FINANCING OF BUSINESS SPENDING

It now appears to be generally recognized that a larger volume of business spending is needed to avoid a serious business recession. Expenditures of business for construction, machinery, and all those many items of equipment which make it possible for a factory, a hotel, a public utility, a gas station, or any other form of business to sell finished goods or services, take up normally a large part of the country's total production of goods, and normally employ a large part of the country's workers. Over a period of years the rapid growth in the standard of living in the United States has rested on large expenditures by business in scrapping old plant and machinery and building new and more efficient plant; in constantly finding new products or services to produce, and new ways to produce old products or services at cheaper prices. It is this process which has made possible a continued increase in real wages.

Capital expenditures have, however, been subject to wide fluctuations. During the late 20s business was making very large and in some cases excessive purchases of plant and equipment, but in recent years exactly the opposite has been true; the amount of business spending has not been adequate to maintain plant in good condition or to carry business into new fields. The process of research, experiment, and invention has been going forward steadily, but the results of research have not been fully exploited to satisby human needs and comforts. At this time when the volume of government spending has been declining rapidly, there is both need and opportunity for an increased volume of business spending which will restore plant and equipment to efficiency, reach out into new fields in order to produce new goods or services to satisfy human need, and make old goods or services more widely available through cheaper production.

The existence at the present time of a large need for business spending is shown by the estimates of the savings of business enterprises prepared as a part of the estimates of national income made by the National Bureau of Economic Research. These figures for the years 1919 through 1935 are as follows:

Net Savings of Business Enterprises *

In Millions of Dollars

1919	6,706
1920	3,722
1921	2,506
1922	663
1923	2,427
1924	2,141
1925	3,355
1926	4,777
1927	2,031
1928	2,810
1929	2,109
1930	- 1,656
1931	- 5,856
1932	- 8,751
1933	- 7,779
1934	- 3,354
1935	- 1,607

From 1919 through 1929 business was making large savings each year. Large amounts of earnings were being retained in the business and in part were being reinvested in plant and equipment. Other funds were being obtained from the sale of securities in the market and used for a similar purpose. Beginning with 1930, however, business suffered huge losses in capital. These losses took the form of the destruction or obsolescence of equipment, losses through reorganization, and revaluation of assets, and through out-payments for dividends and interest in excess of earnings.

While the figures shown above are, of course, somewhat rough, they indicate the large sums of money involved in business capital operations, the

* National Bureau of Economic Research, Bulletin 66, September 27, 1937.

large increases in capital necessary to maintain a rising living standard, and the great reduction in capital in periods like the recent depression. They indicate a need for a large amount of business spending to restore business capital assets to a point where they will minister to human needs more effectively.

Specific obstacles to business spending in the fields of building, utilities, railroads, and general manufacturing and mining have been reviewed in Mr. Harrison's letter to Governor Eccles of November 3 and a memorandum of October 29 by Mr. Williams. It is the purpose of this memorandum to examine the mechanism for the financing of business spending, especially with a view to discovering whether there are in this area obstacles which are standing in the way of a more adequate volume of business spending.

For business generally there appear to be four sources of funds for expenditure for plant, equipment, and other capital uses:

(1) Existing cash balances,

(2) Current earnings,

(3) The new issues market,

(4) Bank credit.

These will be discussed briefly in order.

(1) Existing cash balances. While no complete figures are available the following table which is compiled by the Standard Statistics Company from the midyear balance sheets of 140 large industrial concerns is a rough indication of changes in the aggregate cash position of industry.

	Midyear 1929	Midyear 1936	Midyear 1937	% Change 1936 to 1937
Inventories	$2,069,000,000	$1,074,000,000	$1,427,000,000	+ 32.0
Receivables	575,000,000	484,000,000	590,000,000	+ 21.7
Cash	693,000,000	876,000,000	763,000,000	- 12.9
Cur. Liabilities	402,000,000	572,000,000	776,000,000	+ 35.6

The cash position of these industries is large, but has been reduced somewhat from 1936. It is interesting to note that an increase of $459,000,000 in inventories and receivables appears to have been financed by the following changes:

Reduction in cash	$113,000,000
Increase in current liabilities (mostly bank loans)	204,000,000
Balance, presumably from capital issues and earnings	142,000,000

This comparison suggests that while cash balances are sufficient to finance some increase in business activity they will have to be supplemented for any considerable expansion program. In many cases, especially among smaller concerns, cash balances are quite inadequate to finance expansion.

