%
1961	35.6	36.3	98.0
1962	41.8	43.6	95.9
1963	43.9	45.2	97.1
1964	50.5	51.6	97.9
1965	56.6	62.3	90.9
1966	61.2	76.5	80.0
1967	61.4	71.4	86.0
1968	61.7	75.0	82.3
1969	60.7	83.7	72.5
1970	59.4	84.0	70.7
1971	68.0	87.2	78.0
1972	78.7	102.5	76.8
1973	84.6	121.5	69.6
1974	81.4	125.8	64.7

Source: Flow of Funds, Board of Governors of the Federal Reserve System.

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Table A-6

Annual Net Increase in Debt of Non-Financial Corporations
1968-1974
(billions)

Year	Mortgage Debt	Long & Short Term Bank Loans	Net New Bond Issues
1968	$ 5.7	$ 9.7	$12.9
1969	4.6	11.6	12.0
1970	5.2	5.7	19.8
1971	11.4	4.8	18.8
1972	15.6	13.9	12.2
1973	16.1	30.6	9.2
1974	10.8	27.5	19.0

Source: Flow of Funds, Board of Governors of the Federal Reserve System.

Table A-7

Debt/Equity Ratios
U.S. Manufacturing Corporations
1955-1974

Year	Debt/Equity Ratio	Year	Debt/Equity Ratio
1955	.209	1965	.273
1956	.232	1966	.308
1957	.246	1967	.345
1958	.244	1968	.370
1959	.239	1969	.402
1960	.245	1970	.437
1961	.250	1971	.444
1962	.251	1972	.435
1963	.253	1973	.439
1964	.254	1974*	.469

*NYSE estimate.

Equity: Capital stock (net of treasury stock), capital surplus, minority interest, earned surplus and surplus reserves and reserves not reflected elsewhere.

Debt: 1) Total short-term loans from banks,
2) Installments due in one year or less on long-term debt, and
3) Long-term debt due in more than one year.

Source: SEC/FTC Quarterly Financial Report.

Table A-8

Interest Coverage*
1955-1974

Year	Coverage Ratio
1955	27.3
1960	14.4
1965	11.8
1966	11.0
1967	9.0
1968	8.6
1969	6.9
1970(e)	4.7
1971(e)	4.8
1972(e)	5.3
1973(e)	5.7
1974(e)	6.0

*Pre-Tax corporate profits of non-financial corporations plus interest payments divided by interest payments.

(e) Estimated by Department of Commerce, based on 1970/71 IRS data.

Source: Survey of Current Business, U.S. Department of Commerce.

Table A-9

Net Equity Issues to
Expenditures on New Plant and Equipment
1958-1973*
(Percent)

Annual Averages			
1958-61	1962-65	1966-69	1970-73
5.6%	0.6%	1.7%	9.9%

*Excludes 1974, an extremely atypical year in the equity markets.

Sources: Flow of Funds, Board of Governors of the Federal Reserve System.

Survey of Current Business, U.S. Department of Commerce.

Table A-10

Net Purchases of Corporate Stocks
(billions)

	Annual Averages 1951-55	1956-60	1961-65	1966-70	1971	1972	1973	1974
Private Non-Insured Pension Plans	$0.5	$1.4	$2.4	$4.6	$ 8.9	$ 7.1	$ 5.3	$2.0
State - Local Retirement Funds	0.0	0.1	0.3	1.3	3.2	3.5	3.9	2.7
Life Insurance Companies	0.2	0.1	0.5	1.3	3.6	3.5	3.6	2.1
Fire & Casualty Insurance Companies	0.2	0.2	0.2	0.7	2.5	3.0	2.2	(0.5)
Other Institutions*	0.5	0.9	1.1	1.8	0.9	(1.2)	(1.9)	(1.1)
TOTAL Non-Bank Investing Institutions	$ 1.4	$2.7	$4.5	$9.7	$19.1	$15.9	$13.1	$5.2

*Mutual Savings Banks, Open-End Investment Companies, Security Broker/Dealers.

Source: Flow of Funds, Board of Governors of the Federal Reserve System.

Table A-11

Net Acquisition of Financial Assets -- Selected Institutions
(billions)

	Annual Averages				
	Actual			Projected	
	1960-1964	1965-1969	1970-1974	1975-1979	1980-1985
Private Non-Insured Pension Plans	$4.3	$6.4	$ 8.0	$ 9.5	$12.7
State-Local Retirement Funds	2.5	4.4	8.3	11.8	15.4
Life Insurance Companies	6.7	8.9	14.2	20.6	27.1
Property & Casualty Insurance Cos.	1.3	2.3	6.1	7.1	9.8
Other Institutions*	5.0	7.5	6.9	--	--

* Mutual Savings Banks, Open-End Investment Companies, Security Broker/Dealers. Extreme data variability precluded projection of net asset acquisitions for this category.

Sources: Flow of Funds, Board of Governors of the Federal Reserve System.

NYSE projections.

Table A-12

Net Equity Purchases to Net Acquisition of Financial Assets
Selected Institutions
(Percent)

	Annual Averages				
	Actual			Projected 1975-1985	
	1960-1964	1965-1969	1970-1974**	Scenario A	Scenario B
Private Non-Insured Pension Plans	51%	67%	75%	70%	50%
State-Local Retirement Funds	7	20	39	41	32
Life Insurance Companies	6	11	19	20	16
Property & Casualty Insurance Cos.	16	20	24	26	16
Other Institutions*	--	--	--	--	--

* Mutual Savings Banks, Open-End Investment Companies, Security Broker/Dealers. The ratio was not calculated for these intermediaries because of extreme data variability in the aggregate flows.

** The stock market environment in 1974 was quite atypical insofar as institutional purchases of equities were concerned. The following table indicates how the ratio of net equity purchases to net asset acquisitions is affected by the exclusion of 1974 data:

Institution	Average 1970-1973	1974
Private Non-Insured Pension Plans	90%	18%
State-Local Retirement Funds	43	23
Life Insurance Companies	23	12
Property & Casualty Insurance Cos.	33	-10

Sources: Flow of Funds, Board of Governors of the Federal Reserve System.

NYSE projections.

Table A-13

Annual Net Sales of Corporate Equities by Households*
1958-1973
(billions)

Year	Amount	Year	Amount
1958	$(.1)	1966	$ (4.8)
1959	(1.1)	1967	(7.5)
1960	(1.9)	1968	(13.6)
1961	(1.8)	1969	(9.0)
1962	(3.8)	1970	(5.2)
1963	(4.3)	1971	(6.5)
1964	(2.2)	1972	(4.7)
1965	(5.4)	1973	(6.6)

* Excludes sales of mutual fund shares. Net sales are shown as "negative" net purchases.

Source: Flow of Funds, Board of Governors of the Federal Reserve System.

Table A-14

Net Acquisition of Financial Assets by Households
(billions)

Annual Averages				
Actual			Projected	
1960-64	1965-69	1970-74	1975-79	1980-85
$ 38.1	$ 60.8	$ 106.7	$ 165.8	$ 253.8

Sources: Flow of Funds, Board of Governors of the Federal Reserve System.

NYSE projections.

Table A-15

Net Equity Sales* to Net Acquisition of Financial Assets -- Households
(Percent)

Annual Averages					
Actual				Projected 1975-1985	
1955-59	1960-64	1965-69	1970-74	Scenario A	Scenario B
(1.9%)	(5.3%)	(12.3%)	(4.6%)	(4.5%)	(2.0%)

*Excludes sales of mutual fund shares.

Sources: Flow of Funds, Board of Governors of the Federal Reserve System.

NYSE projections.

INTERNATIONAL IMPLICATIONS OF A UNITED STATES CAPITAL SHORTAGE

Research Department
New York Stock Exchange, Inc.

September 1975

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Introduction

Since the end of World War II, the United States has been the world's principal exporter of investment capital. The book value of U.S. direct investment abroad stands at more than $100 billion. Since 1960 alone, U.S.-based multinational corporations ploughed more than $50 billion into overseas activities.

Today, however, the spectre of a major domestic shortage of investment capital suggests that this country might have to look abroad for substantial infusions of funds to keep its own economy moving forward.

The Exchange's landmark study of the emerging capital problem, The Capital Needs and Savings Potential of the U.S. Economy, published in September 1974, focused national attention on the prospect that, through 1985, America's capital needs could exceed the available supply of savings by some $650 billion.

A second study, published in February 1975, The Need for Equity Capital, focused on the serious deterioration in corporate balance sheet positions. It projected a need for U.S. corporations to raise at least $250 billion through new equity financing over the next decade.

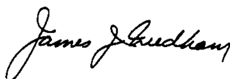
Demand and Supply of Equity Capital, the third study in this series, was issued in June 1975. It pinpointed the likelihood that, in the absence of specific measures to improve the equity investment climate, net equity purchases will fall short of the goal by an average of $7 billion a year.

The continuing concern and debate triggered by these studies has generally overlooked the international implications of a major domestic capital shortage. The present study places the problem in a global context that is far from reassuring.

Some of the prospects other nations may face: Rising interest rates, prompted by intensifying competition for available capital in this country; curtailment of the overseas investment activities of U.S.-based multinational corporations; shrinking markets in this country for the exports of others. A reverse flow of capital <u>into</u> the United States is likely to occur, transferring the impact of a capital shortage to the rest of the world -- and particularly to the less developed nations.

It is difficult to visualize anyone benefiting, in the long run, from a U.S. capital problem. Still, the problem -- if this country allows it to develop -- will be primarily ours. The Exchange has suggested specific programs -- focused on tax incentives to stimulate a resurgence of individual investment by Americans -- to head off the threat of a capital insufficiency.

The present study strongly suggests that other countries should be looking closely at their own capital needs and supplies -- so they, too, can begin devising constructive policies aimed at stimulating economic growth.



Chairman

Overview

The prospect of a major capital shortage in the U.S. economy has become a matter of widespread business and government concern. Studies by the New York Stock Exchange and other organizations indicate that the domestic saving capacity of the nation may be inadequate in the face of the enormous needs for new investment in the next ten years.

Discussion of this issue to date has generally overlooked the international ramifications of a serious capital shortage in this country. However, it is extremely likely that the economies of most other nations will be directly and adversely affected if the U.S. cannot meet its investment needs.

This research report, the fourth in a series on the capital and financing needs of the U.S.,[1/] analyzes the possible impact that a U.S. capital shortage may have on the international economic situation. Section I provides a brief summary of the Exchange's projections of the capital needs and saving potential of the U.S.

1/ The Capital Needs and Savings Potential of the U.S. Economy: Projections to 1985, September 1974.

The Need for Equity Capital, February 1975.

Demand and Supply of Equity Capital -- Projections to 1985, June 1975.

Copies of these research reports are available upon request.

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economy. Section II discusses the international implications of these projections. Sections III and IV focus on policy alternatives to increase the rate of saving and investment in the U.S. An important conclusion is that other nations may be well-advised to begin assessing their own capital needs to better prepare for the economic challenges that lie ahead.

I. Summary of NYSE Projections of the Capital Needs and Savings Potential of the U.S. Economy

In September 1974, the New York Stock Exchange published the findings of a comprehensive study of the capital needs and savings potential of the U.S. economy. That report included detailed projections of the demand for and supply of investment capital for the period 1974-85.

Cumulative demands for capital were projected at nearly $4.7 trillion, with the private sector accounting for $4.5 trillion and roughly $200 billion required to finance Federal government deficits and to meet the capital spending needs of state and local governments. In light of events over the past year, that estimate now appears very conservative. The composition of the private sector's demand for funds is shown in Table 1. The projected totals are considerably higher than spending patterns in the previous 12-year period -- especially in the energy and basic material sectors. These projections assumed a 3.6% real rate of growth and a 5% average rate of inflation through 1985, based on estimates prepared by respected economic research organizations.

Table 1

PROJECTIONS OF GROSS PRIVATE DOMESTIC INVESTMENT
Cumulative, 1974-1985
(billions)

	1974-85 in Current $	1974-85 in 1973 $	1962-73 in 1973 $
Plant and Equipment Spending	$2,568	$1,799	$ 939
Energy	824	571	241
Basic Materials	328	230	125
Transportation and Transport Equipment	225	158	109
Communications and Services	772	548	329
Other	419	292	135
Residential Construction	1,085	771	509
Non-Profit, Agriculture, and Change in Inventories	850	601	400
Total Gross Private Domestic Investment	$4,503	$3,171	$1,848

Source: The Capital Needs and Savings Potential of the U.S. Economy: Projections Through 1985, New York Stock Exchange, September 1974.

On the supply side, the Exchange study projected that only $4.0 trillion in savings would be generated by the domestic economy. Of this total, $2.3 trillion would come from capital consumption allowances, $1.1 trillion from personal saving and $600 billion from corporate retained earnings. These projections were based on extremely stable historical relationships. Comparison of the cumulative capital demand and supply through 1985 indicated a prospective shortfall of nearly $650 billion (Table 2).

