CAPITAL FORMATION AND CAPITAL RECOVERY

STATEMENT

TO

SELECT COMMITTEE ON SMALL BUSINESS
AND
SUBCOMMITTEE ON FINANCIAL MARKETS,
SENATE FINANCE COMMITTEE
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BY

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My name is Norman B. Ture. I am President of Norman B. Ture, Inc., Consulting Economists in Washington, D.C. I am consulting economist to the National Association of Wholesaler-Distributors (NAW).

Mr. Chairman, I welcome your invitation to appear here today to discuss current and future capital formation adequacy for the U.S. economy. Small business has special capital deficiency problems. On Thursday, I will present a detailed analysis of the capital needs and problems of merchant wholesaler-distributors which will demonstrate these problems of small business. However, it is both useful and necessary to view the situation of small business in the context of the entire economy, so — as requested — I will concentrate my remarks today on the adequacy of overall capital formation.

Capital Adequacy: The Central Economic Problem of the U.S.

The central economic problem facing the United States is whether the rate of capital formation will be adequate to meet the economy's capital requirements over the next decade and longer. Virtually all of the other major issues with which public policy makers are concerned turn on this central problem of capital adequacy. Whether the focus is on attaining energy self-sufficiency, protection of the environment, improving and expanding mass transit systems, raising the housing standards of low and middle-income individuals, providing safer and healthier working conditions, and so on, a basic constraint on achieving these goals is how much capital will be available to meet the growing and varied demands of the U.S. economy. The less rapidly we add to our production capability, the more severely will pursuit of any of these public policy objectives limit our success in achieving other public and private goals.

The Meaning of Capital Requirements and Capital Shortage

The Congress and the public have heard much on the subject of the capital

shortage. So far, most of the attention has been given to estimating capital requirements and the prospective shortfall of actual capital accumulation. These estimates have varied widely for numerous reasons, including differences in basic assumptions, analytical method, and projections of such factors as the rate of inflation, the growth of government spending and deficits, and the magnitude of various capital-intensive government programs. To get a useful perspective on these estimates requires us to be clear at the outset as to what we mean by "capital requirements" and "capital shortage."

The term capital "requirements" does not mean that there is some specific amount of capital that must be on hand at some future time. In fact, there is no unique amount of capital that the economy must have at any given time. It makes sense to talk about capital requirements only in relation to other things, principally the growth in the labor force. We aren't interested in adding to the stock of capital for its own sake; the concern with capital accumulation, instead, stems from the role capital addition plays in providing the opportunity for increases in employment, in productivity, and in real wage rates.

Beginning with a projection of the growth in the labor force, it is possible to estimate by how much the stock of capital must grow if the ratio of capital inputs to labor services in production is to increase at some designated rate. It is this increase in the capital-labor ratio, along with technical progress, which primarily determines the rate of increase in labor's productivity, real wage rates, and employment. If public policy aims at maintaining at least the postwar average rate of increase in labor productivity and real wage rates, while avoiding an un-

acceptable rate of unemployment, then if the growth in the labor force can be reasonably estimated so too can the increase in the stock of capital needed to provide the increase in the capital-labor ratio on which attaining these goals depends.

To this amount must be added the capital requirements imposed on business by public policy mandates rather than market forces. For every dollar of capital addition there must be a dollar of saving. Indeed, it is more accurate to speak of a prospective saving shortage than of a capital shortage. Since total saving in the economy consists of private saving plus government budget surpluses or minus government deficits, it is necessary to add to the captal requirements described above some estimate of government budget results in order to estimate the amount of private saving that will be required. The projected required private saving may be expressed as a share of projected GNP and this required saving ratio then may be examined in the light of the postwar record. A projected required private saving to GNP ratio significantly in excess of that actually realized in the postwar years suggests that we are likely to fall short of meeting our capital requirements.

