



MUST WE LOOK FORWARD
TO A NO-GROWTH ECONOMY?

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I'd like to talk with you about a problem which I'm sure most of us never thought we as Americans would ever have to contemplate. Since its founding more than 200 years ago, our Nation has stood for growth. Our history is the manifestation of growth: Physical growth as our population spread from coast to coast; scientific growth . . . the steam engine, the automobile, exploration of space. And another sort of growth that perhaps more than anything else has characterized the American experience . . . namely, our remarkable economic development which transformed a fledgling agrarian society into the greatest industrial and commercial complex this world has ever known.

My message this morning is based on a concern that the American economy may finally be running out of steam . . . that the land of Horatio Alger, Alexander Graham Bell, Henry Ford and the Wright Brothers could conceivably be at the brink of economic stagnation . . . that the dynamic American economy might actually be facing a no-growth future.

The reason for my concern is conclusive evidence that investment in new plant and equipment, an essential element for continued economic expansion, is not occurring at a rate to support a continuation of the economic progress we have had in the past and which we have come to expect for the future.

Plant and equipment are the tools with which our labor force produces the goods and services we all consume. When the economy's stock of plant and equipment grows faster than the labor force, our workers become more productive. And, this increasing productivity creates an improved standard of living for us all. But when the economy's stock of plant and equipment grows more slowly than the labor force, the average worker's supply of tools and equipment declines. Under these circumstances, the worker has little chance to become more productive and the standard of living of society suffers.

I'd like to illustrate why capital formation is important by reverting back to primitive man. In primitive times members of tribes, in order to subsist, had to spend most of their waking hours foraging in the wilderness for wild berries and small animals to eat. In the earliest times, the hunter was forced to capture his prey by hand because he had no tools with which to do the job.

One day, an innovative tribesman discovered that he could fashion a club from wood obtained from the nearby forest. His club would enable him to kill more animals in less time than it took to do the job by hand. By spending part of his time making clubs, our tribesman found he could end up with more food than he could produce by devoting all his time to gathering food with his bare hands. So, the tribe began devoting time each morning to cutting wood in the forest and making hunting clubs. And the hunters found that they were able to harvest more animals in a shorter time, which improved their standard of living.

But, alas, one night, lightning struck the forest igniting a fire which destroyed the tribe's readily-available supply of wood. As a result, our tribesmen were forced to walk many miles to a distant forest for wood for their clubs. This consumed time and reduced the amount of time they had to hunt.

Translated into language economists like to use, the cost of maintaining and accumulating capital increased and the tribe was forced to substitute more labor-intensive methods for the capital-intensive methods of hunting they had developed. As the tribe found its stock of capital equipment for its hunters reduced, productivity fell and the tribe's standard of living declined. They discovered that life was more comfortable when tools were more abundant and less expensive to produce.

Currently we in the United States face a situation analogous to what our primitive tribe faced when its supply of capital equipment was depleted.

Until recently our Nation's stock of plant and equipment has always tended to grow steadily in relation to the size of our work force, through good times and bad, through recession and recovery. During the 1950's and 60's, the stock of plant and equipment available to the average worker in the private sector grew at about three percent a year. This rate of expansion was a major factor contributing to increased productivity which, in turn, resulted in approximately a three percent annual gain in real wages. In the early 1970's, however, this relationship changed. Major disincentives to capital formation occurred and slowed the rate of growth of plant and equipment available to the American labor force. During the past five years, the rate of capital accumulation per worker has averaged only about 1 percent a year, one-third the rate of the 50's and 60's and as a result, the growth of labor productivity has dropped to a rate one-fifth of what it was in the 50's and 60's. And during the past three years, the situation has drastically worsened.

Since 1975 the average amount of plant and equipment available to each member of the labor force has shown no growth whatsoever. This lack of capital expansion is unprecedented in the post-war history of this Nation. If it continues, it will most assuredly lead to serious economic stagnation. The extent of this stagnation is illustrated by the fact that the rate of productivity growth in the 50's and 60's allowed the real income of the average American worker to double in only about one generation. But now, it would take 1-1/2 centuries to accomplish the same thing.

What has brought about this change? It has been caused by several factors. The oil pricing policy adopted by OPEC in 1974 caused energy costs to skyrocket. The production of capital goods requires more energy resources than does the production of other goods. Thus the cost of new plant and equipment rose much more sharply than the prices of goods that most businesses produce. Also, the profitability of using existing capital and of expanding plant and equipment fell sharply. In addition, burdensome government regulations, tax laws that discourage capital spending, and inflation became significant factors in reducing the return on capital.

What can we do to remedy this situation? In the near term there is little we can expect on the energy price front. Our best efforts to increase the supplies of energy resources are not likely to lower the cost of energy. We can, however, take other steps to increase plant and equipment resources. Three specific measures come to mind.

First, we must reduce the heavy burden of excessive government regulation . . . new health and safety standards, product liability changes, pollution abatement requirements and a host of other regulations which have been imposed on business in recent years. Government regulations inevitably raise the cost, reduce return, and increase risks of business investment, all of which in turn discourage capital accumulation. Moreover, the threat that new regulations may be imposed in the future creates uncertainty about the profitability of planned new ventures, which further discourages investment.

