STATEMENT

TO

SUBCOMMITTEE ON FINANCIAL MARKETS
COMMITTEE ON FINANCE
UNITED STATES SENATE

SEPTEMBER 24, 1973

BY

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SUMMARY

Financial market results this year appear to be seriously at odds with the vigorous expansion of the economy in 1972 and early 1973. Of particular concern is the substantial decline in the participation of individual investors. A large number of factors undoubtedly account for the apparent puzzling performance of the stock market this year, and no single, simple answer will deal satisfactorily with the complex questions raised by that performance. Notwithstanding this reservation, changes in tax policy can contribute significantly to improving the efficiency of our financial markets.

The efficiency with which the financial markets perform their basic function of valuation of business enterprises and of allocating saving is a matter of concern for the entire economy, not merely those who are active participants in the market. Impediments to efficient functioning of financial markets prevent the most efficient allocation and use of the economy's resources and distort the consumption-saving choices of the private sector.

A serious impediment to market efficiency is the thin participation which has prevailed for some time past. The market's thinness is principally attributable to inadequate participation by individual savers-investors.

One of the factors accounting for the reluctance of individuals to invest directly in corporate equities is the anti-saving thrust of tax policy. A number of the basic features of taxation in the United States exert a bias against saving. When viewed against the standard of equal treatment of consumption and saving, the present income tax treatment of capital gains and losses turns out to be an important element of this anti-saving bias.

Excluding capital gains and losses entirely from the income tax base would significantly reduce the present disproportionately heavy tax burden on saving and the barrier to capital asset transactions. A less drastic change would be to extend "rollover" treatment, now provided for gains on personal residences, to a larger list of capital assets---at the least to corporate securities. More modest revisions include a lifetime exemption of, say, $50,000 to $100,000 of capital gains realized on corporate securities and other specified types of property or alternatively an annual exemption of, say, $5,000 of such gains. Significant liberalization of the capital loss offset provisions are also called for.

Downward graduation of the capital gains tax rate with length of holding period has been proposed as a means of unlocking the very large amount of gains frozen in capital assets which have been held for very long periods of time. This approach would also implicitly make allowance for the inflation component of much long-term gains in determining tax liability.

A more direct approach to eliminating inflation gains from the tax base would be to provide an explicit inflation adjustment in determining the amount of taxable gains.

Tax Policy, Individual Investors, and Financial Markets

I. Introduction

The performance of the major U. S. financial markets this year has been a source of widespread concern and bewilderment. Against the background of vigorous economic expansion in 1972 and early 1973, as measured by indicators of real---as opposed to monetary---aggregates, the principal indicators of financial market activity appear to have been much more closely in line with a stagnant economy, if not, indeed, one in recession. Aside from a fillip in late 1972 and early 1973, the NYSE composite index shows at best no trend in common stock prices, and in all probability, a downtrend. The price-earnings ratios of all but a relative handful of stocks have been astonishingly low throughout the year. Transaction volume has been so limited as to push many brokerage firms to---or over---the brink. There are numerous indications, moreover, that institutions have accounted for a very substantial part of total volume, while individual savers-investors appear largely to have withdrawn from the stock market.

There is a common and readily understandable proclivity to insist on simple answers to complex questions. In the case of the financial markets, it is tempting to identify one or a few factors as the source of its puzzling behavior. The true explanation, however, is probably as complex as that for any current economic phenomenon. I hasten, therefore, to disabuse this Subcommittee of any idea that my discussion and recommendations

are submitted as exhausting either the causes of the financial markets' present conditions or recommendations for dealing with these factors.

The current concern about the financial markets should stem from recognition of the fundamental role those markets play in the U. S. economy. However recondite or esoteric the operations of the stock market to the man in the street---Main, not Wall---or even to the economist, it is obvious that no advanced and diversified economy depending largely on private enterprises for the conduct of business in free markets could function efficiently without a well developed capital market. When evidence that the capital market is not doing its job effectively begins to accumulate, the occasion for concern far transcends the effects on the immediate capital market participants; it extends to the entire economy, public and private sectors alike. Surely we do not need a repetition of the great market crash of 1929 to have its lessons well in mind.