Estimating Capital Requirements

Over the postwar period, the number of full-time equivalent employees in the private business sector of the economy has increased at an average annual rate of 1.5 percent a year. Associated with this trend, the net stock of capital in the business sector has increased at an average annual rate of about 4.3 percent. The capital-labor ratio, hence, has increased at an average annual rate of about 2.7 percent. In turn, this increase in the capital-labor ratio has contributed to a very nearly equal average annual rate of increase --- 2.3 percent --- in labor's

productivity and real wage rate. Financing the capital outlays required to achieve this increase in the net stock of capital (along with residential investment, net foreign investment, and government deficits) has required total national saving equal, on the average, to about 15.5 percent of GNP; it has required total private-sector saving averaging 15.7 percent of GNP.

If we project the postwar trends in employment and in the capital-labor ratio, over the next 11 years, i.e., through 1985, we shall have to add $675 billion to the net stock of business capital, measured in constant 1974 dollars. Assuming no change in the rate at which business replaces fixed capital facilities, this will require $2.37 trillion of total capital outlays, in constant 1974 dollars.

But this is only the first step in estimating capital requirements. To the amount of capital which must be accumulated to maintain the growth in employment and in labor's productivity and real wage rates there must be added the increase in the Nation's stock of housing to meet private demand and public policy housing goals and the additional capital required to satisfy other government-mandated demands --- 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.

In contrast with business capital, much of this government-mandated capital generates no increase in total income. As a consequence, the businesses making these investments can obtain no return on such captial, hence cannot provide rewards for the private saving which must be channeled into such capital formation. The household or business customer doesn't go into the market to buy cleaner air or

water; it's not easy to persuade the customer that a given amount of groceries are worth more because food processors and distributors produced less air or water pollutants. In other words, much of this type of capital makes only a negligible contribution to the market value of the products customers buy. Aggregate sales proceeds for any given volume of output, accordingly, are not likely to increase by an amount equal to the additional costs of the public-mandated capital. Such capital, hence, cannot be financed by business out of the insignificant additional cash flow, if any, it generates. And since it reduces the rate of return on the business' total capital the business faces increasing difficulty in external financing of its capital additions. Unless the aggregate flow of saving, generated internally by business and/or available in the capital markets, increases substantially, we face a serious shortfall in the capacity of business to finance the increases in capital used to produce the goods and services people do buy. This drain must somehow be offset by additional saving. This is not to suggest necessarily that these government-mandated capital outlays are not warranted or that the goals they seek are inappropriate. But it must be recognized that such capital formation cannot be had for free and that it adds substantially to the Nation's total requirements for capital.

How much do such requirements add to those needed to maintain at least the trend rate of growth in productivity and real wage rates? On the basis of very conservative assumptions this additional investment will have to aggregate at least $1.06 trillion through 1985.

Private Saving Requirements

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 years, the government sector has been in deficit, hence has reduced rather than augmented gross national saving. Gross private saving requirements, in other words, include not only financing gross private investment but also government budgetary deficits. 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 Nation's total private saving will have to aggregate $3.54 trillion in constant 1974 dollars, through 1985.

The aggregate capital requirements are substantially larger if, more realistically, we take account of some continuing inflation. If the price level rises on the average by 3 percent a year through 1985, total requirements aggregate not less than $4.3 trillion. At a 5 percent inflation rate, this total increases to $4.9 trillion.

If gross private saving as a fraction of GNP continues over the next decade at the postwar average rate of 15.7 percent, the total of such saving through 1985 will fall $400 billion short of estimated requirements, measured in constant 1974 dollars. At a 3 percent inflation rate, the gap, conservatively estimated, is almost $500 billion; with inflation at 5 percent, the gap increases to almost $575 billion.