Table 2

SOURCES AND USES OF FUNDS
Cumulative, 1974-1985
(billions)

Sources of Funds		
Business Saving		$2,923
Capital Consumption Allowances	$2,359	
Corporate Retained Earnings	564	
Personal Saving		1,109
Total Sources of Funds		$4,032
Uses of Funds		
Gross Private Domestic Investment		$4,503
Plant and Equipment	$2,568	
Residential Construction	1,085	
Other	850	
Federal and State-Local Capital Needs		175
Total Uses of Funds		$4,678
Savings Gap		($ 646)

Source: The Capital Needs and Savings Potential of the U.S. Economy: Projections Through 1985, New York Stock Exchange, September 1974.

The study developed a number of alternative "scenarios" to test the sensitivity of the Exchange's conclusions to changes in basic parameters, such as inflation, real growth rates, etc. While the size of the projected "capital gap" differed from one scenario to another, the basic conclusion of a long-term shortfall in domestic savings was confirmed. (The full report is available upon request.)

It should be borne in mind that the projected deficiency represents a theoretical imbalance between investment demand and domestic sources of saving. A capital gap would never be directly observable, since actual demand and supply must automatically come into equilibrium. But the impact of the theoretical gap would be experienced through relatively high interest rates, brought about by intensified competition for an inadequate supply of savings, and by reduced credit availability to "second tier" users of funds. It would be reflected in lower rates of economic growth in the U.S., brought about by postponement or permanent shelving of unfinanceable investment projects. Declines in productivity, resulting from a shortage of capital, may further fuel inflationary fires. Prices may continue to climb upward as demand presses against inadequate supply capabilities. U.S. competitiveness in world markets would decline if other nations, with more efficient plant and equipment, were able to underprice U.S. goods.

Obviously, this nation's social fabric would weaken if the economy failed to meet the expectations of the American people. Fewer job opportunities, increased pressures on social services, reduced housing activity and recurring scarcities of materials -- all symptoms of a capital shortage -- would combine to reduce standards of living and impinge upon the overall quality of life.

II. International Implications of a U.S. Capital Shortage

Why should these problems -- which other nations might feel justified in viewing as purely internal manifestations of an enviable prosperity -- generate international concern?

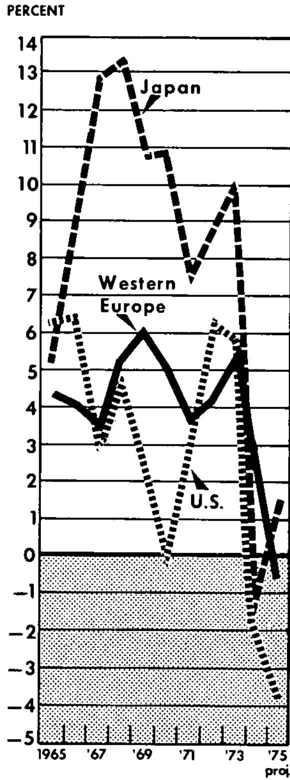
The question seems fair enough -- and the answer may not be immediately apparent.

The fact is, the leading industrial nations, more so now than in even the recent past, find their economies in close cyclical alignment. In terms of rates of growth in real gross national product, the U.S., Western Europe and Japan have all experienced severe falloffs in real output beginning in 1974 (Chart 1). This is also reflected in the simultaneous declines in the index of industrial production for the major economic powers (Chart 2). In 1974, virtually every industrial country belonging to the OECD grew by less than its medium-term average rate. Indeed, the margin of idle resources in the OECD area is now larger than at any time in the post-war period, with unemployment at record levels. Inflation and high interest rates continue to be global problems, though there appear to be signs that pervasive recession has tended to moderate price increases and reduce interest rates (Charts 3 and 4).

The close cyclical alignment of the major economies reflects the growing interdependence of all nations. National boundaries can no longer isolate a country from external economic forces. Sophisticated international investors can shift enormous amounts of funds

Chart 1

RATES OF GROWTH IN REAL GROSS NATIONAL PRODUCT U.S., WESTERN EUROPE, JAPAN 1965-1975



Source: OECD Economic Outlook, July, 1975.

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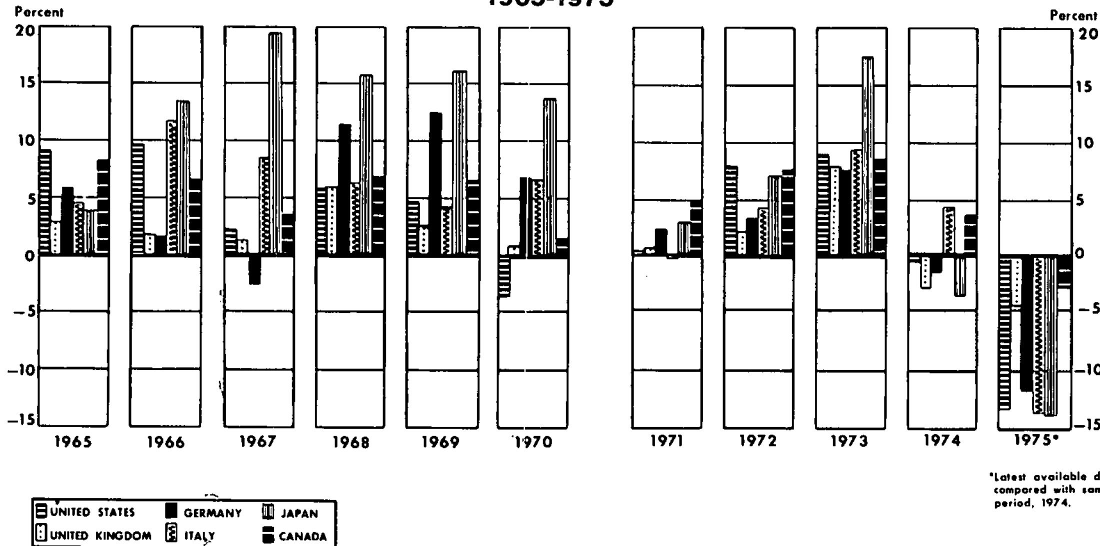
Chart 2

ANNUAL RATES OF CHANGE IN INDUSTRIAL PRODUCTION
1965-1975

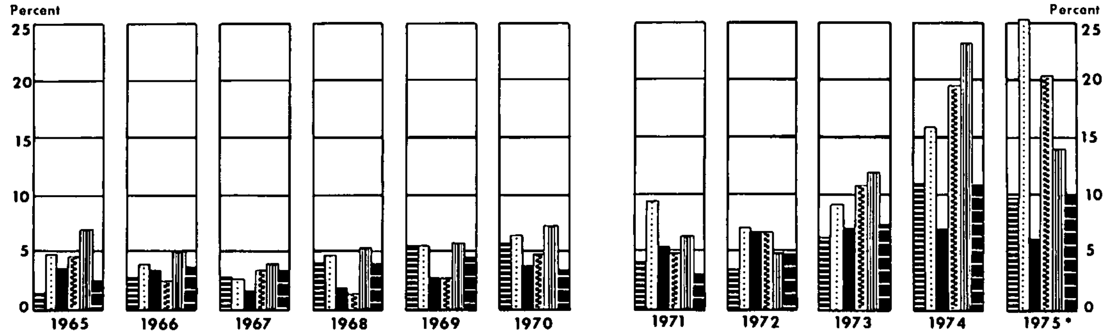


Sources: Rates of Change in Economic Data for Ten Industrial Countries, Federal Reserve Bank of St. Louis, October, 1974. Main Economic Indicators, O.E.C.D., July, 1975.

Chart 3

ANNUAL RATES OF CHANGE IN CONSUMER PRICES

1965-1975



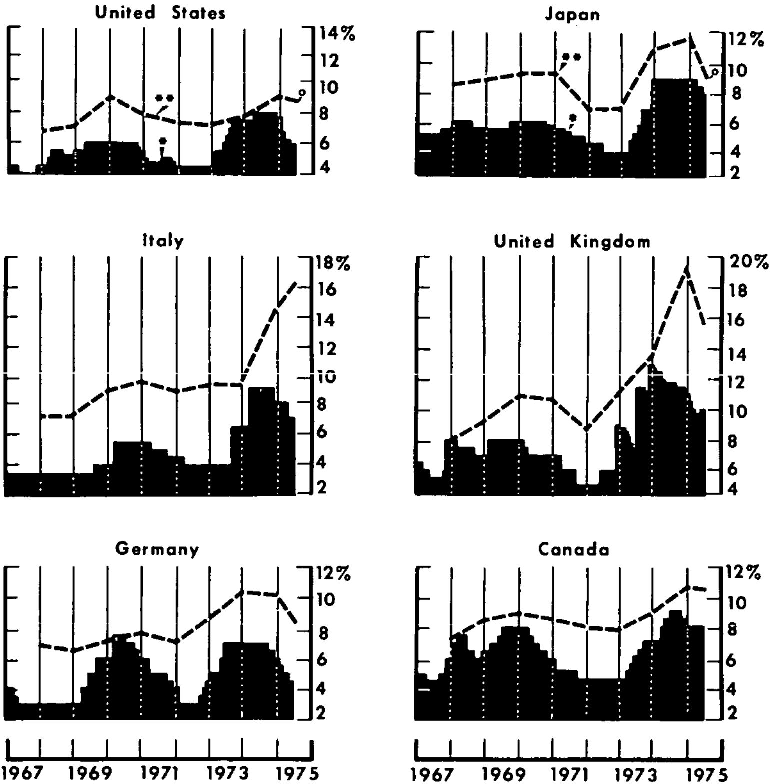
*Latest available data, compared with same period, 1974.

UNITED STATES — GERMANY — JAPAN
UNITED KINGDOM — ITALY — CANADA

Sources: Rates of Change in Economic Data for Ten Industrial Countries, Federal Reserve Bank of St. Louis, October, 1974. Main Economic Indicators, O.E.C.D., July, 1975.

Chart 4

OFFICIAL DISCOUNT RATES* AND YEAR-END DOMESTIC CORPORATE BOND YIELDS** 1967-1975°



°LATEST AVAILABLE DATA

*Source: Main Economic Indicators, OECD, July, 1975.

**Source: World Financial Markets, Morgan Guaranty Trust Company, various years.

on short notice. Multinational corporations have forged commercial ties that bridge political borders. Floating exchange rates have provided a mechanism for continuous international adjustment to changing national policies and to shifts in real circumstances underlying international trade. The various national economies are rapidly evolving into a world economy.

These developments suggest that, while a capital shortage might begin in the United States, its impact will be widespread. A shortage of domestic financing in this country will have major implications for other nations -- in terms of their capital markets, export performance and potential for long-term economic growth. The less-developed nations would almost certainly be most seriously affected. Such countries typically might depend upon massive infusions of investment capital -- as well as strong markets for their exports -- to help build the productive base essential to promote economic growth and better standards of living. Obviously, in areas where capital is chronically in short supply, the impact of a suppliers' shortage will be particularly distressing.

A. A U.S. capital shortage may impede and redirect international capital flows.

The United States, originally a net importer of capital during the 1800's, has become one of the major exporters of financial resources (Table 3). Throughout much of this century, and particularly since the end of World War II, the U.S. has helped to finance much of the world's economic growth. Though capital controls during the 1960's dampened U.S. outflows, data for 1974 show a record $8.4 billion deficit on the long-term capital account.

Table 3

NET BALANCE ON PRIVATE LONG-TERM CAPITAL ACCOUNT*
Annual Averages
1850-1873 to 1966-1974
(millions)

Period	Amount
1850-1873	$ 42
1874-1895	45
1896-1914	53
1914-1922	- 708
1923-1928	- 548
1929-1940	453
1941-1945	564
1946-1955	- 164
1956-1965	-2,828
1966-1974	-1,837

* (-) capital outflow

Sources: Simon Kuznets, Capital in the American Economy, Its Formation and Financing (Princeton University Press, 1961), pp. 120-121.

"U.S. Balance of Payments Developments: First Quarter 1975; Revised Historical Statistics, 1960-1974," Survey of Current Business, June, 1975, Table 1, p. 26.

If a financing shortage develops in the U.S. economy, the volume of capital exported abroad may be sharply curtailed. While it is not projected that the U.S. would become a net importer of funds, that possibility clearly exists.

Effect on Direct Investment

A capital shortage in this country may reduce the ability of domestic multinational corporations to expand abroad and create uncertainties for foreign investors desiring to establish subsidiaries in the U.S.

U.S. Direct Investment Abroad

U.S. multinational corporations have long been major suppliers of capital to the rest of the world (Table 4). Since 1960, they have invested more than $50 billion abroad (on a balance-of-payments basis). In terms of book value, more than $107 billion in foreign investments have been made by U.S. corporations. The distribution of this investment is shown in Table 5. Recent data show that U.S. multinational corporations are responsible for 10% of gross plant and equipment investment in the European Economic Community and 20% in the United Kingdom alone. Indeed, U.S. corporations own about 5% of total corporate assets in Europe.[2/]

Table 4

U.S. DIRECT INVESTMENT OUTFLOWS
1960-1975
(millions)

1960	$1,674	1969	$3,190
1961	1,598	1970	4,281
1962	1,654	1971	4,738
1963	1,976	1972	3,530
1964	2,328	1973	4,968
1965	3,468	1974	7,268
1966	3,625		
1967	3,072	1974 (1st Q.)	1,165
1968	2,880	1975 (1st Q.)	1,366

Source: "U.S. Balance of Payments Developments: First Quarter 1975; Revised Historical Statistics, 1960-1974," Survey of Current Business, June, 1975, Table 2, p. 30.