II. Functions of Financial Markets

Before proceeding, perhaps it would be advisable to go over some familiar ground concerning the functions of financial markets in order to be clear about the context of the discussion to follow.

First of all, financial markets provide valuations. When these markets operate efficiently, they provide objective and impersonal information about the capitalized values of the expected earnings of a huge number of business entities. This information is a summary or consensus of the

varying assessments by the market participants of what future earnings are likely to be, what risks are associated with those future earnings, what costs will be incurred to realize them, and finally, how much those future earnings are worth today. Moreover, the information about any one company and its valuation takes into account the corresponding information and valuation of all others. For any one company, therefore, an efficiently operating financial market's valuation reflects its worth relative to that of all other companies.

For companies that are guided in their activities by the objective of maximizing their profits and the net worth of their shareholders, the valuations provided by financial markets are essential. They are assessments by the market participants of how well such companies have performed and of how well they are expected to perform in the future. Changes in those valuations are cues to management with respect to virtually every aspect of their conduct of business. And they are important inputs in the determination of the cost to the company of using capital services, hence of company investment decisions, even if capital outlays are largely internally financed.

A corollary function of financial markets is to facilitate the efficient allocation of saving. In brief, the condition for efficient allocation of saving is that at the margin the present value of the future income contributed by every dollar of saving is the same (when adjustment for differences in risk are taken into account). In an efficiently operating financial market, information about company performance and prospects is quickly translated

into valuation of the equity interest in companies, and changes in these relative valuations are cues to savers-investors as to changes in the composition of their investments which they can make in order to maximize the future income they can realize from their saving.

Moreover, the aggregate of all such market information provides savers-investors with the essential information about the relative cost of saving---how much current income otherwise available for consumption is required to buy a given amount of future income. Clearly, this information is a basic determinant of the allocation of income as between consumption and saving.

It is evident, I trust, that these functions of financial markets are not peripheral but are basic to the efficient operation and progress of a free-market economy. Impediments to effective performance by financial markets, therefore, also prevent the most efficient allocation and use of the economy's resources, which means that the economy as a whole is deprived of valuable output which it otherwise would enjoy. By the same token, the amount of saving and investment which the economy as a whole undertakes is likely to be less than it would be if financial markets were free of serious impediments; the consequence is slower growth of production capability and output, to the cost of all of us.

Efficient financial markets, therefore, are an important concern for all of us, not only those who are active participants at any time. If those

markets cannot do their job properly, the working American is likely to find himself working with fewer, older, less efficient tools than otherwise. His productivity, hence his real earnings, will be less than otherwise. And he is more likely to be exposed to job displacement by foreign competition. Finally, those markets will afford him less assistance in putting his savings to their most productive use in his efforts to save for retirement or the proverbial "rainy day."

This Subcommittee, I am sure, has heard and will continue to receive a substantial amount of testimony pertaining to deficiencies in our financial markets and to the factors responsible for them. Rather than attempt to go over that ground again, I should like to focus on one aspect, the inadequacy of individual investor participation, and to offer some suggestions to increase that participation. One of the basic conditions for efficient operation of any market is that its structure is highly competitive. In turn, satisfying this condition in the general case requires a sufficient number of buyers and sellers so that the actions of no one can significantly affect the price(s) of the product(s) traded in that market. While economic theory affords no basis for determination of the minimum number of buyers and sellers required for effective competition, it does support the generalization that reducing the number of market participants tends to increase the obstacles to competition. When the number of buyers and sellers is very large, of

course, even a substantial variation in that number is likely to have little impact on the effectiveness of competition. But as the number of participants decreases, their influence on market outcomes increases, and market results tend to become more dispersed, less of a measure of consensus of participants, less meaningful as measures of relative values, and therefore less effective in allocating resources. Thinning out market participation, accordingly, is likely to result in a loss of efficiency by the market in the performance of its functions.