Closing this gap between capital requirements and private saving will require

an increase in the total private sector saving rate from the 15.68 percent postwar average to 17.67 percent, if we assume a zero inflation rate through 1985. At a 3 percent inflation rate, total private sector saving would have to increase to 17.72 percent of GNP. And if inflation is at 5 percent, the private saving rate will have to increase to 17.75 percent. At no time in the postwar years has the gross private saving rate equaled even the lowest of the estimated required rates.[1/]

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. A glib answer is given by those who casually dismiss the capital shortage problem. They assert that if the private saving rate were inadequate, the market rate of interest would rise and private saving would increase. But this answer confuses cause and effect; the higher interest rates would be the market's reflection of the shortfall of saving, hence capital formation, from the levels that would provide the trend rate of increase in the capital-labor ratio; at the lower than trend capital-labor ratio, the return per unit of capital, hence interest rates, would rise. Conceivably we might all be content with the volume of capital formation as determined solely by free market forces. But we obviously are not; through government action, we insist on additional capital to meet public rather than private, market-determined demands. And there is no guarantee that under the present tax laws the market-determined flow of

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1/ The estimated required saving rates in the inflation cases err significantly on the low side. The estimated amount of private saving does not include downward inventory valuation adjustments which would reduce business saving under the 3 percent and 5 percent inflation cases from the postwar average rate of such saving. Moreover, the estimated saving implicitly assumes that capital recovery allowances would increase above the annual zero inflation amounts in the same proportion as the inflation rate. Since capital recovery allowances are based on historical rather than replacement costs, this assumption overstates the amount of this component of private saving under the 3 percent and 5 percent inflation cases.

saving would be adequate to provide a rate of increase in the capital-labor ratio, hence labor's productivity and real wage rates, which would be acceptable.

Another glib answer is that any inadequacy in private saving might and should be made up by the Federal Government's running budget surpluses, instead of deficits. This prescription is based on the belief that the growth in Federal spending will decelerate while Federal revenues will increase. In the light of the fiscal experience for many years past, and particularly that of recent years, it is scarcely realistic to project any significant slowdown in the rate of growth of government spending, however desirable that may be. Hence, achieving budget surpluses would have to depend on a very substantial acceleration in the growth of tax revenues. Some part of this growth, presumably, would be generated by increases in total economic activity, but the principal source of the increase in Federal tax revenues would, according to this view, come from the elimination or reduction of so-called tax "expenditures". Apart from the fact that the estimates of the additional revenues to be obtained thereby are woefully unrealistic (because they are based on the assumption that the affected taxpayers would be completely unresponsive to the increases in their taxes), the principal flaw in this approach is that the increase in taxes would almost entirely represent additional taxes on the return to private saving, thereby accentuating the existing anti-saving tax bias. At best, private saving might be expected to fall by no more than the estimated increase in revenues; more realistically, the decline in private saving would significantly exceed any ultimately realized increase in Federal tax revenues. Whatever one's view about the desirability of reducing tax "expenditures", it is mere wishful thinking to project any

increase in the National saving rate from doing so. Achieving a higher rate of gross national saving by Federal surpluses, therefore, is not a realistic solution.

Consequences of Shortfall in Private Saving

What will happen if actual saving falls short of these "requirements"? In all likelihood, the capital formation shortfall would be largely in the investment in the machinery, equipment, plants, working capital, etc., which increase the real output of marketable goods and services. If the private saving rate were to continue only at the postwar trend rate, the saving shortfall, in 1985, assuming no increase in the price level, would be $64.5 billion. This would be almost 25 percent of the estimated amount of the capital formation needed to maintain the trend rate of increase in the capital-labor ratio. The adverse impact of a shortfall of this magnitude on labor's productivity and real wage rates clearly would be enormous.

Some would argue that we should all prefer to realize a larger proportion of our advance in living standards in the form of a more congenial environment and more publicly-provided services and amenities and accept a slower advance in our ability to produce and buy the goods and services which fill our market baskets. Perhaps this is an acceptable trade-off for the more affluent individuals in our society; it seems unlikely, however, that most of the labor force would be willing to accept any significantly lower rate of gain in ability to buy the products for sale in the marketplace and to save in exchange for more of the output provided by the government-mandated capital, or that most of the economically disadvantaged who aspire to enlarged opportunities for gainful employment would be content to trade away such enlarged opportunities for, say, a cleaner environment. It is

Estimated Capital Requirements and Private Saving, 1975-1985

(billions of dollars)