2/ Arnold W. Sametz, "U.S. Subsidiaries of European Firms Enjoy Independence," The Money Manager, November 26, 1973, p. 11.

Table 5

BOOK VALUE OF U.S. DIRECT INVESTMENT ABROAD
1973
(billions)

All Areas	$107.3
Canada	28.1
Europe	37.2
Japan	2.7
Oceania	6.1
Latin America	18.5
Other Areas	14.7

Source: "Aspects of International Investment," Survey of Current Business, August, 1974, Table 10B, p. 20.

American direct investments abroad have helped increase levels of investment, employment, and goods and services in host countries. In addition, U.S. corporations have provided essential technological and managerial expertise, which not only helps allocate resources more efficiently, but also may be instrumental in improving a host country's balance of payments and international competitiveness. Further, there is little doubt that investments by U.S. multinational companies have led to improvements in local education and upgrading of workers' skills through corporate education programs, seminars and on-the-job training.[3/]

3/ National Association of Manufacturers, U.S. Stake in World Trade and Investment, 1972.

However, if the U.S. capital markets become increasingly strained, the rate of overseas investment may decline substantially. This will result from reduced availability of funds at home and greater competition for funds abroad, especially in the Euro-markets. U.S. subsidiaries may be left, in large part, on their own to raise needed capital. They may well be compelled to reduce dividend remittances to their U.S. parents so as to increase retained earnings for self-financing.

A relative deoendency on internal funding is typical of European-based manufacturing subsidiaries operating in the U.S. During 1967-71, for example, retained earnings supplied 55% of total funds required by foreign subsidiaries in this country, as measured by the increase in book value of direct investment. Recent data for U.S. companies abroad indicate that retained earnings have supplied only 45% of their financial needs.[4/]

Foreign Direct Investment in the U.S.

Until recently, foreign direct investment in the U.S. has been relatively small -- cumulating to only $3.1 billion during 1960-72. Beginning in 1973, however, foreign direct investment increased dramatically, reaching $2.7 billion in 1973 and $2.2 billion in 1974. This growth was largely a result of the substantial

4/ Sametz, op. cit., p. 11.

devaluation of the dollar and the precipitous decline in U.S. equity prices. As shown in Table 6, the flow of direct investment slowed markedly in the first quarter of this year -- primarily because of depressed levels of economic activity, both in the U.S. and abroad. In terms of book value, foreign direct investment here totaled nearly $18 billion in 1973. The bulk of this investment originated from Canada, the United Kingdom, the Netherlands and Switzerland (Table 7). Direct investments were centered primarily in the petroleum and manufacturing industries (Table 8).

Table 6

FOREIGN DIRECT INVESTMENT IN THE UNITED STATES
(Annual Flows)
1960-1975
(millions)

1960	$141	1969	$ 832
1961	73	1970	1,030
1962	132	1971	-175
1963	-5	1972	380
1964	-5	1973	2,656
1965	57	1974	2,224
1966	86		
1967	258	1974 (1st Q.)	1,177
1968	319	1975 (1st Q.)	326

Source: "U.S. Balance of Payments Developments: First Quarter 1975; Revised Historical Statistics, 1960-1974," Survey of Current Business, June, 1975, Table 2, p. 30.

Table 7

VALUE OF FOREIGN DIRECT INVESTMENTS IN THE UNITED STATES
By Country of Origin
(millions)

Year-End	Total	Canada	United Kingdom	Nether-lands	Switzer-land	Ger-many	Japan	Other
1960	$ 6,910	$1,934	$2,248	$ 947	$ 773	$103	$ 88	$ 817
1965	8,797	2,388	2,852	1,304	940	209	118	986
1970	13,270	3,117	4,127	2,151	1,545	680	229	1,421
1971	13,655	3,339	4,438	2,225	1,537	771	-230	1,575
1972	14,263	3,422	4,621	2,357	1,567	845	-129	1,581
1973	17,748	4,003	5,437	2,550	1,825	768	307	2,858

Source: Statement by James L. Pate, Assistant Secretary for Economic Affairs, U.S. Department of Commerce, before the Subcommittee on Securities of the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, March 4, 1975, p. 95.

Table 8

VALUE OF FOREIGN DIRECT INVESTMENTS IN THE UNITED STATES
By Industry
(millions)

Year-End	Total	Petroleum	Manufacturing	Trade	Insurance and Other Finance	Other
1960	$ 6,910	$1,238	$2,611	$634	$1,810	$ 617
1965	8,797	1,710	3,478	748	2,169	692
1970	13,270	2,992	6,140	994	2,256	888
1971	13,655	3,113	6,755	512	2,352	923
1972	14,263	3,234	7,228	511	2,437	853
1973	17,748	4,425	8,418	948	2,712	1,244

Source: Statement by James L. Pate, Assistant Secretary for Economic Affairs, U.S. Department of Commerce, before the Subcommittee on Securities of the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, March 4, 1975, p. 95.

Foreign direct investment in the U.S. is motivated by a number of factors, including the desire to acquire or preserve a share in one of the largest and richest marketing areas, the availability of skilled labor, an extensive capital market, and access to new technology. How the uncertainties generated by a U.S. capital shortage will affect these incentives is not at all clear. To be sure, higher interest rates here may attract some capital, but direct investment decisions are generally not made solely on the basis of interest rate differentials. On the other hand, it may well be that _if_ the U.S. economy slows as a result of a domestic capital insufficiency, foreign investors may be loath to commit large sums to a sluggish American market.

In all likelihood, a capital shortage will cause the U.S. government -- as well as state and local governments in this country -- to redouble their efforts to attract foreign direct investment. At present, the Federal government offers no direct financial or other incentives to foreign investors. While this policy is not likely to change -- because of inherent problems involving discrimination against domestic industries -- expanded programs might well be undertaken in other areas. These could include greater emphasis on loan guarantees through the Small Business Administration (available to domestic _and_ foreign companies), a greater flow of information about investment

opportunities (through the Department of Commerce's Investment Services Division), and greater coordination among governmental agencies in supporting foreign investment projects.

On the state and local level, direct assistance is already available to foreign investors -- particularly through investment offices which have been set up in Europe and Asia. Financial assistance, special tax considerations and site-study services are also available in many states to foreign as well as domestic investors.

In the long run, the relative profitability of the U.S. market will determine the volume of foreign direct investment in this country. If the United States can meet its own economic challenges, then foreign direct investment should show marked increases in the years ahead -- even without specific government-sponsored assistance.

Influence on Banking and Portfolio Investment

An imbalance between the demand and supply of funds in this country will also significantly influence bank lending and portfolio investment flows.

Bank Lending Policies

Recent data on claims reported by U.S. banks indicate a sharp rise in capital outflows. As shown in Table 9, loans to foreigners have increased significantly, as have transfers of funds to

overseas branches of U.S. banks -- primarily in the Bahamas. The marked increase in short-term liquid flows to the Caribbean in 1974 and 1975 is directly related to the lifting of the controls on capital outflows in January, 1974. Most of these deposits are channeled into the Euro-currency markets.

Table 9

CLAIMS ON FOREIGNERS REPORTED BY U.S. BANKS*
1972-1975
(millions)

	1972	1973	1974	1st Qtr. 1974	1st Qtr. 1975
Total Claims	$-3,506	$-5,980	$-19,325	$-5,244	$-3,479
Long-Term	-1,307	- 933	- 1,159	- 178	- 400
Short-Term, non-liquid	-1,457	-3,886	-12,186	-2,723	1,980
By Type:					
Loans	-1,705	-1,989	- 3,654	-1,369	1,873
Acceptance Credits	1,050	- 934	- 7,063	- 990	- 71
By Area:					
W. Europe	- 503	- 562	- 843	- 596	581
Japan	370	-1,784	- 5,483	-1,157	1,984
Short-Term, liquid	- 742	-1,161	- 5,980	-2,343	-5,059
of which:					
Canada	- 19	- 16	- 396	- 478	- 317
Bahamas	- 110	- 358	- 2,067	- 475	-2,477

* Credits (+), Debits (-).

Source: "U.S. Balance of Payments Developments: First Quarter 1975; Revised Historical Statistics, 1960-1974," Survey of Current Business, June, 1975, Table 2, p. 30.

A rise in interest rates in this country, responding to a capital shortage, could trigger a reversal of current lending strategy. U.S. banks might be less willing to lend abroad, except

under extremely favorable conditions -- at interest levels far higher than at present. Even fairly large foreign borrowers could find themselves priced out of the market and, thus, compelled to cut back on their financing programs.

A constricted environment would subject the Euro-market to increased pressures, with a reduced flow of dollar-denominated deposits impairing its ability to meet the growing capital needs of multinational corporations, local governments and international organizations.

The Board of Governors of the Federal Reserve System, apparently uneasy about increasing transfers of funds to foreign branches of U.S. banks, has forcefully reiterated its position that banks under its jurisdiction should not solicit or accept deposits from U.S. citizens at their foreign branches unless such funds are to be used in connection with legitimate business purposes.

Portfolio Flows

If interest rate differentials widen in favor of the U.S. as a result of a capital shortage, foreign portfolio funds should be increasingly attracted to the U.S. At the same time, however, the ability of foreigners to borrow in the U.S. from non-bank sources (by issuing bonded debt, for example) should weaken. This type of borrowing showed a marked increase in 1974 and has mushroomed so

far this year. As shown in Table 10, foreign governments and international organizations have been the major foreign borrowers.

Table 10

FOREIGN BOND ISSUES IN THE UNITED STATES
1972-1975
(millions)

	1972	1973	1974	January-July 1974	January-July 1975
All Borrowers	$1,361	$960	$3,281	$1,840	$3,384
Foreign Companies	199	78	798	482	253
State Enterprises	382	492	844	564	760
Governments	530	390	1,029	784	1,421
International Organizations	250	--	610	10	950

Source: World Financial Markets, Morgan Guaranty Trust Company, July, 1975, p. 13.

The close linkages among the major industrial economies, especially where interest rate movements are concerned (Chart 4, page 11), suggest that foreign capital markets will become tighter as the U.S. economy absorbs an increasing portion of internationally mobile capital. While interest rates would sooner or later achieve some equilibrium, the general rate level would be higher than in the absence of a capital shortage.

The impact of a U.S. capital insufficiency on petrodollar recycling may be particularly troublesome to other nations. If the OPEC states divert a larger portion of their investable funds to the U.S., many less-developed oil-importing countries could experience serious financial dislocations. While it is too soon

to reach any firm conclusions in this area -- in part because the size of the projected OPEC surplus is still a matter of conjecture -- the recycling issue is likely to be of increasing importance in the years ahead.

Though recent data show an over-all decline in annual OPEC investment flows into the U.S. -- from $11 billion in 1974 to $4 billion (annualized) in 1975[5/] -- long-term OPEC investment in this country has increased sharply in 1975. During the first half of this year, the OPEC countries' ownership of U.S. government securities aggregated to $1.6 billion, compared with holdings of $364 million in all of 1974 -- a 400% increase. Similarly, OPEC net purchases of U.S. corporate equities have been accelerating, with an increase of $659 million during the first half of 1975, far outdistancing the annual increase of $367 million recorded in 1974.

A recent Internal Revenue Service ruling confirming the tax-exempt status of quasi-governmental agencies (such as government-

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5/ The $7 billion decline in OPEC investment inflows to the U.S. primarily reflects a sharp reversal in short-term OPEC investment policies. In 1974, the OPEC countries poured $9.7 billion in short-term funds into the U.S. During the first half of 1975, by contrast, the same countries withdrew more than $1 billion. However, considerable caution should be used in interpreting the declining over-all rate of OPEC investment in the U.S. While some of the fall-off may reflect diversion of capital to other markets, a large part of the reduction may simply be attributable to shrinking pools of investable funds. The massive slump in worldwide oil consumption and increased domestic investment demands within the OPEC countries themselves may have sharply curtailed the amount of capital left over for investment abroad. In addition, a considerable amount of OPEC capital may be entering the U.S. through intermediaries; such investments would not be identifiable as originating in an OPEC country.

owned oil companies) should further increase the flow of oil-related funds to this country. This ruling appears to have played a significant part in facilitating the private placement by American Telephone & Telegraph Co. of $100 million of six-year notes with the Saudi Arabian Monetary Agency at 8.40% -- even though the Saudi central bank had already been exempted from withholding tax liability by a previous IRS ruling.[6/]

B. U.S. imports may be curtailed as a result of a domestic capital shortage.

The U.S. is a major market for foreign goods and services (Table 11). With exports accounting for a major portion of the gross national product of many countries -- particularly among those with less developed economies -- the U.S. is, in many instances, the principal market. Curtailment of U.S. growth, due to a capital shortfall in this country, could limit the import capacity of the U.S. economy. If domestic production suffers a significant slowdown and aggregate income fails to maintain historical growth rates, the demand for imported products must inevitably fall.

