

Economic, Fiscal, and Monetary Developments
Affecting the Capital Markets

A Discussion Prepared for
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Before calendar 1975 draws to a close, the Federal Government will have raised \$76-\$85 billion in net new money in the Nation's capital markets. Of this staggering amount, \$28½ billion had been financed as of May 1, an additional \$7½ billion is scheduled to be raised by June 30, and the remainder . . . \$40-\$49 billion . . . is to be raised in the second half of the calendar year.

The enormity of these requirements has generated widespread misgivings about the impact of the Treasury's financing on the capital market --- about the availability and cost of financial resources to the private sector. There has been much discussion in the press and in public forums about "crowding out" --- about business being displaced by the Treasury in drawing on the supply of funds in financial markets. Regrettably, much of this discussion has been intemperate: dire prophecies that the Government's preemption of funds, with a consequent escalation of interest rates, will abort economic recovery have been confronted with equally overblown assertions that the Government could finance substantially larger deficits than are actually in prospect without seriously impeding business access to funds.

The matters at issue are important and deserve better than such hyperbolic, adversary contention. From the point of view of financial market developments, the issue is not whether the Government's efforts to meet its financial requirement

will prevent economic recovery; they will not. Nor is the issue whether the financial markets will be able to allocate financial resources among the competing claimants; they will. The issue, rather, is whether the upward pressure on interest rates and bond yields will induce the monetary authorities to provide an excessively rapid expansion in the stock of money in a misguided effort to stabilize credit conditions at interest rate levels not much above those now prevailing. The consequence of any such excessive growth in the money stock will be a resurgence of inflation and of interest rates; a seriously adverse byproduct of renewed acceleration in the climb in the price level will be a return to the disastrous bear market conditions for equity financing which prevailed throughout 1973 and 1974.

Three months ago, in an advisory letter analyzing the effects of projected Treasury and private sector financing requirements, we pointed out that unless there were a massive inflow of private sector saving into the capital markets, there would be severe upward pressures on money market rates in the second half of this year. No such private saving splurge is in prospect. We also cautioned that vigorous supportive action by the Federal Reserve, to hold back the upsurge in interest rates by monetizing a substantial portion of the Government deficit, would very likely result in so large an increase in the stock of money as to reverse abruptly the slowdown in the inflation rate and to skyrocket the costs of credit.

Since late February, there have been mixed developments in the money markets. On the one hand, across a broad spectrum of public and private issues, interest rates and bond yields have declined, quite dramatically in some cases. The equity market has bulled ahead, up about 100 points on the Dow-Jones.

There has been a substantial amount of major corporate financing, on the one hand, and a significant number of important financing withdrawals, on the other. The Federal Reserve during the last month and a half has sharply increased its holdings of Government's --- at an amazing annual rate of 44+ percent, and Reserve Banks credit has increased almost as fast --- at a rate of 41 percent --- in the same period. The increase in the stock of money, while at a substantially faster rate than in 1974 as a whole, has lagged behind the expansion of Reserve Bank credit. Overall, one would have to say that financing the Government's deficit has not as yet this year severely impinged on the private sector's raising funds.

For the remainder of the year, the outlook is less optimistic. Checking and refining our late February projections, we estimate that total funds raised by the non-financial sectors in the credit markets in 1975 will range from a low of \$238 billion to a high of \$260 billion, compared with \$180 billion in 1974. These estimates imply 1975 average Moody's Aaa corporate bond yields of 10.6 percent and 9.71 percent respectively. To put these rates in perspective, the Moody's Corporate Aaa rate peaked at 9.27 percent in October 1974. The 1975 year-end rates implied by these annual averages are considerably higher, since the Moody's Corporate Aaa stood at 8.89 percent in mid-May. Moreover, these estimates assume that the March-April surge in the stock of money is not continued through the year and that the overall 1975 growth rate in the money stock will not be materially greater than the 5.7 percent rate of last year.

The overall thrust of this analysis is that we may expect an end in the near future to the slide in yields and should be prepared to see a strong upward

movement in money market rates during the latter half of the year. However distressing such developments might prove to any company seeking to raise funds, they do not spell financial catastrophe. Far more serious and perilous would be excessive monetary expansion which would transmute a temporary surge in interest rates into a far longer-term escalation, based on renewed inflation and inflationary expectations.

Largely ignored in this concern over financial market developments is the far more persistent and serious problem of real crowding out. While not minimizing the financial aspects of large government deficits, we must not lose sight of the fact that, whether financed by taxes or by additions to the debt, the growth in government expenditures is the basic phenomenon which increasingly pre-empt and directs the use of the economy's production capability. If incremental government spending is deficit financed, it directly retards or reduces gross national saving, hence gross investment. In the current calendar year, for example, the Federal Government's budget deficit is likely to result in a reduction of at least \$19+ billion---and perhaps as much as \$50 billion in the Nation's total saving, hence private capital foundation. If financed by additional taxes from our principal revenue sources, the effects on private saving lead to very much the same results.