B. Three Percent Inflation

Year	CAPITAL REQUIREMENTS	GROSS PRIVATE SAVING	SAVING GAP
1975	263.8	242.9	20.9
76	282.5	259.6	22.9
77	303.3	277.4	25.9
78	325.8	296.5	29.3
79	350.5	316.8	33.7
1980	377.5	338.6	38.9
81	407.0	361.8	45.2
82	439.8	386.8	53.0
83	476.0	413.4	62.6
84	516.3	441.7	74.6
85	561.3	472.0	89.3
Total	4,303.8	3,807.5	496.3

Estimated Capital Requirements and Private Saving, 1975-1985

(billions of dollars)

C. Five Percent Inflation

Year	CAPITAL REQUIREMENTS	GROSS PRIVATE SAVING	SAVING GAP
1975	268.9	247.6	21.3
76	293.6	269.8	23.8
77	321.3	293.9	27.4
78	351.9	320.2	31.7
79	358.8	348.8	37.0
1980	423.7	380.1	43.6
81	465.9	414.3	51.6
82	513.0	451.1	61.9
83	565.9	491.5	74.4
84	625.8	535.4	90.4
85	693.5	583.2	110.3
Total	4,909.3	4,335.9	573.4

Estimated Capital Requirements and Private Saving, 1975-1985

(billions of dollars)

A. Zero Inflation

Year	CAPITAL REQUIREMENTS: Nonresidential Fixed Investment Plus Inventory Accumulation	CAPITAL REQUIREMENTS: Other Capital Outlays, Including Government Deficits	CAPITAL REQUIREMENTS: Total	GROSS PRIVATE SAVING	SAVING GAP
1975	174.5	81.6	256.1	235.8	20.3
76	181.6	84.7	266.3	244.7	21.6
77	189.2	88.4	277.6	253.9	23.7
78	197.2	92.3	289.5	263.4	26.1
79	205.3	97.0	302.3	273.3	29.0
1980	213.9	102.3	316.2	283.6	32.6
81	222.6	108.3	330.9	294.2	36.7
82	232.0	115.2	347.2	305.3	41.9
83	241.5	123.3	364.8	316.8	48.0
84	251.5	132.7	384.2	328.7	55.5
85	262.0	143.5	405.5	341.0	64.5
Total	2,371.3	1,169.3	3,540.6	3,140.7	399.9

unrealistic, therefore, to suppose that these government-imposed demands for capital can be substituted for market-determined capital formation instead of increasing the rate of aggregate capital formation.

Increasing Private Saving: A Challenge for Public Policy

The imperative for changes in public policies to reduce the burden on private saving and capital formation is inescapable. The foremost challenge facing the Congress is to deal realistically with the surging demands for a higher rate of private saving. If this challenge cannot be met, one or more of the high-priority objectives of economic policy will have to bear the brunt of the failure.

In meeting this challenge, the Congress and the Executive branch will confront serious problems. The greatest difficulty probably will be to overcome the accumulation of many years of doctrinal notions that any changes in the law to reduce the disproportionate tax burden on saving and investment is a "loophole" or tax "break" for business or rich individuals. Tax changes to permit all of us to save a larger proportion of our incomes, however, are not issues of business vs. individuals, or business vs. labor or consumers, or rich vs. poor. The issue, instead, is how rapidly we advance employment opportunities, labor's productivity, and real wage rates and how much we expand our capacity to meet the public sector's surging claims on total production capability.

Components of National Saving

To deal effectively with this problem, it is useful to begin by examining the components of the nation's total saving. The following tables, taken from the Department of Commerce's national income account estimates, show gross national saving, gross private saving, and the major components of gross private saving in relation

to gross national product in the years 1947-1974.

Government sector drain on National saving

One fact emerges immediately from examining these data: in only 13 of the 28 years in this postwar period has the government sector contributed positively to the Nation's total saving. The Federal government has added to rather than subtracted from total saving in only 11 of these 28 years. And over the entire period, the government sector has reduced aggregate saving by a total of $38.8 billion; the Federal government has drained a total of $62.8 billion from the Nation's aggregate saving in these 28 years. Moreover, the Federal deficits in prospect for this calendar year and in the next year or more will reduce the Nation's aggregate saving by enormous amounts.