It is, of course, no news to the members of this Subcommittee that thin participation has been the rule rather than the exception in the operations of the U. S. financial markets for some time past. Volume of transactions is, to be sure, only a proxy for the number of buyers and sellers, but in the case of the securities markets there is other evidence to support the inference that the downtrend in volume during the past 18 months has been associated with a downtrend in the number of buyers and sellers. In the month of August this year, average daily volume on the New York Stock Exchange was only 11.8 million, lower by far than any other month in 1972 and 1973. The average daily volume through August of this year has been about 14.9 million shares, compared with 16.5 million for the whole of 1972. And except for January and July, the average daily volume each month this year has been lower than in the corresponding months of 1972.

These volume data, while not themselves establishing a reduction in

individual investors' participation in the market, are nevertheless highly indicative. They strongly suggest that the 800,000 decline in the number of shareholders in the United States recently reported by the N.Y.S.E. has continued through 1973. Continuation of this decline will inevitably be associated with reduction in the number of buyers and sellers and with increased concentration of volume in the very large institutional market participants. The implications of this development for the efficiency of the market has already been noted.

What accounts for the inadequate participation of individual savers-investors? Obviously a great many factors, which have been explored before this Subcommittee in its earlier hearings, contribute to the reluctance of individuals to hold directly equity interests in U. S. corporations and to manage these interests actively. In my judgment, the thrust of tax policy in the United States is one of these factors.

III. Taxation and Individual Saving and Investment

Generally overlooked in the periodic furor over tax reform is that taxation in the United States, particularly at the Federal level, is heavily biased against private saving. The demonstration of this bias on analytical grounds has been made by numerous economists at one time or another, and I shall not burden the Subcommittee at this time with an elaborate exposition of this analysis. If I may, however, I should like to call the Subcommittee's attention to my testimony on February 5 of this year, to the Committee on Ways and Means in the House of Representatives. This testimony was

addressed explicitly and at length to various basic elements of the Federal tax system and their disproportionately heavy weight on saving as compared with consumption. May I also take the liberty of referring the Subcommittee to the publication by the NAM early this year of my study of Tax Policy, Capital Formation, and Productivity, in which I have attempted to demonstrate not only the existing tax bias against saving and capital formation but also the adverse consequences of that bias for the rate of advance of labor's productivity and real earnings.

On this occasion, I'd like to concentrate on the Federal tax treatment of capital gains and losses. As this Subcommittee is well aware, the differential between the taxes imposed on capital gains and on ordinary income is one of the principal targets of the standard list of tax reform proposals. This differential is alleged to be one of the principal "loopholes," primarily availed of by upper-income individuals. In principle, it is argued, capital gains are in no significant way different from ordinary income, and, it is claimed, they should be similarly taxed. And so on.

In fact, however, when the present tax treatment of capital gains is viewed against the standard of equal treatment of consumption and saving uses of income, it turns out not to be a "loophole" but an additional tax burden on saving---a negative loophole. Perhaps an extended example will help to make this clear.

Suppose for the moment a tax-free economy. Individuals in that society

continuously make choices between the use of their current income for consumption or for buying additional income in the future, i.e., saving . The amount of future income which any given amount of saving buys depends on the contribution at the margin of the additional capital in which the savings are invested. The cost of any given amount of future income is the amount of current consumption which must be foregone by the saving needed to acquire it. Many considerations, of course, enter into individuals' consumption-saving decisions, but given these considerations, those decisions depend on the relative cost of saving and consumption.

As an example, suppose that in the tax-free economy a person might be able to buy some given quantity of consumption goods for $1,000 or he might use the same $1,000 instead to buy common stock in a company earning , say, $120 per share, when the market rate of interest is 12 percent. Now suppose an income tax is levied; for ease of illustration, suppose the tax rate is 50 percent. With the tax, the cost of the same amount of consumption goods goes up 100 percent in the sense that it now takes $2,000 of pretax income to buy the same $1,000 of consumption goods. But the cost of saving goes up much more. To have $120 per year of additional income, one has to receive $240 of pretax income. But with no change in the market rate of interest, one must now buy $2,000 worth of the stock to get $240 per year.[1/] And to have $2,000 with which to

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[1/] Assuming no income tax is separately levied on the corporation income.

buy the stock, $4,000 of pretax income is needed. The 50 percent income tax, thus, has doubled the cost of consumption, but it has quadrupled the cost of saving. Thus, the tax has doubled the cost of saving relative to the cost of consumption.