The direct relationship between domestic incomes and imports is borne out in recent trade data. As a result of the recession in this country, imports of foreign goods fell by $7.7 billion, on a seasonally adjusted basis, between the second half of 1974 and the first half of 1975.

6/ "OPEC Purchases of U.S. Equities, Corporate Debt Up; IRS Ruling May Give Further Boost," American Banker, August 5, 1975, p. 1.

Table 11

EXPORTS TO THE UNITED STATES AS
A PERCENT OF TOTAL AREA EXPORTS
1973

	Percent
Developed Areas	11.66%
Industrial Countries	11.77
Industrial Europe	6.57
Other Developed Areas	10.43
Other Europe	9.55
Australia, New Zealand, S. Africa	11.48
Less Developed Areas	18.95%
Latin America	31.70
Other Western Hemisphere	62.74
Middle East	5.21
Other Asia	22.27
Other Africa	12.13
Other Countries	4.52

Source: Directions of Trade (Annual, 1969-1973
International Monetary Fund.

To be sure, foreign capital inflows could tend to cushion any reduction in U.S. purchases of foreign goods -- at least in the short run. If high interest rates here attract capital from abroad, the value of the dollar, *ceteris paribus*, could appreciate on world markets -- and that could tend to reduce the price of foreign goods in the U.S. However, though changes in relative currency values may impact on trade flows, recent research suggests that *real* factors in the domestic economy tend to be more decisive over the long term.[7/]

7/ Marina Von N. Whitman, "The Payments Adjustment Process and the Exchange Rate Regime: What Have We Learned?" *American Economic Review*, Papers and Proceedings, May, 1975, pp. 139-141.

C. <u>A capital shortage in the U.S. may retard long-term economic growth abroad</u>.

A major U.S. capital shortfall could make it increasingly difficult for other countries to fulfill the type of investment required by their own long-term needs. Relatively high interest rates here will attract capital that might otherwise be invested elsewhere and will increase the cost of borrowing in local markets. Moreover, slower U.S. growth will limit opportunities for the type of export-led expansion which characterized much of the growth in the European economies in the early 1970s.

With insufficient investment, both in the U.S. and abroad, any expansion in economic activity can only be transitory. Concerned observers, particularly in the U.S. and in the United Kingdom, are increasingly recognizing that <u>sustainable</u> economic growth cannot be achieved through government deficits and related spurs to consumer spending. While temporary growth can be obtained through such means, the effects will rapidly wear off unless investment can take over the task of creating extra demand and provide the capacity to satisfy it over the longer term.

D. <u>Capital controls are a potential danger</u>.

A U.S. capital shortage, by drawing funds from abroad, may foster a return to some form of capital export controls. Foreign governments, with their own domestic problems, may view an exodus

of investable funds with considerable alarm. They may, consequently, feel compelled to halt the outflow of capital to "insure" that national needs will be satisfied.

But while patriotically motivated restrictive policies may elicit popular support, the fact is that they generally do not work. Capital controls are inherently inefficient because they prevent funds from being invested where they can earn the highest return. They did not prevent sizeable capital outflows from the U.S. during the late 1960s and early 1970s. Nor did they prevent massive capital inflows to many European countries during the recurring currency crises of 1971-1973.

The obvious alternative to restricting the free flow of capital -- and running the risk of impairing global economic well-being -- is to try to develop ways and means of generating sufficient capital to meet worldwide investment needs. Here, the United States may well be able to learn from the experiences of other developed nations which have been more far-sighted in structuring their economies to stimulate high levels of saving and investment.

III. Foreign Programs to Stimulate Saving and Investment

Comparative data show that the U.S. lags far behind other countries in offering viable incentives to saving and investment. As shown in Table 12, the U.S. ranks last among the leading industrial nations in terms of the share of gross national product attributable to investment. While some caution should be used in interpreting these data (because of historical factors and differing national tax and social systems), it is nonetheless clear that the U.S. has been allocating a relatively disproportionate share of output to current consumption.

Table 12

INVESTMENT AS A PERCENT OF GROSS NATIONAL PRODUCT
Selected Countries
Average, 1970-1974

	Percent
United States	14.96%
Canada	22.70
United Kingdom	18.63
Japan*	38.21
Germany	26.21
France*	27.56
Italy	21.71

* 1970-73 average

Source: International Financial Statistics, various issues.

A major reason for the significantly higher rates of capital formation of many other countries is that they have adopted policies to promote saving and investment. The following

summary, by no means exhaustive, indicates the range and types of incentives provided abroad.

Integration of Corporate and Personal Taxes

A number of industrial countries, including the United Kingdom, Japan, Canada, France and Germany, have taken steps to eliminate the double taxation of corporate profits, by partially integrating their tax systems. Dividend credits or split-rate systems (where undistributed profits are taxed at a higher rate than distributed profits) are the major integration techniques currently in use.

Such measures help promote equity within the tax structure and reduce the incentives to finance through debt. Combined with an overall reduction in corporate taxes, they should lead to increases in corporate investment.

Liberalized Depreciation Policy

Other countries have also been highly innovative in developing depreciation policy. Germany allows accelerated depreciation for "environmental" investment. Canada permits a two-year write-off for investment in certain manufacturing and processing industries. Sweden provides for a five-year write-off of plant and machinery expenditures. The United Kingdom recently authorized free depreciation for certain sectors of the economy, permitting corporations to choose their own method of writing down the value of capital assets.

Reduced Taxes on Inventory Profits

Foreign governments have also been in the forefront of insulating private investment decisions from the pernicious effects of inflation. Germany and, belatedly, the United Kingdom have taken measures to reduce or defer the tax burden on inflation-induced inventory profits. These countries realize that if the tax system fails to correct for inflation, the net effect will be tantamount to destroying capital and reducing productive capacity.

Investment Tax Credits

Many nations, including the U.S., have enacted investment tax credits. In general, however, these have been used only for counter-cyclical purposes. The credit system used in Sweden is particularly innovative and frees up to 22% of a corporation's profits from tax liability provided certain technical requirements are met.

Generalized Consumption Taxes

Most foreign governments tax consumption at significantly higher rates than in the U.S., primarily through the use of value-added taxes. A value-added tax is a proportional tax on the value added to a product at each stage of production. In the European countries this tax is applied only to consumer goods -- a factor which would be expected to increase private investment and saving from what it would have been if, say, corporate taxes were employed to generate similar revenues.

IV. Recommendations for Changes in U.S. Tax Law to Stimulate Saving and Investment

Prospects for a serious capital demand/supply imbalance underscore the urgency of reorienting U.S. tax policy to help stimulate saving and investment. The New York Stock Exchange has advocated a number of basic modifications in U.S. tax law, ranging from a complete overhaul of capital gains taxation to elimination of the withholding tax on foreign portfolio investment.

Treatment of Capital Gains and Losses

Existing capital gains taxes unduly hamper the mobility of capital in this country. What may seem to be an attractive investment switch can lose its appeal when the tax cost of the transfer is considered -- in effect, encouraging the investor to lock into an investment situation which may not be the most suitable use of available resources. With millions of investors "locked-in," a high proportion of existing capital is being put to less than optimum use. While this is disadvantageous to investors themselves, it is far more damaging to the U.S. economy, which clearly is not utilizing all of its existing investment resources to their fullest potential.

To ease the tax drag on equity investment and to increase capital mobility, the Exchange has recommended restructuring the tax treatment of capital gains and losses along the following lines:

-- Adopt a capital gains tax inclusion rate that decreases as holdings mature.

-- Return to a maximum tax rate of 25%, regardless of the size of a gain.

-- Allow an annual tax exclusion of up to $1,000 of capital gains, when total gains do not exceed 25% of earned income.

-- Retain the minimum six-month holding period for qualification as long-term capital gains.

-- Raise the net loss deduction substantially and introduce a three-year carryback as initial steps toward eventual full deductibility of losses.

-- Provide 100% inclusion for long-term losses.

Double Taxation of Corporate Income

To ameliorate the serious inequities inherent in double taxation of corporate income distributed as dividends, the Exchange has recommended permitting companies to deduct dividends, as a business expense, in computing their tax liability. Interest payments are already deductible; the proposed change would lessen the present substantial incentive to finance through debt and would help bring corporate debt/equity ratios into better balance.

The Exchange recognizes that an immediate shift to complete deductibility for dividends would have far-reaching, unsettling

ramifications for both traditional corporate financial policy and portfolio investment, and a considerable impact on Federal revenues. However, a giant step in the direction of neutralizing the disparity between tax treatment of dividends and interest payments could be taken by providing initially a partial deduction for dividends of, say, 25%.

Depreciation Policy

The Exchange has strongly recommended basing depreciation allowances on replacement cost rather than on historical cost, as at present. The recent bout of unprecedented high inflation has sharply underscored the shortcomings of present policy which discourages corporations from replacing superannuated plant and equipment, suppressing productivity and growth and impinging on the ability to compete in international markets.

Investment Tax Credit

The investment tax credit should be made a permanent part of the tax structure to further encourage more rapid replacement of U.S. industry's relatively aged stock of plant and equipment. Experience shows that the current stop-and-go tax credit policies create uncertainty -- which is hardly conducive to efficient corporate planning -- and tend to discriminate against projects requiring long lead times.

Elimination of Foreign Withholding Taxes

As a means of supplementing domestic savings and increasing the flow of capital to the U.S., the Exchange has urged repeal of the withholding tax on foreign portfolio investment. The reasons for repeal are self-evident. The tax discourages needed foreign investment and produces relatively little revenue for the U.S. Treasury, both on an absolute and relative basis -- especially when costs of collection are taken into account. Indeed, the net gain to the economy from repealing this tax -- in terms of increased job opportunities and higher incomes -- would more than offset any revenue loss.

Conclusion

If a major capital shortage is permitted to develop in this country, its effects will inevitably be exported to other nations. In particular, a capital insufficiency in the U.S. would:

1. Impede the expansion of U.S. direct investment abroad. This would be especially detrimental to economic advancement in the less developed countries.
2. Create uncertainties for foreign investors desiring to establish subsidiaries in the U.S.
3. Reduce the willingness or ability of U.S. banks to lend funds overseas. Relatively higher U.S. interest rates and sterner Federal Reserve guidelines may dissuade bankers from expanding their overseas lending operations.
4. Attract foreign portfolio investment to the U.S. -- again because of relatively higher yields available here.
5. Give the U.S. the lion's share of recycled petrodollars, as relatively high interest rates channel increasing amounts of OPEC revenues to this country.
6. Limit foreign opportunities to export goods and services to the U.S., as slower U.S. growth weakens the demand for imports.
7. Brake growth rates in other nations as interest rates elsewhere rise to compete with higher U.S. rates.

8. Encourage other nations to impose capital controls as a defensive measure -- a throwback to economic insularity that would seriously impede international capital flows and ultimately work to the disadvantage of all nations -- particularly in the less developed world.

The threat of a major U.S. capital shortage remains primarily a U.S. problem, to be solved domestically. As a first step, a long-overdue analysis of U.S. tax laws is underway. At the same time, U.S. governmental agencies and private corporations are actively reassessing their own functions and operations and seeking ways to increase productivity and make maximum use of existing capital resources.

While the specific projections and policy recommendations outlined in this study apply only to the United States, many other countries may face comparable or analogous problems which have not yet been identified. Thus, it may be worthwhile for other nations to consider reviewing their own situations in the light of this country's experience, with a view to undertaking studies of their own capital needs.

The global implications of a major capital shortage strongly suggest the desirability of examining national capital requirements in an international context. One possibility might be to convene an International Conference on World Capital Needs, at which

national studies could be discussed and policy implications and alternatives explored.

Adoption of realistic policies in this country, combined with international cooperation and understanding, can help avoid the domestic and international disruptions that would result from a U.S. capital shortage. Determined encouragement of saving and investment throughout the world can help set the stage for expanded growth opportunities and prosperity for all nations.

Senator HUMPHREY. We do thank you very much.

Senator JAVITS. Mr. Chairman, may I say that Mr. Needham, he has been doing a very interesting job with the New York Stock Exchange, and he is very closely on top of the situation, especially in the effort to have the body's possible distribution of American's listed securities.

That is one of the great jobs he is doing. I wanted it noted for my colleagues.

Senator HUMPHREY. Very good.

Governor Wallich, I will just ask one or two questions. I know the time is getting late, but we will try to move right along.

You suggested the Fed could help small business bank lending by providing sufficient overall reserves to permit the maintenance of adequate bank liquidity.

I should say that Mr. Needham suggested that. Would the Fed be willing to take such a step?

Governor WALLICH. The monetary aggregates have gone up fairly stably over time as the Fedreal Reserve has presented the Congress with a target of 5 to 7½ percent. It is interesting to see how this flow of the aggregates has worked its way into loans for different sizes of businesses.

What we know is mostly what happens to loan volume at banks of different sizes, but it is plausible that small banks make the majority of their loans to small businesses. During 1975, business loans at small banks have gone up and business loans at large banks have gone down, so that the sources of funds for small business seem to have been adequate.

I might comment also, if I may, on the other proposal, of Mr. Needham.

Senator HUMPHREY. Please.