It is obvious, of course, that the government sector drain on total saving has resulted in large part from the extraordinary growth in government spending --- more than 9.2 percent a year, on the average, since 1947. So long as government spending continues to grow at that rate, it is unrealistic to assume that government revenues can grow even more rapidly to generate budget surpluses and thereby add to, rather than subtract from, total saving. Providing the increased flow of saving required to meet our captial needs, therefore, will depend on whether the private sector increases its saving rate.

A second impressive fact these data reveal is that while the fraction of GNP which has been saved by the private sector has varied widely, at no time in the postwar years has it reached the rate which will be needed to meet the capital needs discussed earlier. For the entire period, private saving has averaged 15.68

Sources of Gross Saving, 1947-1974
(billions of dollars)

Year	Gross National Product	Gross National Saving									
		Total	Government Surplus or Deficit (-)		Private Saving						
							Business				
			Total	Federal	Total	Personal	Total	Unincorp. Business Capital Recovery Allowances	Corporate Saving		
									Capital Recovery Allowances	Retained Profits	Total (Cash Flow
1947	231.3	42.0	14.4	13.4	27.5	7.3	20.2	6.4	5.8	8.0	13.8
48	257.6	49.9	8.5	8.4	41.4	13.4	28.0	7.5	7.0	13.4	20.4
49	256.5	35.9	- 3.2	- 2.4	39.0	9.4	29.7	8.6	7.9	13.2	21.1
1950	284.8	50.4	7.9	9.1	42.5	13.1	29.4	9.5	8.8	11.0	19.8
51	328.4	56.1	5.8	6.2	50.3	17.3	33.1	10.9	10.3	11.8	22.1
52	345.5	49.5	- 3.8	- 3.8	53.3	18.1	35.1	11.7	11.5	12.0	23.5
53	364.6	47.5	- 6.9	- 7.0	54.4	18.3	36.1	12.5	13.2	10.5	23.7
54	364.8	48.5	- 7.0	- 5.9	55.6	16.4	39.2	13.3	15.0	11.0	26.0
55	398.0	64.8	2.7	4.0	62.1	15.8	46.3	14.1	17.4	14.8	32.2
56	419.2	72.7	4.9	5.7	67.8	20.6	47.3	15.2	18.9	13.2	32.1
57	441.1	71.2	.7	2.1	70.5	20.7	49.8	16.3	20.8	12.7	33.5
58	447.3	59.2	-12.5	-10.2	71.7	22.3	49.4	16.9	22.0	10.5	32.5
59	483.7	73.8	- 2.1	- 1.2	75.9	19.1	56.8	17.9	23.5	15.4	38.9
1960	503.7	77.5	3.7	3.5	73.9	17.0	56.8	18.5	24.9	13.4	38.3
61	520.1	75.5	- 4.3	- 3.8	79.8	21.2	58.7	19.0	26.2	13.4	39.6
62	560.3	85.0	- 2.9	-3.8	87.9	21.6	66.3	19.9	30.1	16.3	46.4
63	590.5	90.5	1.8	.7	88.7	19.9	68.8	20.9	31.8	16.1	47.9
64	632.4	101.0	- 1.4	- 3.0	102.4	26.2	76.2	22.2	33.9	20.1	54.0
65	684.9	115.3	2.2	1.2	113.1	28.4	84.7	23.4	36.4	25.0	61.4
66	749.9	124.9	1.1	- .2	123.8	32.5	91.3	24.4	39.5	27.3	66.8
67	793.9	119.5	-13.9	-12.4	133.4	40.4	93.0	25.9	43.0	24.2	67.2
68	864.2	128.3	- 6.8	- 6.5	135.2	39.8	95.4	27.7	46.8	20.9	67.7
69	930.3	144.0	8.8	8.1	135.2	38.2	97.0	29.6	51.9	15.4	67.3

Sources of Gross Saving, 1947-1974
(billions of dollars)