The effect of the tax on the total volume of private saving depends on how responsive people are in their consumption-saving choices to changes in the relative cost of saving. Some economists assume that this response is zero, that personal saving decisions are unaffected by changes in the real rate of return on their saving. I find this assumption untenable on analytical grounds and unverified by actual experience. Rather, it seems to me, an increase in the real cost of saving relative to the cost of consumption will reduce the proportion of income used for saving.

To return to our example. Suppose the corporation whose stock the individual purchases uses the proceeds of the stock sale to buy a $1,000 machine. Suppose, to simplify the example, the machine is expected to last forever. To warrant the investment of $1,000 in the machine if there were no tax, the machine would have to add $120 per year to the company's net revenues. But if an income tax, applicable to both the corporation and the individual at a marginal tax rate of, say, 50 percent, were imposed, the machine would no longer earn $120 per year, after taxes. The corporation income tax itself would reduce the after-tax earnings to $60.00 per year. And if the corporation were to distribute the after-tax cash flow to the

shareholder, he would net only $30.00 per year on his $1,000 saving.

If before the tax was imposed he required $120 per year to induce him to give up $1,000 of current consumption, he will hardly be likely to settle for $30.00. Clearly, he will reduce his saving-investing. So will others like him.

Collaterally, the corporation is hardly likely to invest $1,000 in a machine that returns only $60.00 per year after tax. With no change in the market rate of discount of future earnings, $60.00 per year is worth $500, not $1,000. If the company's objective is to maximize its profits and the net worth of its shareholders, the after-tax earnings of the machine will have to increase to $120 per year; pretax earnings, then, will have to go up to $240 per year to justify the investment, if earnings are retained. And if earnings are distributed to the shareholders, pretax earnings would have to increase still further---to about $480 per year.

Obviously, a great many capital outlays which would contribute enough to the corporation's net revenues to warrant their undertaking in the absence of the tax become unprofitable and are foregone when the tax is imposed. The reduction in saving and capital formation resulting from the tax will continue until the stock of capital falls relative to the amount of labor services used in production sufficiently to generate the required pretax and after-tax earnings.

To complete the example, suppose that after the adjustments in saving

and investment are completed, the corporation retains its after-tax earnings and buys another machine which will also add $240 per year to pretax earnings, hence $120 per year to the company's after-tax earnings. The market value of the shareholders' stock in the company will go up from $1,000 to $2,000. This increase in value, of course, is exactly equal to the present or discounted value of the additional $120 per year of after-tax earnings, discounted at 12 percent as before.

Recall that every dollar of the corporation's earnings on the original machine out of which the $1,000 to buy the new machine was accumulated was taxed as it was earned. And every dollar of the earnings of the new machine will also be taxed as it is earned.

If the shareholder decides to sell his share of stock in the corporation he will realize a capital gain of $1,000. Under the present tax treatment of capital gains he'd pay an additional tax of $250 on this realized capital gain. This additional tax is properly viewed as a surcharge on the tax already paid on the prior years' earnings on his initial investment or equivalently as a surcharge on the tax that will be paid over the succeeding years on the new machine's earnings. In either case, the same future earnings stream will be taxed twice, once at the 50 percent rate as the earnings are realized each year, and again at 25 percent (in our example) on the capitalized value of that future stream of earnings.

The present tax treatment of capital gains, therefore, when evaluated

against the standard of equal proportionate taxation of consumption and saving uses of income, emerges not as a loophole but as an additional, heavy burden on saving. Coming as it does on top of the disproportionately heavy individual and corporate income tax load on saving, the taxation of capital gains significantly increases the relative cost of saving.

But this is not the sole effect of capital gains taxation. The tax is imposed on gains not as they accrue but only when they are realized by sale or exchange of the assets. The occasion for the tax, then, is not merely the increase in value but the transfer of the asset as well. Taxing capital gains not only increases the relative cost of saving but also increases the cost of changing the composition of the assets one owns. The interaction of these two effects of capital gains taxation is to increase the difference between the expected returns on alternative investments required to make a shift in asset holdings worthwhile.