Government intervention in energy markets is a particularly damaging type of regulation. For example, the threat that government might impose additional restrictions on the types and quantities of energy businesses may use injects an added risk factor to long-term capital planning and often discourages businessmen from expansion plans that otherwise might be undertaken. A plant designed to use natural gas, for example, might become virtually useless if the government creates a regulation that prevents the plant from

using the kind and amount of fuel for which it was designed. The best way to eliminate this sort of investment disincentive would be to permit the market the allocation and price of the various forms of energy.

A second way to encourage capital investment is by increasing tax incentives for plant and equipment expansion. Such proposals as an expansion of the investment tax credit for new equipment purchases and reduction of the corporate tax burden by lowering corporate tax rates would, of course, be very helpful.

We might also consider an investment tax credit for new plant construction. Plant expenditures have never had the benefit of tax incentives. And of the two, new plant or new equipment, the recent pace of new plant investment has been by far the more deficient. In many industries, there is no way to avoid higher energy costs without shutting down or constructing new plants which allow more energy efficient technologies to be used. In most cases, however, because of the higher relative cost of capital goods, firms have simply shut down. This situation could substantially be reversed by tax credits for new plant expenditures.

It is also time to give more serious attention to the burden of double taxation of corporate income. Currently, investors pay taxes through corporate earnings taxation as well as through the personal taxation of their dividends or capital gains. By allowing dividends to be deducted as an expense, like interest payments, we would increase investment incentives. It would be an even greater investment incentive, as well as more equitable, to tax corporate earnings through the personal tax system, regardless of whether the earnings were received by the individual investor as a dividend or a capital gain.

I would caution however, that any tax reduction resulting from an increased tax incentive plan, be implemented in a manner to ensure that it does not further increase the federal budget deficit. Any tax cut not matched by a reduction in government spending must be financed in the security market. Government borrowing to finance existing programs already exceeds total funds available for new business capital formation. Any further increase in the government deficit to finance new tax stimulus would tend to crowd out the capital investment which it was intended to promote.

Finally, and perhaps most important of all, we must come to grips with inflation. We simply cannot tolerate a continuation of 5-6 percent inflation to which we have

become accustomed in recent years.

Inflation discourages capital formation in several ways: First, under current tax laws, inflation reduces the rate of profits business can expect from new plant and equipment. Under inflationary conditions, the cost of replacing worn-out plant and equipment increases, while the depreciation deduction allowance under our present tax laws does not. Thus, revenue needed to cover the expense of replacing worn-out capital is taxed as income. In effect, a tax is levied on the use of plant and equipment.

Inflation also makes it more difficult for businesses to raise funds to finance new plant and equipment. Inflation causes a firm's dividends and interest payments to increase along with its earnings, regardless of gains in real profitability. Taxes are based on nominal profits and not on their purchasing power. So, as inflation moves investors into higher tax brackets, a higher percentage of their earnings is collected as taxes even though the purchasing power of their earnings may not have increased at all. In order to continue to attract investment capital, business is forced to continually increase dividends, further reducing the funds available for expansion of plant and equipment.

A third reason inflation discourages capital formation is that it generates uncertainty. We might think a steady rate of inflation should generate no more uncertainty than zero inflation. But can we really believe that the rate of inflation will remain steady? If we can't reduce our current inflation when we have made that one of our national objectives, how confident can a businessman or an investor be that inflation won't increase in the future? And it is this concern . . . this doubt . . . about what might happen to the future earnings of the firm that discourages business from committing itself to long-term programs of capital expansion.

By reducing inflation we would, in effect, repeal part of the indirect tax on the use of capital. We would make it easier for businesses to raise the funds needed to buy new plant and equipment. And, we would overcome much of the uncertainty now discouraging businesses from committing themselves to long-term capital expansion programs.

Thus, if we are to insure the type of economic progress we have enjoyed in the past, it is vitally important that we conduct monetary policy in a manner that will result in reduced inflation.

As we return to our offices in a few minutes, I know that some of you will say, "So what? We've heard these dire predictions so often and somehow the economy always seems to muddle through."

I was in London last week at the end of a two-week vacation abroad and had the opportunity to talk with several English bankers. I was struck by the transformation that has occurred in that once-proud economic giant.

Inflation, confiscatory taxation and usurpation by the government of the prerogatives of the private sector of the British economy have all but destroyed any incentive for capital expansion in what was once the economic leader of the Western World. Now, I am not predicting that we will necessarily follow in the footsteps of England, but I do say it can happen here and most assuredly will if we sit back and do nothing.

I have pointed out that for the first time in our history capital investment in expanded plant and equipment is not occurring at a rate sufficient to maintain satisfactory future economic growth. I have described some of the reasons for our predicament and have suggested several remedial measures we can take.

Whether or not we respond while there is still time, remains to be seen. One thing I know! We cannot look to government alone to do the job. Certainly, the Federal Reserve System cannot restore economic momentum through monetary policy.

What is needed is a national will to face up to our problems and the discipline to correct them even if the cure requires occasional sacrifice on the part of us all. Some will say that if the trite old slogan . . . "Trust in the free enterprise system" . . . is the best answer we can find, there is no hope.

I, for one, disagree. For I believe it is perfectly reasonable to place our faith in a system that has enabled us to achieve prosperity unprecedented in all of human history. And, I'm convinced that, if made aware of the stakes involved, most Americans will agree that the best way to restore growing prosperity in America is through private enterprise aided only where absolutely necessary, by government.

Regardless of your political and economic beliefs, I hope that you as opinion leaders in this community will involve yourselves in the debate over these important issues. By

doing so, and only by doing so, will you assure the future well-being and prosperity of this great Nation.