Year	Gross National Product	Gross National Saving									
		Total	Government Surplus or Deficit (-)		Private Saving						
							Business				
			Total	Federal	Total	Personal	Total	Unincorp. Business Capital Recovery Allowances	Corporate Saving		
									Capital Recovery Allowances	Retained Profits	Total (Cash Flow
1970	977.1	143.1	-10.1	-11.9	153.2	56.2	97.0	31.3	56.0	9.8	65.8
71	1054.9	152.2	-18.5	-21.9	170.7	60.5	110.2	33.3	60.4	16.2	76.6
72	1158.0	173.3	- 5.1	-17.5	178.5	52.6	125.9	36.6	66.3	23.3	89.6
73	1294.9	214.4	- 3.5	- 5.6	210.9	74.4	136.5	39.6	71.2	25.7	96.9
74	1397.4	207.5	- 6.3	- 8.1	213.8	77.0	136.8	42.8	76.7	17.3	94.0

Sources of Gross Saving as Percent of Gross National Product, 1947-1974

Year	Gross National Saving	Gross Private Saving						
		Total	Personal	Business				
				Total	Unincorp. Business Capital Recovery Allowances	Corporate Saving		
						Capital Recovery Allowances	Retained Profits	Total (Cash Flow)
1947	18.2	11.9	3.2	8.7	2.5	2.5	3.5	6.0
48	19.4	16.1	5.2	10.9	2.9	2.7	5.2	7.9
49	14.0	15.2	3.7	11.6	3.4	3.1	5.1	8.2
1950	17.7	14.9	4.6	10.3	3.3	3.1	3.9	7.0
51	17.1	15.3	5.3	10.1	3.3	3.1	3.6	6.7
52	14.3	15.4	5.2	10.2	3.4	3.3	3.5	6.8
53	13.0	14.9	5.0	9.9	3.4	3.6	2.9	6.5
54	13.3	15.2	4.5	10.7	3.6	4.1	3.0	7.1
55	16.3	15.6	4.0	11.6	3.5	4.4	3.7	8.1
56	17.3	16.2	4.9	11.3	3.6	4.5	3.1	7.7
57	16.1	16.0	4.7	11.3	3.7	4.7	2.9	7.6
58	13.2	16.0	5.0	11.0	3.8	4.9	2.3	7.3
59	15.3	15.7	3.9	11.7	3.7	4.9	3.2	8.0
1960	15.4	14.7	3.4	11.3	3.7	4.9	2.7	7.6
61	14.5	15.3	4.1	11.3	3.7	5.0	2.6	7.6
62	15.2	15.7	3.9	11.8	3.6	5.4	2.9	8.3
63	15.3	15.0	3.4	11.7	3.5	5.4	2.7	8.1
64	16.0	16.2	4.1	12.0	3.5	5.4	3.2	8.5
65	16.8	16.5	4.1	12.4	3.4	5.3	3.7	9.0
66	16.7	16.5	4.3	12.2	3.3	5.3	3.6	8.9
67	15.1	16.8	5.1	11.7	3.3	5.4	3.0	8.5
68	14.8	15.6	4.6	11.0	3.2	5.4	2.4	7.8
69	15.5	14.5	4.1	10.4	3.2	5.6	1.7	7.2

Sources of Gross Saving as Percent of Gross National Product, 1947-1974

Year	Gross National Saving	Gross Private Saving						
		Total	Personal	Business		Corporate Saving		
				Total	Unincorp. Business Capital Recovery Allowances	Capital Recovery Allowances	Retained Profits	Total (Cash Flow)
1970	14.6	15.7	5.8	9.9	3.2	5.7	1.0	6.7
71	14.4	16.2	5.7	10.4	3.2	5.7	1.5	7.3
72	15.0	15.4	4.5	10.9	3.2	5.7	2.0	7.7
73	16.6	16.3	5.7	10.5	3.1	5.5	2.0	7.5
74	14.8	15.3	5.5	9.8	3.1	5.5	1.2	6.7

percent of GNP, with a low of 11.9 percent in 1947 and a high of 16.8 percent in 1967. Clearly, major changes in the tax system are needed if the required increase in the private saving rate is to be achieved.