Unless it could be established that people are utterly unresponsive to changes in transaction costs, taxing capital gains must reduce the frequency of transfers and impede prompt changes in the composition of assets in response to changes in their relative values. In turn, this clearly impedes the efficient functioning of the financial markets in providing valuations of alternative uses of saving and in allocating saving optimumly.

The present tax treatment of capital losses further burdens private

saving and impedes prompt change in the composition of asset holdings. Under present law, capital losses are offset against capital gains and up to $1,000 of ordinary income. Any losses not so offset may be carried forward for an unlimited number of years, but in the case of individuals, no carryback to earlier taxable years is allowed. Since capital gains are fully subject to the additional tax in the year they are realized, the tax cushion against losses may very well be less than the additional tax burden on gains.[1/] The risk of investment is increased. In addition, where losses have accrued on an investment, the limitation on their deductibility tends to deter liquidation of that investment and its replacement by other assets. Loss treatment, therefore, accentuates the bias against saving and shifts in asset holdings imposed by the taxation of capital gains.

The weight of these tax impediments to efficient performance by the financial markets is difficult to measure in precise quantitative terms, but there can be little doubt that they are significant. There are a number of studies which show that the average length of time stocks are held is astonishingly long. And unless one attributes these very long holding periods to irrationality on the part of savers-investors, the tax treatment of gains and losses must be held largely accountable for the immoblization

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[1/] In such cases, the mean value of the probability distribution of the after-tax outcomes of any given investment is reduced. The investment, then, is not only less productive but also riskier.

of huge amounts of past saving. It must, therefore, be viewed as a serious impediment to financial market efficiency.

This is not to say that taxation alone accounts for the declining role of individual investors in our security markets or even that those tax considerations are primarily responsible for the security market conditions now causing so much concern. Nor do I mean to suggest that changes in the tax law to ease the existing burden on saving and on transactions will, of themselves, reverse the trends in the securities markets with which this Subcommittee is concerned. But surely appropriate changes in the tax law will make an important contribution to a higher rate of private saving, to greater participation by individuals in the financial markets, and to more efficient functioning of those markets.

IV. Tax Changes to Encourage Individual Investment

Any discussion aimed at changes in the tax treatment of capital gains and losses in the interests of mitigating the existing tax bias against saving and ready transferability of assets faces a huge barrier of conventional wisdom arguing for even heavier tax burdens on capital gains. That argument is oriented primarily to so-called equity considerations. It is predicated on a concept of income deemed to be needed if the principal purpose of taxation is to equalize economic status, without regard to the impact of implementing that income concept on the neutrality of taxation with respect

to the consumption-saving choice. That income concept insists that capital gains are in no wise different from any other kind of "income" for purposes of measuring economic status of various individuals, and that taxing capital gains less heavily than other income defeats the purpose of progressive taxation. The conventional wisdom is clearly based on highly circular reasoning. But it has so broadly permeated the policy forum that any proposal to alter the tax treatment of capital gains and losses in the interests of neutrality---equal treatment of saving and consumption---is more often than not received as special pleading for "fat cats."

As an economist, I profess no expertness regarding tax equity. Both the historical record and abstract analysis strongly suggest to me that government tax and expenditure policies and programs are ineffective in redistributing income and are likely to be counterproductive. The interests of all active participants in the economy---that is, the overwhelming majority of us---rather lies in a tax system that as little as possible interferes with our private choices as to how we obtain and use our income and wealth. Such a tax system should as little as possible change the relative costs of the alternatives we face in the market place. And given the enormous requirements for additional capital we face in the coming years if we are to maintain--let alone advance---our productivity and living standards, top priority in tax policy should be given to reducing the existing

heavy tax bias against saving.

The tax proposals presented following are oriented toward reducing this tax bias. In my judgment, they are also likely to make the tax laws fairer. But that judgment, just as the contrary judgments of others, should be taken as expressions of preference, not as scientifically derived truth.