Governor WALLICH. I think that Mr. Needham's suggestion is already being implemented. We have reserve requirements against deposits, but not against loans, as Mr. Needham knows of course. These reserves are graduated, and they are lower for small banks than for large banks; so that to the extent that reserve requirements are a burden on banks and reduce their ability to grant credit and raise the cost of the credit—to that extent small banks which probably help small business are better situated.

Senator HUMPHREY. All right.

You suggested, Mr. Wallich, that the Federal tax system's buyers, that they get financing, that it be shifted, so I guess you would call it a bias or at least lean toward equity financing.

I wonder how this proposal would help small business which is rarely in a position to issue stock to raise capital.

Governor WALLICH. To the extent that small business is incorporated, I think it would help that sector considerably—perhaps more than big business—for the following reasons:

There is a problem of how to shift from one debt structure to another, how to get debt down and equity up. Now, small business can, if it pays a lower tax, accumulate more funds and simultaneously get rid of its indebtness at the bank more easily than the large corporation can get rid of its bonds in the market, if it has floated these bonds with terms of 20 or 30 years. The greater flexibility smaller firms have

in the handling of debt would seem to me an advantage for small business if the proposal were implemented. Of course, the rate reduction that is applied on the equity component of the income stream which is that part of income going into dividends, and retained profits, would have to be reduced for small business, the same as for large business. The recent rate is temporarily 20 percent, and if it were reduced for large business this 20 percent would have to be reduced correspondingly.

Mr. LAUN. One of the things we find in dealing with many small businesses, we are paying double digit interest payments on this debt.

They have almost no way of coming out, unless they get a higher percentage of equity in their business, so anything that would tilt that balance sheet would help small business.

Senator HUMPHREY. But if you knocked out the tax, the interest as a deductible item, then it would not have that adverse effect.

Mr. LAUN. It would have to be over a longer period.

We would have to do something to help us get equity into small business. That is the serious lack.

Senator HUMPHREY. One of the things we are concerned about, Mr. Wallich, is the role of the Fed, the Federal Reserve System, and its activities, with small business. I noticed that somewhere along the line, I have received a communication to the effect that the Federal Reserve did not have any particular expertise in matters relating to small business.

Senator Nelson and I have introduced a resolution to establish an Office of Small Business, Economic, and Financial analysis for the Board of Governors of the Federal Reserve System.

We said, for example, it is the sense of the Senate, the Chairman of the Federal Reserve Board assure an analysis of all forms of economic and financial data relative to the health of the small business sector, shall be made and taken into account by the Board of Governors in making any of its decisions, and, in addition, the Board of Governors shall determine the impact on the small business sector of the U.S. economy before any of its decisions are financially made.

We would of course expect, in other words, that sufficient attention would be given to the Fed, to the needs of small business.

What do you say about that?

Governor WALLICH. Senator, I am not an expert on the small business sector of the economy; however, I would like to point out that we have a good staff, and some of the staff has specialized knowledge of small business.

Now, as far as the degree of attention given to small business by the Board is concerned, there are 14,000 banks in the country, all of whom are affected by our monetary policy, and the great majority of whom deal mainly with small business. Therefore, the impact of what the Federal Reserve does is necessarily in part on small business, and has to be considered by the Board even though we do not have a special small business office.

In considering bank holding company applications, we try to improve the competitive structure of the banking system. By permitting acquisitions that improve competition we improve access to credit. We make it a condition, in implementing the laws passed by Congress, that there must be net benefits to the public before an application can

be approved. By allowing bank holding companies to go into closely related financial activities, we know that benefits to small business often result. In areas such as leasing and mortgage banking and factoring and commercial financing, improvements in the credit system are taking place gradually, a great many of which will help small business.

Senator HUMPHREY. Well, we are going to encourage the Fed to give even more attention to this, as you can see, by our resolution, and I wondered, has the Fed ever considered keeping records on the level of small business borrowings on their quarterly basis?

Governor WALLICH. The Fed conducts a survey that provides data on the interest rates charged by banks for small loans to businesses, although there are technical problems with these data. We are in the process of developing a better survey, which will certainly give us much better interest rate data on small business loans than we have at the present time, and that I think will put us in a better position to assess what is happening to small business.

The dollar volume of loans to small business is difficult to get from the banks, because the banks organize their loan records by risk classes, not necessarily by size of business, so banks do not readily know the asset or sales size of businesses they lend to. Also, in attempting to gather volume data, we encounter serious problems in defining small businesses for purposes of a survey.

Mr. NEEDHAM. Mr. Chairman, I do not want to interfere with your interrogation of the witnesses, but at this particular point I think the statements that Governor Wallich is making, really are worthy of some comment by myself, in the sense that I feel that one of the difficulties that we have in analyzing economic and financial investment in the United States, is that we deal too much with aggregate data, and to many assumptions, for example, small banks lend all of their money, or a good portion to a small business. I do not think such an assumption can withstand a test and close scrutiny.

I know to many small banks participate in large loans with large banks, and it would be interesting if we knew what percentage of the loans that small banks have which are allocated in that fashion, versus to what could properly be defined as loans to small business. I also think that a bank that does not know anything about its borrowers is really in pretty bad shape.

Senator HUMPHREY. I was going to suggest that, when I find the Fed does report the volume of agriculture credit, of broker credit, and consumer credit, it would seem to me they would be able to report on the volume of small business loans.

I cannot imagine a banker not asking what is your sale, what is your debt structure, what is your outlook, your inventory. It is incredible they do not have that information.

Mr. NEEDHAM. In preparing this testimony, I asked Dr. Freund—sitting along side of me—he is our chief economist, and head of our research department to obtain for me the number of loan applications, and loans turned down from small businesses, as I thought that information ought to be available some place.

Governor WALLICH. The number of turn-downs is very difficult to make meaningful, because if a person gets turned down by one bank

in a town that has five banks, he may go to each of these banks and will register five turn-downs for one loan. One must always be careful to collect meaningful statistics.

The Board's staff tried to collect good data with the monthly survey, but these statistics are not very good. As a result, we do have data that are of some use and hopefully can be exploited; but we are trying to get better data, and we will eventually have a scientifically designed sample.

It is much better to do this on a sampling basis than to survey all banks. We hope to have some data on the daily flow of loans, including the details of the particular loans—for instance not just the interest costs, but the other terms like commitments, compensating balances, and collateral—things that are interesting to everyone who is concerned with the small business sector of the economy.

Senator NELSON. I think that point made by Mr. Needham on participating loans of small banks, and larger enterprises is important.

I do not know what the statistics would show. By coincidence a year ago, a friend of mine who owns a very small bank, was critical of a number of his colleagues, who are always happy to participate in loan building of a shopping center 75 miles away from the little town, because the interest rate is higher, and the resources of the group is higher. He said he constantly is getting offers to participate at a higher interest rate. He feels a sense of that responsibility, and I think that is a proper responsibility as a banker, to help and service the local community. But, he said a lot of bankers find it much easier to participate in loans many miles away from their primary operations.

I have just one question. On page 2, Mr. Needham, you make reference to the fact that you believe that it would be necessary to raise an average of $23 billion a year in new equity, which you state is twice the equity capital raised in 1971, by nonfinancial corporations, and that was a peak year.

What has happened within a 4 year span, as to the need for equity capital. In your view, why will it be twice what it was at a peak year in history, only 4 years back?

How do you come by that figure?

Mr. NEEDHAM. How do we come by the need figure?

Senator NELSON. How did you reach this conclusion that $23 billion a year is needed, and what has happened to double the need?

Mr. NEEDHAM. That is what our studies are all about, and we go into that depth in the studies.

If you want me to answer it now, I would like to ask Dr. Freund to do it. He is head of the task force that prepared the study.

Senator NELSON. Well, your studies have been received for the record.

It just struck me as a very dramatic figure.

Senator HUMPHREY. I think a brief word would be helpful. Just put the microphone over there.

Dr. FREUND. Yes; the way we have got to it. Let me read from the study, because of the uncertainties involved in estimating the magnitude of equity financing that might be required, it is assumed that at a minimum, corporations would finance 10 percent of their future capital expenditures, by means of equity.

The proportion recorded during 1970 and 1973, that is how we arrived at it.

The next sentence goes on to say this implication of net equity accumulating to approximately the amount, and then you get the $23 billion by dividing $250 billion by 11.

Senator NELSON. What happens if you double the requirement, with the addition of the inflation factor?

You do not double the capital requirements every 4 years. Is what you are saying is that it will require double the equity capital from now on, as was required in the peak year 1971?

What happened to make that demand so high?

Dr. FREUND. We have accumulated the need for capital on an aggregate basis by industry classifications, and certain things we know about, transportation, and so forth, which we referred to earlier.

Senator NELSON. Let me ask you a question at this point.

You are saying that this is what you think the need is in the country.

Mr. NEEDHAM. That is correct.

Senator NELSON. Well, supposing you had done a survey on the same basis, projecting the need in 1971, rather than the figure actually raised, what figure would you have had?

Mr. NEEDHAM. We did not do that retrospectively.

Senator NELSON. So the need in 1971, then, if you are using the same standard, probably was not one-half of what it is now.

Mr. NEEDHAM. No; we did not have 8 percent unemployed in 1971, either.

That is the other side of the equation.

You know, Senator, if you will forgive me, I am not an elected official, and I am really just suppose to deal with the financial significance of these hearings, but, you know——

Senator NELSON. If you will forgive me for being one. I will forgive you for not being one.

Mr. NEEDHAM. You have my appreciation, Senator, for undertaking the burden of elected office.

You know, we are not talking about economics. We are not talking about financing. We are talking about what we want this country to be, and what kind of a social fabric we want it to have, and what kind of a political system we want it to have, and those are the things we at the New York Stock Exchange never really have an opportunity to address, because we are not elected people—but that is what this study was all about. When Dr. Freund and I sat down to discuss the outline of this study, I communicated to him what I thought was my views of what this country ought to be, taking into the account the policies of the Congress, and to the extent that we know what the policies of the administration are, and that is how we got to the numbers here.

We warted to have an inflation rate of 4 percent, and which we thought was acceptable, 5 percent, and we used a gross national product, we increased the gross national product of 3.6 percent, in order to maintain levels of unemployment, which we felt would arise just normally out of the typical activities of our economy.

You know, the bigger and broad question, once we answer that, the rest of it is really mechanical.

It is a question of tuning up the Federal Reserve, tuning up the stock market, maybe the ideas Senator Javits was mentioning here earlier,

the one you have about a small business, a department of the Federal Reserve Board, those are details.

I really feel that what we must take into consideration, in the context of this Joint Committee, the deliberations, is really, what do we want in this country.

The English have a great advantage over us, in terms of knowing what their Government is all about.

The Government issues a white paper. The Labor government tells you what they want out of a particular sector of the economy, and what they will do about it.

Senator HUMPHREY. We have, as you know, hearings underway on what we would call growth and development, and economic planning. The latter phrase scares the living daylights out of some people, but I still think what you are talking about, is what we are talking about—what are the forecasts, what are the goals, what are the priorities, and how do we shape the mechanisms to achieve those goals and priorities.

Mr. NEEDHAM. The point I was trying to make, not by way of an apology, but by way of explanation is, this is a model that we think that fits, taken into consideration the decisions made by the Congress, about pollution, about transfer of payments, we do not argue about that.

That is for you to decide.

We have taken those decisions and incorporated them into studies to determine whether or not the engine that runs the economy has the capacity to produce the kind of society that you want.

We do not argue with you on that.

We may differ, but we are accepting them.

Senator NELSON. I just wanted to understand what method you are using, and I understand what you are saying now, which, I gather is the following—if we do what "we ought to do" in this country in capital investment, it will be required in your judgment, based on your studies, to raise about this amount of equity capital.

Mr. NEEDHAM. That is correct.

Senator HUMPHREY. I say this will be very helpful to all of us.

We will want to look at that study, because that gets at the central problems, that this committee is involved in.

We are not a tax committee, we are not a legislative committee.

We are a committee of inquiry, investigating and studying.

The same thing is true of the Select Committee on Small Business.

You do not have legislative authority, do you?

Senator NELSON. No, except we have six members who are on the Finance Committee, and that helps.

Senator HUMPHREY. Yes, that helps.

Mr. NEEDHAM. I did not mean to give you all of that rhetoric when I came, but it just fits in with our philosophy.

Senator HUMPHREY. Very good. It is not rhetoric. It is very encouraging to have that attitude from the stock market, and from the business community.

Mr. Laun, I want to ask you just a quick question.

I am told the OMB will be cutting SBA's 1977 fiscal year budget, that the loan guarantee program will be reduced, is this true?

Mr. LAUN. We have not completed our discussions with OMB on it.

Senator HUMPHREY. What is the temperature like?

Mr. LAUN. The overall temperature is trying to hold the overall outlays on one hand and us asking for increases, and we are in the negotiating part.

It is hard to tell at this point.

Senator HUMPHREY. What are you doing to maintain your budget?

You made a very strong plea for the activities of the Small Business Administration. I have never heard of a better one, and I have listened to the testimony on small business for a long time.

You have lifted my sights, you have inspired me, you have excited me, now what are you doing?