Contribution of business saving

Another impressive fact shown by these data is that business saving has accounted for an increasing proportion of the economy's total saving. In 1947, business saving was 48.1 percent of gross national saving; by 1974, it had increased to 65.9 percent of the total. This large and growing contribution of business saving to the total saving in the economy should be kept clearly in mind in evaluating tax reform proposals which would, one way or another, increase total business tax burdens. Any such increase must erode business saving and necessarily retard the increase in total saving in the economy.

Gross business saving, as measured in the national income accounts, consists of the capital consumption allowances of unincorporated businesses, corporate retained profits, less adjustment for changes in the value of inventories, and corporate capital consumption allowances. Of the growth in business saving shown above, by far the most important and most rapidly increasing component is the amount shown as capital recovery allowances. While total saving in 1974 was about 5 times that of 1947, capital recovery allowances in 1974 were almost 10 times those of 1947. And in 1974, this component of business saving accounted for almost 58 percent of total saving, more than twice the fraction in 1947. It is against these hard data on the importance of capital recovery allowances as a source of the Nation's total saving that the Congress should evaluate such tax "reform" proposals as eliminat-

ing ADR. The factual record provides unmistakeable evidence of the contribution of past legislation and administrative actions, including the accelerated depreciation provisions in 1954, the guidelines lives in 1962, and the ADR in 1971, to the nation's total saving; it also attests to the effectiveness of further improvements in capital recovery allowances in increasing aggregate private saving and capital formation.

In sharp contrast, retained corporate net profits have added only modest amounts to total private saving. As a share of the GNP originating in corporations, pretax profits, adjusted for inventory valuation changes, have shown a marked downward trend over the entire postwar period; in the five years 1947-1951, the ratio of profits to gross corporate product ranged between 20 percent and 23 percent, while in the last five years the ratio has been between 11.8 percent in 1970 and 13.6 percent in 1973, when profits allegedly soared out of sight. This ratio has been falling since the first quarter of 1973; in 1974 it was down to 12.4 percent, lower than at any other time in the postwar period, except for 1970. Measured in current dollars, corporate profits adjusted for changes in inventory valuation increased from $25.6 billion in 1947 to $105.6 billion in 1974 or roughly four times. The increase in income taxes was $44.4 billion or 55½ percent, of the $80.0 billion increase in pretax profits, while the increase in dividend payouts was $26.4 billion, a third of the increase in pretax profits. Retained profits rose from $8 billion to $17.2 billion, little more than twice.

The growth in corporate capital recovery allowances has scarcely been adequate to offset the declining share of profits in corporate GNP and the increase in corporate profit taxes. Corporate cash flow, i.e., net retained earnings plus

capital recovery allowances, as a share of corporate GNP shows no positive trend over the postwar period. Since the mid-1960's, this ratio has been falling; in 1974, it fell to 10.8 percent, the lowest level since 1947.

Urgency of Tax Revisions to Reduce the Burden on Saving

These data highlight the urgency of tax changes to augment business capital recovery allowances and to reduce corporate income tax liabilities if the Nation's saving and capital formation requirements are to be met. The cost of failure to do so will be measured in fewer jobs and lower real wages than otherwise would be realized, in lower levels of achievement of public policy goals, or both.

I do not mean to suggest that changes in the tax system to reduce the burden on saving and capital formation should be confined to business taxes. On the contrary, reducing the disporportionately heavy tax burden on personal saving is also urgently required. As the table shows, personal saving represents a declining share of the Nation's total saving. Reducing the share of disposable personal income used for consumption by even a very modest degree, for example, from 92½ percent to 90 percent or by 2.7 percent, would increase personal saving at 1975's estimated level of disposable income by more than $26 billion. Tax changes to bring about this result by giving the taxpayer a larger claim on the economy's future income would have the collateral benefit of reducing his dependency on government programs to provide for his retirement and temporary financial setbacks.