It should be added also that the willingness of a business concern to spend the cash which it has depends in part on the prospect of rebuilding its cash balances over a period through the retention of earnings or through sale of additional capital stock.

(2) Current earnings. Current earnings have in the past been a major source of business capital. It has been the practice of American business to plow back into the business a substantial part of each year's earnings. This is illustrated by the following table taken from an unpublished study of 213 leading industrial concerns by the Standard Statistics Company. It shows that in the period from 1922 to 1929 these concerns were retaining from one-third to more than half of their net income. For these particular concerns the total amount so retained in these eight years was over $5,000,000,000. These retained earnings served the double purpose first, of enabling these companies to continue to pay dividends through the depression despite small earnings or deficits, and second, of providing funds for expansion, for the introduction of new machinery, for the development of new products, and in general for the utilization of the products of research to satisfy human need. These large concerns probably show a more favorable picture than the generality of business concerns.

DISPOSITION OF PROFITS - 213 CONCERNS

(Millions of Dollars)

Year	Net Profit	Fixed Charges	Net Income	Preferred Dividends	Common Dividends	Bal.after Dividends
1922	1,163.6	156.4	1,007.2	160.1	425.5	421.6
1923	1,439.6	163.3	1,276.3	166.3	564.0	546.0
1924	1,441.5	163.7	1,277.8	170.3	588.5	519.0
1925	1,861.2	159.6	1,701.6	175.0	693.8	832.8
1926	2,019.5	153.1	1,866.4	173.1	885.8	807.5
1927	1,763.3	172.5	1,590.8	161.4	1,007.9	421.5
1928	2,267.0	169.6	2,097.4	145.9	1,103.5	848.0
1929	2,652.9	172.2	2,480.7	148.4	1,322.9	1,009.4
1930	1,601.2	168.7	1,432.5	149.9	1,273.3	9.3
1931	685.9	162.7	523.2	140.7	1,016.3	d 633.8
1932	264.5	149.3	115.2	109.5	618.0	d 612.3
1933	676.9	133.4	543.5	81.9	517.9	d 56.3
1934	940.3	133.4	806.9	99.2	611.2	96.5
1935	1,322.1	120.6	1,201.5	102.9	704.1	394.5
1936	1,886.9	111.7	1,775.2	169.9	1,154.0	451.3

d deficit

If we were to add to these retained earnings of leading industrial concerns similar figures for other industrial companies, for the utilities and for the railroads, it is clear that the result would be a substantial sum available in earlier years for business spending, the general size of which was shown by the table on page 2. In addition the amounts set aside for depreciation, depletion, etc., are available out of gross earnings for maintenance or new equipment.

Turning to the present situation, substantial sums are now gradually becoming available from these sources. One important question which arises, however, is the effect of the undistributed profits tax upon the utilization of these funds for increased employment. A comparison between the 1935 and 1936 figures in the preceding table shows that whereas net income of these corporations increased by $573,000,000 between the two years, only $57,000,000 of these added earnings was retained for utilization in the business. It is reasonable to assume that this reflects in some measure the effect of the undistributed profits tax which became effective in 1936.

The principal objections which have been raised from time to time to the undistributed profits tax are:

(a) That it penalizes and makes more vulnerable the company in weak position which is in debt or has inadequate reserve funds,

(b) That it shuts off the natural means of growth for the concern which is too small or unseasoned to go to the capital market for funds,

(c) That it makes for business instability by forcing large disbursements of dividends some years, with resulting small disbursements in other years, because business concerns are not able to set aside earnings to be disbursed as dividends or for capital improvements in lean years. It makes extremely difficult the maintenance of a reasonably stable dividend or capital expenditure policy, such as has been followed by the American Telephone and Telegraph Co., for example.

A further and different objection may be raised that in the present situation the tax makes very expensive funds set aside from earnings to be used for capital purposes in making available to the people the results of research and invention, for lifting employment, and the standard of living. Modification of the tax for the benefit of weak concerns or concerns in debt, or small concerns unable to go to the money market, while it would be generally helpful, would not meet this point at issue. To meet this point it would be necessary to modify the tax to enable concerns to retain without penalty funds needed for sound capital uses involving additional employment.