The concern about Federal budgetary policy transcends doctrinal preferences for little or big government. It goes to the very heart of a problem to which much attention has been directed --- the problem of capital shortage. In focusing on this problem we should keep in mind the facts that

- o failure to meet (properly defined) capital requirements almost certainly will mean deceleration in the growth of real wage rates; hence,
- o while all of us have a vital stake in having these capital needs met, labor should be most concerned about any prospective shortfall;
- o the most serious limitation on meeting these capital needs is the likely inadequacy of business and household saving;
- o increasing the private sector's saving rate will require tax revisions to reduce the present tax penalties on individual saving, not merely revisions to permit more business saving;
- o increasing the household saving rate will require raising the saving rate of low and middle income individuals as well as that of more affluent individuals;
- o tax policy, accordingly, should place greater emphasis than in the past on relieving the excessive tax burden on individual saving.

A useful way to approach the idea of capital needs is to begin with the assumption that labor will not long tolerate any marked slow down in the increase in real wage rates. If at least the postwar trend rate of increase in real wage rate is to be maintained over the next decade or so, there must be an equal increase in labor's marginal productivity. One of the most important determinants of the increase in labor's productivity is the increase in the capital-labor ratio. Hence, if real wage rates are to continue to increase at least at the postwar trend rate, so too must the capital-labor ratio increase at least at the postwar trend rate. Given the projected increase in the labor force, the required increase in capital and in investment may be readily estimated.

In addition to these capital requirements, the business sector will

have to undertake substantial additional investment to satisfy public policy mandates---to meet environmental standards, to achieve energy self-sufficiency goals, to comply with occupational health and safety standards, to expand and improve mass transit, etc. On the basis of very conservative estimates of this additional investment, aggregate private capital formation to meet public policy mandates and to sustain at least the trend rate of increase in labor's productivity and real wage rates over the next decade will have to command a substantially larger proportion---perhaps 12 to 15 percent greater---share of total output than it has on the average over the postwar period to date.

For every dollar of gross private investment, there must be a dollar of gross national saving. Gross national saving is the sum of gross private saving plus government surpluses or minus government deficits. In most of the postwar year, the government sector has been in deficit, hence has reduced rather than augmented gross national saving. The burden of financing the Nation's capital requirements, therefore, falls on gross private saving, which also must finance government deficits. Gross private saving requirements, therefore, depend not only on gross private investment requirements but also on the budgetary results of the government sector. If it is assumed that government deficits average no more than \$10 billion per year over the next decade---an extremely conservative assumption in view of recent experience and near term prospects---the gross private saving rate (gross private saving divided by gross national product) in the decade ahead will probably have to increase by something more than 15 percent above the postwar average rate.

There is no assurance that gross private saving will continue at the postwar trend rate, let alone that it will increase by the indicated amount. Although

some private saving is very nearly automatic, a very large part depends on household and business choices, constrained by market conditions and institutional arrangements such as the tax laws. If the proportion of total income which is saved is to increase, either or both market conditions or the tax laws must also change so as to reduce the cost of saving relative to the cost of consumption. So long as inflation persists, however, market conditions will tend to increase the relative cost of saving and capital formation. And if the recent trend of tax "reform" continues, the tax laws will also increase the weight of the existing bias against saving.

What happens if actual saving falls short of requirements? The principal consequence will be a slower rate of increase in productive capital inputs, hence a slower rate of increase in the capital-labor ratio, in the advance of labor's productivity, in the rise in real wage rates, and in the economy's total output. The reason is simply that if the total amount saved falls short of aggregate capital requirements, some investment will be foregone; with the present thrust of public policy, it is likely that the capital formation which would be short-changed would be investment in the machinery, equipment, plants, etc., which increase the real output of marketable goods and services (included in this category, of course, is the capital required for increasing energy output). The economy as a whole will lose, of course, but the largest group of losers will be labor.

Tax revisions to reduce the existing bias against saving, that is, to cut the cost of saving relative to consumption, would exert a powerful influence on increasing the rate of gross private saving. To the extent that the proportion of gross private saving to GNP were to increase, the pressure for too rapid an

expansion in the stock of money to finance excessively rapid growth in government spending and deficits would also be reduced. Tax revisions to provide greater neutrality between saving and consumption, therefore, would afford greater promise of meeting saving-capital requirements and would erode inflationary pressures, as well.