Mr. LAUN. We are trying to show that our programs are helpful to small business, and to the economy, and to the free enterprise system, and individual liberties, and that the investment in some of these programs really pays dividends, and is not a cost to the Government. Whether or not OMB will know that, we will know in a week.

Senator HUMPHREY. Has SBA lost money for the country?

Mr. LAUN. I think the SBA runs at considerable profit for the country.

Senator HUMPHREY. That is correct.

As Senator Javits says, by the way, to get out of this mess, we need to get this country moving, and to get these investments moving.

I do not care where they come from. I am not even opposed to having the Arabs investing.

If you can get the money in here, get it in here, and let's get the wheels of industry moving. But if we have a philosophy, that you make everything look better by tightening up on the program that really yields dividends, then we will be in one fix. We will be in a mess, and a continuing mess, and that of course is one of the things that has bothered me.

I go back again to Mr. Wallich's on the Fed's program.

I just wondered, for example, does the Fed have any records as to what its policy does, for example, to the housing industry?

This has been especially hard-hit by higher mortgage rates, which are the outgrowth of the Fed's tight money policy from time to time.

Does the Fed keep records on the impact of this policy on specific sectors like the housing industry?

I say that, because I am convinced there is no way out of this recession, as long as the housing industry is in the doldrums.

Governor WALLICH. The Board has the latest data on developments in the housing sector as well as current data on developments in the housing finance sector, both for banks and other intermediaries.

Senator HUMPHREY. But did you relate your policies to what your observations are?

I am sure you have got a report that shows the housing business is about half of what it ought to be, and that you have reports that indicate that the number of charts are slowing down, but does that tell you anything about what the Fed is doing in its money policies.

Governor WALLICH. Yes. The housing sector is naturally one of the main considerations in determining an adequate supply of money and credit.

Senator HUMPHREY. And housing is made up of thousands of small business contractors. That may be one of the big segments of small business. But my point is, again, I know you have the records, and

we know that housing is terribly important for the regeneration of the economy. Then how come the policies do not direct themselves more toward getting money loosened up for the housing industry.

Governor WALLICH. Well, first, I think they do.

New housing starts have gone up by more than 50 percent this year. Second, the Board's main concern has to be to avoid a new wave of inflation since past inflation has led to our present problems.

Senator HUMPHREY. I cannot understand when there ought to be inflation in housing, when you are down to 1,300,000 starts, and the figures are very deceiving.

I just do not understand all this, even with your figures about the plan capacity, the use of plan capacity, it is down to 69 percent. You say this is into obsolescence, but I saw figures on the Federal Republic of Germany. They were using their plan capacity at 92 percent, and they have had half the inflation we have had.

Governor WALLICH. I think the German statistics on plant capacity, like their unemployment statistics, are different from ours. If I may return to the inflation theme, it is now evident that inflation is very pervasive; that it does not affect just one sector; rather it influences the whole economy, including interest rates; and that as we have more inflation, we have both higher interest rates and a higher rate of unemployment. Thus, the way to lower interest rates and lower unemployment, in my opinion, is to work on the inflation problem.

Senator HUMPHREY. But when we had these pollsters in here, we had six major firms, the public believes that one of the greatest factors in this inflation is high interest.

I don't know, maybe the public does not know what it is talking about. The folks spending the money are of the opinion that high interest indicates high inflation.

Now, you feel that if you lower the interest rates and loosen up on the money, it creates inflation.

The public feels if you keep the interest rates high and tighten up on the money, that it creates inflation, because the minute you tighten up, the people raise their prices. They have to put into the price structure the higher interest rates. Any man that runs a business, knows interest is just rent on money, like rent on a piece of property.

It is the same thing. If you raise the rate, if the interest goes up, the rent on your business is raised 100 percent, or let us say from $500 a month to $750 a month for a little retail establishment, you have to put this into your price structure.

If your rent has been raised up from 6 percent, because if you are an independent businessman, you are paying more than that, but let us say they go up to 12, 14 percent, you have to put that into your price structure, or you go broke.

How do you explain that if a worker gets more money, that is inflation, that if a doctor gets more money, that is inflationary, but if a banker gets more interest, that is not inflationary?

How does that work?

I got a letter from a fellow back home in Minnesota, he wrote, he said, Senator, how is it that when the doctor gets more money, and he was reading about medicare and medicaid, and when the businessman makes more profits, then that is inflation, but when the banker is doing better, and so forth, and he went down the line, they all say

that is recovery, but when I get more money as the wage earner, they say that is inflation.

Will you please explain that to me?

I have not been able to answer that letter yet, but I have been asking everybody in the Government, and I have not been able to find out the answer, because after all, interest is nothing but a wage on money. That is all it is.

Would you care to comment?

Governor WALLICH. I think the public has gotten hold of a small part of the truth, but the main effect of not trying to have high interest rates, by creating more money and spreading it around, is inflation. Therefore, the bigger part of the truth is that more money causes inflation; and high interest rates are not the cause but the effect of the inflation.

Senator HUMPHREY. Now, I would buy that under certain classical themes, and I have studied enough economy to be at least acquainted with themes. If there was excess demand, it might hold. But there is no excess demand today, except in a few industries. There is no excess demand of automobiles.

There really is no excess demand of lumber, even though lumber prices are going up. You cannot have an excess demand when you are down on your housing starts.

There is no excess demand of electrical appliances, but everyone of these prices are going up and up and up and up. And today in October the wholesale price index is up seven-tenths of 1 percent. Again, this is not because there was a new wage contract, not because taxes have gone up, or because they have not gone up.

It is not because of any of this. Prices are just going up, and I get back to the same old problem that we have had, I think that not only is our solution off, but I think our analysis is also.

I think on the one hand, while some of us can be scolded for using certain economic theories—I am of the opinion it has not worked as well as what we thought it would—I would have to say a lot of other people are thinking in terms of Adam Smith, when they are talking about the monetary policy.

Governor WALLICH. I think part of the analysis is off, because many do not think in terms of the long-run effects of different economic policies.

The effect of monetary policy on output is something like half a year to 9 months; and its effect accumulates over time.

Senator HUMPHREY. I agree with that.

Governor WALLICH. Apparently the effect of monetary policy on prices is a good deal slower; so in acting today, one has to think not what his actions will produce tomorrow or next month but a year or two hence.

Now, hopefully we will be in different circumstances in a year or two, and if we ignore the prospects for that time, we are going to suffer the same fate we now have suffered three times. We have had three of these stop-go cycles because we did not take into account the long delay with which our action would have an effect. We were surprised when policy action finally did have an effect, and we did not like the effect because it was badly timed.

Senator HUMPHREY. Well, I know it is a complicated business, and I am not unaware of the lag, I think that is true, but what has disturbed me is that we have had the tax reduction for a year, almost a year, and it has given some benefits.

We have had some loosening of the money policy. There has been more stabilized monetary policy. At the same time, the wholesale price index in the last 12 months has shown a very, very unhappy situation. And I repeat, that all of the classical reasons for that are nonexistent. There has not been a labor contract of any significance negotiated. Wait until next year.

This is the one industrialized Nation that has a moderate wage increase.

Second, taxes are down in most areas from what they were a year ago, and demand is off, and prices are up.

Of course, this to me shows something structurally wrong in the economy, and I think one of the reasons prices are up, is that just like people are uncertain in investing, when they do not know what the future looks like.

The businessman looks down the road, and says, well, I am not selling as much as I used to, so I will raise the price on what I sell. I think this is happening all the time, particularly when there is no real competition. And when you see 8,000 small enterprises go bankrupt, in that period of a year or less, that indicates to me that there the rate of competition is falling, and the large institutions are growing, and the possibilities of administered prices are increasing.

Mr. LAUN. What you have is a big daily auction going on out there. I mentioned in my testimony about the savings supply, but then you have everybody lined up bidding for that money, the Federal Government, the State government, the large businesses bidding for it, the small businesses are at the end of that lineup, and by the time the small businessman gets there, everybody else has bid those interest rates up before he gets there.

We think that is one of the reasons, a simple supply and demand situation.

Senator HUMPHREY. I can understand that there is a demand for money.

Mr. NEEDHAM. Senator, just a few moments of your time.

First, I would like to say, I believe the Federal Reserve really manages the money supply beyond anyone's reasonable expectations.

I think too that the people in the Congress and the administration that manages the budget, do a job there. I am a CPA, and it just defies my imagination.

I think the key here is that we are given a deficit of substantial amount, not only the current yield on an accumulated basis.

Now, if this were a normal business situation that we were looking at the financial statements on a consolidated basis, one would have to conclude that perhaps the Federal Government is in precisely the same position as the city of New York.

We cannot afford to let the Federal Government even go into a chapter 12 or 13 or 16 type of bankruptcy, that is not possible, so it seems to me that what we ought to do, and I do not have enough information to do it, but the Congress can get it, is we ought to say to ourselves, we have made a lot of mistakes in the past, we should not be

where we are, we should not have one-third of the gross national product outstanding in the form of Federal debt. That is too high.

That is a big cost to the Federal Government also.

You are talking about the impact of interest on individuals and small businesses. Look at the Federal budget allocation for interest.

Senator HUMPHREY. Just fantastic.

Mr. NEEDHAM. So let's start from the position that we are at a point financially where we do not want to be.

Let us also start with the assumption that the people of the United States want more than we can deliver.

So then we have to look at all of these assumptions, and then we have to look at some of the economic theories that were brought up, and they just do not apply in these circumstances.

So the question is really, how do we get things going, and how do you do that, without increasing the Federal debt, and without increasing budgetary deficits, because we do know as a matter of fact, and I do not think there is any disagreement on either side of the aisle, that deficits are an inflationary factor.

How do we get the productive mechanism going again, when we cannot raise taxes, so that we can again generate surpluses, reduce the outstanding debt, reduce the reliance of the entire American population and the business community on the Federal Government.

I heard a shocking statement by the former Chairman of the Securities and Exchange Commission. For 3½ years I have been chairman of the New York Stock Exchange, and I am a former Commissioner of the SEC, so I know something about the business from that side. For 3½ years I have been asking the question, why do you want to change the existing market structure of the United States, and put aside all of the improvements in the technology in the industry that we have had.

Why do you want to change the capital market structure of the United States, why do you want to dismantle the stock exchange of the United States, because that is what we are doing, and I have never gotten an honest answer for that question.

Last night, the former SEC Chairman, finally explained, and when the American people find out, and the American investors find out, and I will make sure they find out, there will be a hue and cry the likes of which Congress has never heard before, you know why we are restructuring the stock exchanges of the United States, because the individual investor is not worth paying attention to.

We should build a stock market system compatible solely to the needs of the institutional investors of the United States.

To me, that is absolutely shocking.

Senator HUMPHREY. I do not think any Member of Congress is aware of that, if I were aware of it, it is the first I have heard of it.

I think that is ludicrous, not only that, but dangerous.

Mr. NEEDHAM. Well, the Congress I think, and this is a matter for Senator Williams' subcommittee, and I intend to convey this to Senator Williams, and I think Congressman Van Deerlin, on the House side, to tell them what was said, because we will come out very shortly with a study that will show the number of individuals in America who own stock has diminished.

Our whole effort, and Senator Javits congratulated the stock market in its efforts, is to try to get more people to buy equity securities.

Here I thought we had a national policy designed to encourage every American to own a piece of America through the private enterprise system.

Now we have an independent Federal agency coming out and saying, what we are out to do is to cater to the needs of the large financial institutions, and we will not be too concerned about what happens to the individual investors.

Competition should set the prices, no argument over that from the securities industry.

Who got the benefit, the large institutions.

The individual investors pay 15 percent or more now in commission charges. People do not understand why interest rates have to go up. Low interest rate is our national policy, there is no mistake about that.

I do not understand it, and everyone at the table is the same way, but the question is how do we get to where we should go, we have to come up with a new mechanism that will get this country going.

You can see what is happening in New York, they have a deficit, they managed poorly, and that is not just a Democrat problem.

It is a bipartisan problem in the city of New York. We never had the kind of management looking back at what we should have, so the sole action is to balance your budget, wipe out all of the nonessential surpluses. Do you know what they are?

That is the way to solve the problem for New York, and it is not the way to solve the problem for the United States.

We cannot bring this economy to a shreiking halt just to bring down inflation.

What are we going to tell the young people, they cannot go to college?

Are we going to deny the minority groups a chance to move forward?

You cannot do that. A solution which will get us out of the problem we are in, and we have been there now for 2 years.

I am sorry to do this to you, Senator.

Senator HUMPHREY. I am very grateful to you, and it is the most encouraging news a man can have in public life is to hear a person of your standing in the private sector to say what you have said.

To try to expand this country's production capacity, to modernize, to make it more efficient, to generate the capital, that is what is needed.

I spoke with some business people up in New York the other night, and they were complaining about all kinds of things, I said why don't you tell your story. You put one ad in the paper, and you think that is it, and you think that we politicians talk too much, and the reason we do that is that the people have to be told, again and again.

Everybody in the advertising business knows that, and there are things that if you are going to change people's attitudes, get people to understand that you have to make, simplify it, you have to show what you can do, by repetition on things that make some sense to the people.

I do not mean to just keep you here, because it is right, and I want to let you go.

I think it is important that we recognize that our ultimate answer is not just more Federal Government. I recognize that.