There are any number of tax changes which would reduce the existing tax burden on individual saving and bring about an increase in the personal saving rate. These tax changes need not be confined to or even be primarily directed to upper-

bracket taxpayers. For example, suppose taxpayers were given a tax credit for increases in the amount of their total saving in the taxable year. The credit might be allowed at a rate, of say, 20 percent, with an upper limit of, say, $1,000 on a joint return. A very substantial part of these tax benefits would go to persons of modest incomes. Statistics of Income data for 1972, for example, show that 50 percent of the total income representing the yield on savings was reported on returns with less than $20,000 of adjusted gross income.

Responsibility for meeting our future saving and capital requirements should not be limited to one or another part of the private sector. All of us will have to get in on the act. By the same token, no one type of tax change will be adequate to meet the extraordinarily diverse demands for capital throughout the U.S. economy. The tax change which would most quickly increase the saving and capital outlays of, say, large manufacturing enterprises would not necessarily be most directly effective for, say, the small wholesaler-distributor. And the tax revisions which would most effectively reduce the existing tax barriers to additional saving by the upper bracket individual stockholder will not necessarily be the most efficient means to allow low-income individuals to increase their saving in the forms they prefer. Since the need for increases in saving and investment is not confined to any one particular group of individual or business, a long list of tax changes is needed to insure that all individual and business taxpayers will have greater inclination and ability to save and invest.

Tax Changes to Improve Financial Market Performance

Concommitant to the requirement to alleviate the excessive tax burden on private saving and investment is the need to reduce impediments to the efficient

operation of the Nation's financial markets. With respect to tax policy, the need is to reduce, if not eliminate, the existing tax distortions which change the signals which the financial markets would otherwise provide as to the best allocation of any given amount of saving among alternative capital formation uses.

The corporation income tax per se grossly distorts the allocation of saving. The tax constitutes a heavy excise on the returns to corporate equity, layered on top of the extra tax on individual saving which is inherent in our income tax. Not only does it bias the allocation of saving, it also distorts the capitalization of corporate businesses by discriminating against new external equity as compared to debt financing. The resulting pressure toward excessive debt increases risk and the cost of capital above the levels that would otherwise prevail.

Some progress toward integrating the individual shareholder's and the corporate tax is urgently desirable in the interests of reducing existing tax distortions. The simplest measure to this end, obviously is to reduce the corporation income tax. In addition, reducing the double taxing of dividends whether by allowing corporations to deduct their dividend payouts or by permitting shareholders to claim a credit for the corporate tax paid on the dividends, would contribute to reducing these distortions as well as to increasing total private saving.

One of the most serious tax impediments to efficient financial market performance is the tax treatment of capital gains and losses. The tax on capital gains is properly viewed as an additional tax on the returns to saving; the tax on capital gains on corporate securities is a heavy third layer excise on the returns to saving invested in corporate business. The limited deductibility of capital losses further

increases the risk of equity investment and raises the cost of capital.

In addition, the tax on gains is a substantial excise on the transfer of saving from one investment to another. Accordingly, it significantly increases the cost of capital transactions and by freezing asset holdings, impedes the financial markets from efficiently performing their important function of valuating the worth of companies.

Optimumly, capital gains and losses should be entirely eliminated from the income tax; indeed this would be essential if the basic tax bias against saving were eliminated by excluding current saving from taxable income while fully taxing the subsequent gross returns on the saving. Short of this basic change, there are a number of changes which would move in the right direction. Among these are the proposals to exclude the first $1,000 of gains each year, to defer the tax when the gains are rolled over into new investment, to reduce the amount of gains included in income the longer the asset had been held, to increase the offset of capital losses against ordinary income, and to liberalize the carryover of capital losses.

As this brief review indicates, the list of changes to reduce the existing tax inhibitions to saving and to permit the financial markets to perform more effectively is long and diverse. The obstacles facing the enactment of these tax changes must not be minimized. Neither, however, should any of us lightly dismiss the costs in terms of retarded growth in productivity, employment, and real wage rates in failing to reduce the present excessive tax burden on private saving and capital formation.