The ultimate goal of tax revisions should be to produce a tax structure as nearly neutral as possible in its impact on the cost of saving relative to the cost of consumption out of current income. The present tax structure is heavily biased against saving; the principal sources of this bias are

- o the inclusion in the individual income tax base of both current saving and the returns on saving;
- o the corporation income tax, which is a heavy excise on one set of returns on private saving;
- o the tax on capital gains, an additional, substantial excise on the capitalized value of anticipated increases in returns on saving, which will in turn be taxed as they are realized;
- o estate and gift taxes, additional excises on capital on the occasion of the transfer of the property rights;
- o property taxes, the equivalent of high-rate income taxes on the returns to saving invested in real property; and
- o miscellaneous other taxes (for example, the minimum tax) which impose additional taxes on the returns on particular investments.

At the Federal level, the long-range focus of tax revisions to achieve greater neutrality between the tax burdens on saving and consumption should be on

- o transforming the present individual income tax into an expenditures tax, by allowing the taxpayer to deduct his current saving

and requiring him to include the gross returns on his saving, including the full amount of the proceeds from the sale of assets, in his current income;

- o eliminating the corporation income tax and attributing corporate earnings to individual shareholders;
- o eliminating the tax on capital gains; and
- o eliminating estate and gift taxes.

Boldly stated, any such tax revision program appears to be radical and politically unattainable. It nevertheless is useful as a criterion against which to assess short-term tax revisions.

By and large, the public policy focus on the capital shortage problem to date has aimed almost exclusively at tax measures to increase business investment incentives. Such measures as the ADR provisions and the investment credit have assuredly been highly constructive; one of their principal virtues is that they have contributed importantly to increasing business saving---a major component of total private sector saving. Moreover, further liberalization of depreciation allowances, increases in the investment credit, and generally less burdensome taxes on business income would be desirable measures to increase the private sector's saving rate. But confining a capital-conscious tax program to such measures suffers two limitations:

- o it raises the false issues of "tax giveaways" to business at the expense of labor and/or consumers, and of tax favors for the rich at the expense of the poor; and
- o feasible tax revisions of this sort may fall short of providing the required increase in total private saving.

Accordingly, the inventory of tax revisions focused on reducing the existing tax bias against private saving should prominently feature proposals

aimed at low-and middle- income individual taxpayers. Individual income tax returns reporting adjusted gross incomes of less than \$20,000 accounted for 50 percent of total returns on saving, in one form or another, in 1972. Individuals in these brackets, it is evident, provide a substantial proportion of total personal saving. They represent, therefore, a highly eligible target for tax revisions to encourage individual saving.

One such tax revision would be to provide a tax credit for increases in the taxable year in the amount of the individual taxpayer's saving. A credit of this sort could easily be designed to be proof against the charge that it would favor upper-bracket as compared with low- and medium-bracket taxpayers. Even on very conservative assumptions about the responsiveness of individual saving to changes in the cost of saving compared to consumption, the revenue loss from such a credit would be relatively small---indeed, there might be a revenue gain; any likely loss would be substantially more than offset by the increase in personal saving. It would present no significant problems of compliance or administration.

High on the list of constructive tax changes to meet the Nation's capital demands is some substantial amelioration of taxes on capital gains. The revisions proposed by the Ways and Means Committee last year is to be commended as evidence of awareness of the need for reducing the tax burden on capital gains, but surely this should be viewed as a very modest first step. If the Congress deems a \$2,000 tax credit to be an appropriate inducement for buying a newly-built residence, it should seriously consider the benefits to be obtained from offering the taxpayers of about the same income status an equal credit against their tax liability on capital

gains they might realize on corporate equities. Special attention should also be given to rollover treatment for all capital gains, not merely for those realized on the sale of a residence.

An overall 50-percent effective rate limitation on income tax liability for all income and for estate and gift tax purposes would be highly desirable in reducing the relative cost of saving at those brackets where the present tax bias against saving is most severe. Revenue losses from this limitation would be modest; indeed, revenue gains might very well be realized.

Significant steps should be taken toward reducing the combined corporation and individual income tax burden on corporate income. A reduction in the statutory corporation income tax rate would be desirable. As a first step toward full intergration of corporate and individual taxes, individuals should be given a tax credit for dividends received; individual taxpayers would gross-up their dividend receipts by the amount of the corporate income tax to be credited, compute their tax liabilities on their total taxable incomes including the grossed-up dividends, and claim a credit against tax for the amount of corporate tax included in the grossed-up dividends.

A short-range tax revision program should include converting the existing depreciation system into a capital recovery system along the lines recommended by President Nixon's Task Force on Business Taxation. Elimination of the particularization of depreciation to the taxpayer and to his particular assets in favor of conventionalizing capital recovery allowances for broad classes of assets in itself would represent a major advance. Shorter recovery periods would also be highly desirable.