The trouble is the answers have not been coming, and, therefore, the doctors have to be called in, and we are somewhat in the condition, may I say, of the patient that is living off of machines, and that is just about where we are.

I frequently use the physical analogy. We have got some very serious disabilities, and even to the point where some people think they are terminal.

I do not think they are.

I am much more optimistic than that, but we are relying on all kinds of machines and gadgets to keep the old body economy going, rather than having it be regenerative, and create its own strength, and its own heating.

Gentlemen, thank you.

We are adjourned.

We will keep the record open for whatever time is necessary to receive additional materials.

[Whereupon, the committees were adjourned at 1:20 p.m.]

APPENDIXES

APPENDIX I

Letter, requesting continuation of reporting of small business loans, from Alan Bible, Chairman, and Jacob K. Javits, Ranking Minority Member, Senate Select Committee on Small Business; and Alan Cranston, Chairman, and Lowell P. Weicker, Jr., Ranking Minority Member, Subcommittee on Small Business, Senate Banking, Housing and Urban Affairs Committee, December 4, 1974 (to Arthur F. Burns, Chairman, Board of Governors of the Federal Reserve System). Identical letter sent (to Frank Wille, Chairman, Federal Deposit Insurance Corporation).

ALAN BIBLE, NEV., CHAIRMAN

JOHN SPARKMAN, ALA.
GAYLORD NELSON, WIS.
THOMAS J. MCINTYRE, N.H.
SAM NUNN, GA.
J. BENNETT JOHNSTON, JR., LA.
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PETER H. DOMINICK, COLO.
EDWARD J. GURNEY, FLA.
J. GLENN BEALL, JR., MD.
JAMES L. BUCKLEY, N.Y.
WILLIAM L. SCOTT, VA.
WILLIAM V. ROTH, JR., DEL.

CHESTER H. SMITH,
STAFF DIRECTOR AND GENERAL COUNSEL

United States Senate

SELECT COMMITTEE ON SMALL BUSINESS
(CREATED PURSUANT TO S. RES. 58, 81ST CONGRESS)
WASHINGTON, D.C. 20510

December 4, 1974

Honorable Arthur F. Burns
Chairman
Board of Governors of the
Federal Reserve System
20th and Constitution Avenue, N. W.
Washington, D. C. 20551

Dear Mr. Chairman:

We know you are aware of the credit problems faced by small businesses, particularly during a period when the highest bank interest rates in a century caused special problems for new, small, family, local, and independent enterprises.

We are writing this letter to request that reporting of small business loans, which was developed by the Committee on Interest and Dividends, be continued as appropriately modified, so that Congress can learn the nature and extent of these problems.

Our Committees have legislative responsibilities which include oversight of the business and economic opportunity loan portfolios of the Small Business Administration.

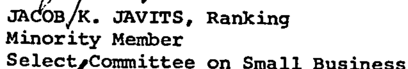
We deem it necessary and important in fulfilling these and other responsibilities to request that this reporting be continued, both as to rates and volumes of small business credit along the lines agreed upon by the

Federal Reserve System and the Federal Deposit Insurance Corporation, so that participation would be balanced between banks both inside and outside the Federal Reserve System. We would hope that the results of these quarterly or other surveys could be reported to our Committees at yearly or other appropriate intervals. We also realize that there are difficulties in attempting to refine the definitions of small business, developing appropriate samples of banks of different sizes and in different parts of the country, assuring the confidentiality of information, and avoiding undue burdens upon reporting personnel. We would be pleased to collaborate with you and with the FDIC on the staff level in tackling these problems.

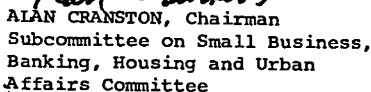
Your cooperation and assistance to our Committees in this regard would be greatly appreciated.

Sincerely,

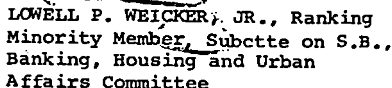
ALAN BIBLE, Chairman
Select Committee on Small Business



JACOB K. JAVITS, Ranking Minority Member
Select Committee on Small Business



ALAN CRANSTON, Chairman
Subcommittee on Small Business, Banking, Housing and Urban Affairs Committee



LOWELL P. WEICKER, JR., Ranking Minority Member, Subctte on S.B., Banking, Housing and Urban Affairs Committee

APPENDIX II

Letter, response to December 4, 1974, letter from Senate Select Committee on Small Business and Subcommittee on Small Business, Senate Banking, Housing and Urban Affairs Committee, from Arthur F. Burns, Chairman of the Board of Governors, Federal Reserve System. January 3, 1975.

CHAIRMAN OF THE BOARD OF GOVERNORS
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

January 3, 1975

The Honorable Jacob K. Javits
United States Senate
Washington, D. C. 20510

Dear Jack:

Thank you for your letter of December 4 regarding the collection of data on loans to small businesses by commercial banks. As your letter suggests, there are very considerable difficulties, both of definition and of measurement, in obtaining an accurate picture of bank credit flows to such firms.

I believe it would be quite helpful if representatives from the staff of the Select Committee on Small Business and from the Committee on Banking, Housing and Urban Affairs would meet with our staff to discuss the issues involved. I have suggested, therefore, that a member of the Select Committee's staff contact Mr. Edward C. Ettin, of the Board's Division of Research and Statistics, to arrange such a meeting.

Chairman Patman of the House Committee on Banking and Currency has also written to me on this question, and I am inviting representatives from the staff of that Committee to participate in the discussions.

With warm personal regards,

Sincerely yours,

Arthur F. Burns

APPENDIX III

Table, interest rates charged on selected types of bank loans, from Federal Reserve Statistical Release, January 17, 1975.

FEDERAL RESERVE

statistical release

G.10

For immediate release

January 17, 1975

INTEREST RATES CHARGED ON SELECTED TYPES OF BANK LOANS

Type of Loan	Interest rate (per cent per annum)		
	January 1972	November 1974	December 1974
Small short-term noninstalment loans to businesses 1/	7.31	11.75	11.48
Farm production loans (one year of less maturity)			
Feeder cattle operations	7.55	10.94	10.70
Other farm production operating expenses	7.63	10.58	10.39
Consumer instalment credit for:			
New automobiles (36 months)	10.26	11.57	11.62
Mobile homes (84 months)	10.94	11.87	11.71
Other consumer goods (24 months)	12.57	13.16	13.27
Other personal expenditures (12 months)	12.74	13.47	13.60
Credit card plans	17.11	17.16	17.16
Business loans--prime rate			
To small businesses	n.a.	10.10	9.95
To large businesses	5.25	11.00	10.50

1/ Loans of $10,000 to $25,000 maturing in one year or less.

NOTE: Except for the prime rate on loans to large businesses, the interest rates shown on this release are based on a survey conducted jointly by the Federal Reserve System and the Federal Deposit Insurance Corporation at 370 insured commercial banks. All rates except the prime rates represent simple unweighted averages of the "most common" effective annual rate on loans made during the first full calendar week of the month in each loan category. The "most common" rate is defined as the rate charged on the largest dollar volume of loans in the particular category during the week covered in the survey. Consumer instalment loan rates are reported on a Truth-in-Lending basis as specified in the Federal Reserve Board's Regulation Z.

r--Revised

The prime rate on loans to small businesses, as provided for in the dual prime rate structure established by the Committee on Interest and Dividends in the interest rate criteria for commercial banks, issued April 16, 1973, is the best rate charged by a bank to its most credit-worthy local customers. For the Committee's purposes, a small business is defined as any domestic commercial, industrial, or agricultural borrower whose total borrowings outstanding at any one time over the preceding 12 months (exclusive of long-term real estate mortgage debt) did not exceed $350,000 and whose assets do not exceed $1 million. The figure shown is the simple unweighted average of the rates in effect on the last business day of the first full calendar week of the month; the range of variation of these rates is considerable. The large business prime rate is the rate most commonly quoted by large banks on that date. Since the prime rate information has not been converted to an effective rate basis, the rates shown are not directly comparable to the other rates shown on this release.

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APPENDIX IV

Letter, concerning development of reports on credits to small business, from Gaylord Nelson, Chairman of the Senate Select Committee on Small Business, June 12, 1975 (to Peter Keir, Adviser, Division of Research and Statistics, Federal Reserve Board).

GAYLORD NELSON, WIS., CHAIRMAN

JOHN SPARKMAN, ALA.
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BOB PACKWOOD, OREG.

WILLIAM B. CHERKASKY, EXECUTIVE DIRECTOR
RAYMOND D. WATTS, GENERAL COUNSEL

United States Senate

SELECT COMMITTEE ON SMALL BUSINESS
(CREATED PURSUANT TO S. RES. 58, 81ST CONGRESS)
WASHINGTON, D.C. 20510

June 12, 1975

Mr. Peter Keir, Adviser
Division of Research and Statistics
Federal Reserve Board
20th Street and Constitution Avenue
Washington, D. C. 20551

Dear Mr. Keir:

The Committee very much appreciated your arrangements for Messrs. Herbert Spira and John Adams to meet with you and other staff members of the Board on June 3rd regarding the possibilities for continuation of reporting of small business loan information.

We continue to believe that the development of a series of consistent reports as to the magnitude as well as the interest rates of credits to small businesses would be of great benefit.

During your discussions, it emerged that a "proxy" which your people were considering for loans to small business might be those loans which ranged in size between $10,000 and $25,000. In this connection the Committee has recently received an indication that the average Small Business Adminis-tation business loan in 1972 was in the neighborhood of $59,400. In an effort to be of assistance in this area, we are requesting that the SBA provide the Committee with a profile showing the percentage of its loans in various size categories during recent years.

As soon as this information reaches us, I shall be glad to share it with you and your colleagues.

For the present, best wishes.

Sincerely,

Gaylord Nelson
Chairman

APPENDIX V

Letter, requesting information on small business loans from SBA, from Gaylord Nelson, Chairman, Senate Select Committee on Small Business, June 12, 1975 (to Robert D. Holland, Assistant Administrator for Advocacy, Planning and Research, Small Business Administration).

GAYLORD NELSON, WIS., CHAIRMAN

JOHN SPARKMAN, ALA.
THOMAS J. MC INTYRE, N.H.
SAM NUNN, GA.
J. BENNETT JOHNSTON, LA.
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WILLIAM B. CHERKASKY, EXECUTIVE DIRECTOR
RAYMOND D. WATTS, GENERAL COUNSEL

United States Senate

SELECT COMMITTEE ON SMALL BUSINESS
(CREATED PURSUANT TO S. RES. 58, 81ST CONGRESS)
WASHINGTON, D.C. 20510

June 12, 1975

Mr. Robert D. Holland
Assistant Administrator for
Advocacy, Planning and Research
Small Business Administration
1441 L Street, N. W.
Washington, D. C. 20416

Dear Mr. Holland:

For some time we have been trying to arrange with the Federal Reserve Board for a continuation of its statistics on small business bank loans which were begun under the Stabilization Act. In order to carry forward this project, we would appreciate it if the available data on business loans could be furnished to us for recent years in the following size categories:

$1,000 to $10,000
10,000 to 25,000
25,000 to 50,000
50,000 to 75,000
75,000 to 100,000
and over $100,000

If the figures are readily available for two or three years, it would be helpful to indicate what effect inflation and other economic forces might have on SBA loan sizes.

Your cooperation in this matter would be very much appreciated.

Sincerely,

GAYLORD NELSON
Chairman

GN:hsmvc

APPENDIX VI

Table, SBA tabulation of guaranteed business loans of various size categories (FY 1973–75), from U.S. Small Business Administration, July 14, 1975

Size categories	Number of loans	Dollar amounts	SBA Share
Fiscal year 1973:			
$1,000 to $10,000	1,778	$14,947,800.50	$12,420,766.36
$10,001 to $25,000	5,343	102,292,853.00	89,834,670.44
$25,001 to $50,000	6,016	233,448,534.00	203,916,184.70
$50,001 to $75,000	3,022	194,996,967.00	169,412,116.60
$75,001 to $100,000	2,258	208,070,898.00	180,996,840.70
$100,001 and above	5,146	1,116,801,761.00	952,108,156.42
Total	23,563	1,869,658,813.50	1,608,688,005.16
Fiscal year 1974:			
$1,000 to $10,000	1,256	9,998,615.13	8,855,507.12
$10,001 to $25,000	4,086	78,697,210.00	69,209,310.01
$25,001 to $50,000	5,050	197,863,595.00	173,459,517.56
$50,001 to $75,000	2,489	160,893,356.00	140,292,523.56
$75,001 to $100,000	1,975	181,409,652.00	157,914,428.14
$100,001 and above	4,634	1,025,363,433.67	873,781,011.42
Total	19,490	1,654,225,861.80	1,423,512,297.81
Fiscal year 1975:			
$1,000 to $10,000	804	6,463,950.00	5,714,054.75
$10,001 to $25,000	2,639	50,970,240.55	44,756,269.37
$25,001 to $50,000	3,480	135,794,777.00	118,277,081.27
$50,001 to $75,000	1,745	112,756,558.00	97,580,051.56
$75,001 to $100,000	1,345	124,238,348.00	107,835,346.32
$100,001 to above	3,165	675,653,319.00	576,241,259.67
Total	13,178	1,105,877,192.55	950,403,719.94
Program total	56,231	4,629,761,867.85	3,962,604,052.91

JULY 24, 1975.