It follows from my earlier argument that one important revision to reduce the existing income tax bias against saving and capital asset transactions would be to eliminate capital gains and losses entirely from the tax base. In the context of the history of the U.S. income tax, of course, this would be a drastic change. But this Subcommittee surely is aware that the income tax laws of few other advanced industrial nations apply to capital gains.

A less drastic approach would be to extend the present "rollover" treatment of gains on personal residences to a larger list of capital assets---at the least to gains on corporate securities. Under this treatment, the tax on capital gains would be deferred so long as the proceeds from the sale of eligible assets were fully reinvested. The basis of the property acquired upon reinvestment would be proportionately adjusted downward by the amount of the tax-deferred gains.

This proposal would in effect tell the saver-investor that he could maintain the value of his eligible asset holdings as long as he fully reinvests the proceeds from the sale of any of these assets. This rollover treatment,

therefore, would exert a powerful incentive for remaining an active investor without penalty for engaging in capital asset transactions.

Both of these proposals, of course, encounter the objection that they would primarily benefit the affluent. As indicated, I am highly skeptical about the relevance and validity of this objection. To the extent that such measures increase saving and business investment, their principal effect is to increase the amount of capital with which labor services are used, hence to increase the rate of advance of labor's productivity and real wages. In evaluating proposals for tax changes, it is important to look beyond their initial impact on the distribution of tax liabilities to their ultimate effects. Failure to do so is largely responsible for the existing tax bias against saving and for resistance to tax changes to reduce that bias.

But insofar as egalitarian preferences restrict the opportunities for constructive tax changes, there are a number of less drastic revisions in the tax treatment of capital gains and losses which would provide significant abatements of the existing anti-saving tax bias and encouragement for individual ownership of equity interests in American business. One of these revisions would be to allow everyone a lifetime exemption of up to, say, $50,000 or $100,000 of capital gains realized on corporate securities and perhaps other specified types of property. A variation of this approach would be to exempt up to some specific amount of capital gains per year,

say $5,000, realized on corporate securities. The tax abatement in this general approach would obviously be far more significant to persons of modest incomes than to those with very large portfolios.

A companion change would be to increase substantially the amount of capital losses which might be offset against ordinary income. The limit under present law is $1,000. This might be increased to, say, $10,000 or $20,000. Indeed, full offset of losses against ordinary income would be highly desirable and effective. And a three- or four-year carryback of losses should be added to the present carry forward provisions for losses which cannot be offset in the current taxable year.

A proposal currently receiving a great deal of attention would provide for a downward graduation of the capital gains tax rate the longer the capital assets had been held. For example, the rate applicable to gains on property held for 5 years or less might be 25 percent, that on property held as long as 10 years might be 20 percent, and so on, with a bottom rate of 10 percent on property held for 20 years or longer. As noted earlier, there is a large amount of gains locked up in capital assets which have been held for very long periods of time. The downward graduation of rates with length of holding period would certainly result in a flood of realizations of long-held appreciated capital assets.

To the extent that accrued gains on long-held assets reflect primarily inflation, the graduated step-down proposal would afford at least partial

recognition of this fact in determining tax liability. A more direct way of dealing with this serious difficulty would be to provide an explicit inflation adjustment in determining the amount of taxable gain.

Both of these proposals would be effective in freeing up assets which would be realized but for their illusory appreciation. Both would somewhat reduce the additional tax burden on saving. Neither, however, deals head-on with the fundamental bias against saving in the present income tax and capital gain provisions. While these proposals deserve serious consideration, I hope that they would be regarded as merely very modest first steps toward the more basic revisions suggested earlier.

V. Conclusion

In my introductory remarks, I alluded to the proclivity to look for simple answers to complex questions. Mindful of that caution, I do not offer the above suggestions for tax revisions as a panacea. Many factors other than taxes impact on the functioning of the financial markets and influence market results. But these tax changes should make a significant contribution to mitigating existing impediments to efficient operation of these markets. Hopefully, these proposals at the least will spur a more innovative search for constructive tax reform than is usually found in the standard reform program.