MEMORANDUM OF COMMENT ON SIZE DISTRIBUTION OF SBA LOANS

From: Herbert L. Spira, Associate General Counsel.

The information furnished by the Small Business Administration on the distribution of Section 7(a) business loans by size categories has been analyzed as to the percentage of numbers of loans and of funds disbursed in each size category for fiscal years 1973, 1974, and 1975. A table showing percentages in each instance is attached.

It may be observed that the numbers and percentage of funds in the two categories under $25,000 have declined in each of the last two years (overall, from 30.21 percent of the number to 26.09 percent, and from 6.22 percent to 5.18 percent of the dollars). Inflation may be part of the explanation.

The category from $25,000 to $50,000 has increased in the number of loans from year to year (from about 25½ percent to 26½ percent) and been rather stable in the percentage of funds in this range (12 to 12½ percent).

It seems pertinent also that the category of $100,000-and-above loans has increased from about 22 percent to 24 percent, and consistently accounts for the predominance of the dollars disbursed, around 60 percent.

More should be learned about the financial significance of loans of these different sizes. Can any generalizations be made as to why loans are concentrated in certain ranges? How much of the answer depends on the size of borrowers and how much on the purpose of the loans; e.g., whether they are primarily used for working capital, medium-term, or long-term financing. It would be most helpful if we could obtain the comments of such bodies as the Federal Reserve and bankers' associations on this material.

Attachment.

SELECT COMMITTEE ON SMALL BUSINESS TABULATION OF PERCENTAGES OF LOAN-NUMBERS AND DOLLARS IN LOANS OF VARIOUS SIZE CATEGORIES (FISCAL YEARS 1973–75)

	Fiscal year 1973		Fiscal year 1974		Fiscal year 1975	
	Percent of number	Percent of funds	Percent of number	Percent of funds	Percent of number	Percent of funds
$1,000 to $10,000	7.54	0.75	6.44	0.60	6.07	0.58
$10,001 to $25,000	22.67	5.47	20.96	4.75	20.02	4.60
$25,001 to $50,000	25.53	12.48	25.91	11.96	26.40	12.27
$50,001 to $75,000	12.82	10.42	12.77	9.72	13.24	10.19
$75,001 to $100,000	9.58	11.12	10.13	10.96	10.20	11.23
Above $100,000	21.83	59.73	23.77	61.98	24.01	61.09

APPENDIX VII

Letter, information on breakdown on guaranteed loans from SBA to Federal Reserve Board from Gaylord Nelson, Chairman, Senate Select Committee on Small Business, July 24, 1975 (to Peter Keir, Adviser, Division of Research Statistics, Federal Reserve Board).

GAYLORD NELSON, WIS., CHAIRMAN
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RAYMOND D. WATTS, GENERAL COUNSEL

United States Senate
SELECT COMMITTEE ON SMALL BUSINESS
(CREATED PURSUANT TO S. RES. 58, 81ST CONGRESS)
WASHINGTON, D.C. 20510

July 24, 1975

Mr. Peter Keir
Adviser
Division of Research Statistics
Federal Reserve Board
20th Street and Constitution Avenue
Washington, D. C. 20551

Dear Mr. Keir:

This will supplement our correspondence of June 12 regarding the desirability of continuing the reporting of small business bank credit.

At that time, we undertook to request of the Small Business Administration a tabulation of business loans made by that agency in various size categories.

We have just received a table showing a breakdown of guaranteed loans approved by the SBA in fiscal years 1973 through May 31, 1975. The listing includes the number of loans approved in each category, the total dollar amount approved, and, in the final column, the SBA share of these loans. We also enclose a staff analysis of this information.

As far as I am aware, this is the first time information of this kind as to the distribution of SBA loans by size has been available to our Committee. We do plan to inquire further as to the significance of these patterns and we would appreciate having the observations of the Board staff on these figures.

2.

In the meantime, we hope that the statistics and other material will be helpful to the Federal Reserve in advancing the reporting of meaningful small business credit information.

Sincerely,

GAYLORD NELSON
Chairman

GN:hsmvc
Enclosures

APPENDIX VIII

Letter, need for study of small business financing from E. W. Sandberg, Assistant Administrator, Planning, Research and Analysis, U.S. Small Business Administration, August 1, 1973 (to J. Charles Partee, Director, Division of Research and Statistics, Board of Governors, Federal Reserve System).

RECEIVED AUG - 3 1973

U.S. SMALL BUSINESS ADMINISTRATION
WASHINGTON, D.C. 20416

OFFICE OF THE ADMINISTRATOR

AUG 1 1973

Mr. J. Charles Partee
Director, Division of Research and Statistics
Board of Governors
Federal Reserve System
Constitution Avenue and 20th Street, N. W.
Washington, D. C. 20551

Dear Mr. Partee:

The Federal Reserve System has provided material assistance to Congress and small business through the studies it conducted in 1952 and 1958. The 1958 Federal Reserve Study of small business financing, is the only comprehensive study of this type that has ever been made; but this study is rapidly becoming dated.

After conversations with relevant committees in Congress and in order, similarly, to aid small businessmen, the Small Business Administration feels that there is an urgent need for a current study of small business financing that would be comparable in scope and comprehensiveness to the 1958 Federal Reserve Study. Such a study would provide numerous benefits to the Federal Reserve as well as to SBA.

Although SBA has some resources to dedicate to the successful prosecution of such a study, it is felt that a cooperative effort by several government agencies and industry associations is necessary and that the participation of the Federal Reserve System is singularly essential to the success of this study because of what we believe to be the central role commercial banks play in financing small business. Not only would the Federal Reserve System, the Congress, the Small Business Administration gain significant advantages from the study, but other federal organizations such as the Council of Economic Advisors, the Treasury, and the Office of Management and Budget would also benefit from the study. Groups significantly benefiting from the study in the general economy would include the small businessman, financial institutions, and academia.

The various questions that could be asked in this study might be incorporated into the following topical areas: (1) What is the total amount of capital available for the financing of business? (2) What proportion of that financing is going to small business? (3) What are

the sources of capital to small business and how much credit do they supply to this sector? (4) What are the terms that these suppliers of capital require? (5) What are the problems encountered in matching the capital needs of the independent small businessman with the supply capabilities of the sources of capital?

The need for the study is evident given that an estimated 95 percent of American businesses are relatively small. Collectively, these businesses account for about 37 percent of the gross national product and employ around 43 percent of the nation's labor force. These data indicate the significant role small business plays in our economy and the importance that may be assigned to small businesses being able to obtain adequate capital at a reasonable cost; but available information respecting small business operations and financing is extremely limited. Our major statistical services are national aggregates that are so heavily weighted by large corporate business data that what is happening in the small business sectors can not be deduced with any degree of certainty. Aggregate data concerning small business is needed on a continuing basis.

The last comprehensive study of small business financing was conducted in 1958. During the 15 years that have elapsed since this study was made, major changes have taken place in the economy. These include, among others, major changes in the organization and operation of commercial banking and other institutional sources of small business financing. Similarly, major changes have taken place in small business organization and operation with corresponding changes in financing requirements. Information respecting small business financing, however, has not kept pace with these changes. As a consequence, we are now confronted with information gaps of major proportions concerning small business financing.

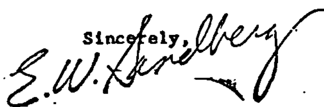
Numerous objectives can be attained by this study. They might include, among others, (1) information regarding the existence of capital gaps, (2) a determination of possible actions of the Federal Government which would further aid commercial banks and other financial institutions in channeling credit to small businessmen, and (3) definition as to what is a small business. Additionally, vital national goals in the areas of housing, foreign trade, innovation, competitiveness, and environment might be greatly assisted through the prosecution of this study.

With the idea in mind of helping to initiate the study, I have had preliminary discussions with staff members of the Senate Small Business Committee and of the Federal Reserve. It was agreed in a joint discussion, July 5th, that I should address a memorandum to you briefly characterizing the need for such a study and proposing a topical framework. At a later date I can provide a more detailed outline.

3

I will be in touch with you later to arrange further discussions which would also include members of the staff of the Senate Small Business Committee.

Sincerely,



E. W. Sandberg
Assistant Administrator
Planning, Research and Analysis

cc: Mr. Herbert L. Spira
Counsel
Senate Small Business Committee

APPENDIX IX

Letter, need for establishing reliable source of information on small business bank credit, from Gaylord Nelson, Chairman of Senate Select Committee on Small Business, October 22, 1975 (to Rex Duwe, President, American Bankers Association). Identical letter sent (to Kenneth J. Benda, President, Independent Bankers Association of America).

GAYLORD NELSON, WIS., CHAIRMAN
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United States Senate

SELECT COMMITTEE ON SMALL BUSINESS
(CREATED PURSUANT TO S. RES. 58, 81ST CONGRESS)
WASHINGTON, D.C. 20510

October 22, 1975

Mr. Rex Duwe, President
American Bankers Association
P. O. Box 305
Lucas, Kansas 67648

Dear Mr. Duwe:

The Senate Small Business Committee periodically sponsors studies of the credit needs of the small business community.

In recent years, considerable effort has been devoted to establishing a reliable source of information on the volume and interest levels of small business bank credit. There has been effort on the staff level to enlist jointly the Federal Reserve System and the American Bankers Association in these endeavors. The Committee has benefited from the contacts we have had with Mr. James Cash and Mr. John Bevan of your association's staff.

During the past year, our interest has centered on the possibility of continuing the credit reporting introduced by the Committee on Interest and Dividends under the Stabilization Act.

Further staff discussions with the Federal Reserve during 1975 have indicated one possible proxy for "loans to small business" might be loans between $10,000 and $25,000. In this connection, the Committee has obtained a breakdown of guaranteed loans made by the Small Business Administration showing the distribution of these loans by number and funds disbursed in several size categories. We have also had a preliminary analysis of these figures by the staffs of the Committee and the Federal Reserve, which will be enclosed for your information.

Mr. Rex Duwe, President -2- October 22, 1975

In our view, it would be most helpful if the American Bankers Association could examine these statistics as they may relate to more meaningful reporting of small business credit information and give the Committee the benefits of its comments in this regard.

We would be particularly interested in whether, on the basis of experience of association members or studies in this field, any conclusions can be reached as to the relative size of loans utilized by business for plant expansion or purchase of additional tangible assets or intangible assets, compared to working capital or seasonal credit needs.

This is an area where the expertise of the banking industry would be valuable to the Senate, and we would be grateful for any observations which your organization might wish to make at this time.

Very truly yours,

GAYLORD NELSON
Chairman

GN:hss
Enclosures

APPENDIX X

Table, loans to selected sectors of the economy, Federal Reserve Bulletin, January 1975, p. A16

ASSETS BY CLASS OF BANK, JUNE 30, 1975

(Assets and liabilities shown in millions of dollars)

Account	All commercial banks
Cash bank balances, items in process	128,716
Currency and coin	10,102
Reserves with F.R. Banks	26,890
Demand balances with banks in United States	34,278
Other balances with banks in United States	5,727
Balances with banks in foreign countries	2,296
Cash items in process of collection	49,422
Total securities held—Book value	212,058
U.S. Treasury	68,191
Other U.S. Govt. agencies	33,882
States and political subdivisions	101,472
All other securities	8,513
Trade-account securities	6,198
U.S. Treasury	2,945
Other U.S. Govt. agencies	941
States and political subdivisions	1,907
All other	406
Bank investment portfolios	205,860
U.S. Treasury	65,246
Other U.S. Govt. agencies	32,941
States and political subdivisions	99,566
All other	8,108
Federal funds sold and securities resale agreements	38,841
Commercial banks	34,083
Brokers and dealers	3,054
Others	1,704
Other loans	496,990
Real estate loans	131,445
Secured by farmland	6,105
Secured by residential	81,360
1- to 4-family residences	74,612
FHA insured	5,626
VA guaranteed	3,167
Other	65,818
Multifamily	6,748
FHA insured	762
Other	5,986
Secured by other properties	43,981
Loans to domestic and foreign banks	11,155
Loans to other financial institutions	32,413
Loans on securities to brokers and dealers	5,534
Other loans for purch./carry securities	3,836
Loans to farmers	19,071
Commercial and industrial loans	178,993
Loans to individuals	101,816
Instalment loans	79,246
Passenger automobiles	32,128
Residential-repair/modernize	5,627
Credit cards and related plans	10,835
Charge-account credit cards	8,240
Check and revolving credit plans	2,595
Other retail consumer goods	15,273
Mobile homes	8,807
Other	6,466
Other instalment loans	15,383
Single-payment loans to individuals	22,570
All other loans	12,726
Total loans and securities	747,889
Fixed assets—Buildings, furniture, real estate	16,254
Investments in subsidiaries not consolidated	1,820
Customer acceptances outstanding	9,462
Other assets	26,917
Total assets	931,057
Number of banks	14,573

Source: Federal Reserve Bulletin, January 1976, p. A16.