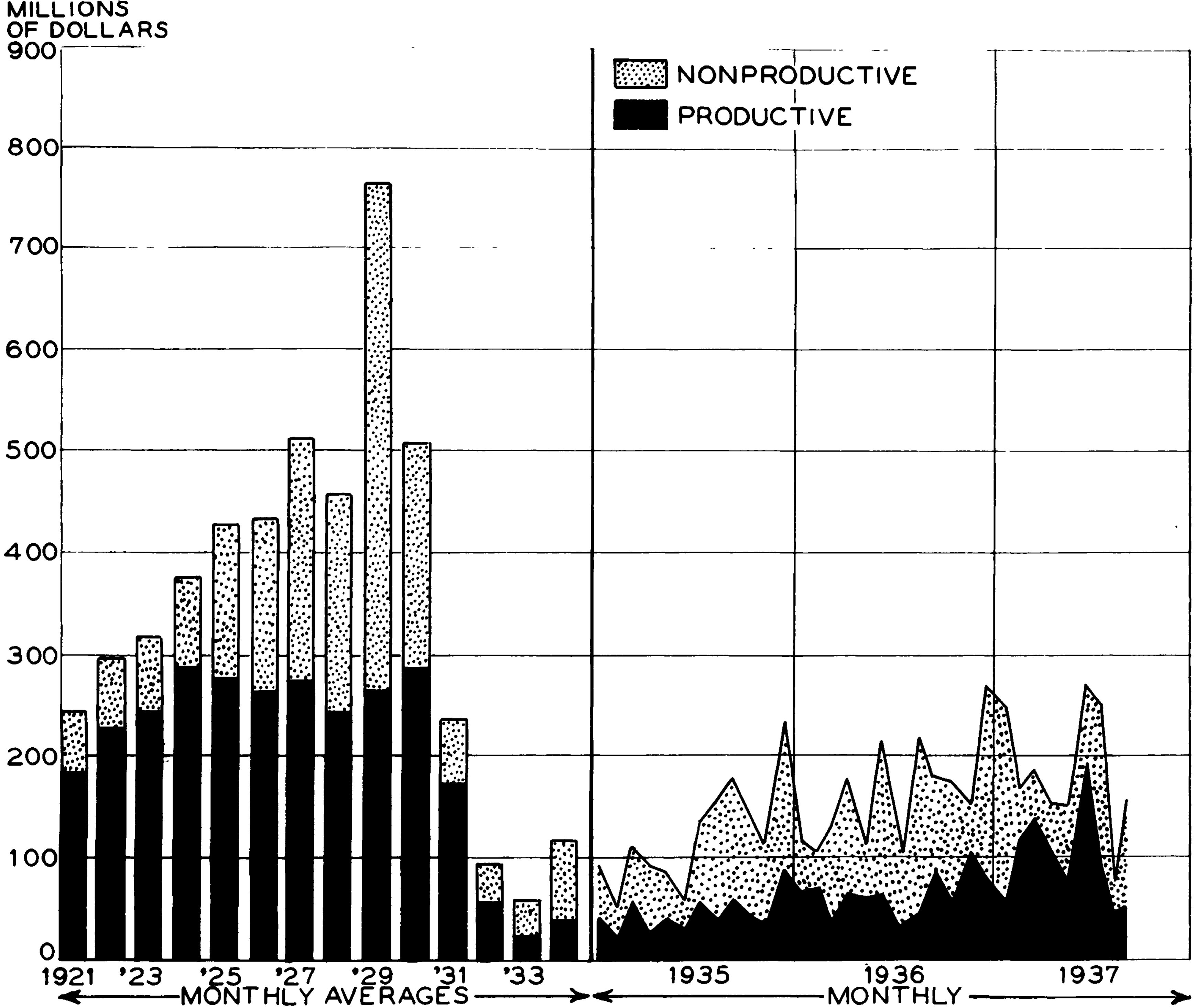
The undistributed profits tax was designed in part to prevent excessive savings and excessive building of plant capacity by industrial concerns such as may have occurred during the prosperity of the 1920s. Without discussing whether the tax was adapted to conditions of business at that time, the question may be raised whether it fits the present situation when there is no evidence of over-investment, but on the contrary, when investment has been greatly depleted during the period of depression. It may be adapted to a period of over-investment, but not suitable for a period of under-investment, such as the present.

One suggested method for dealing with this situation is to exempt from the tax funds actually spent for plant or equipment over some specified period. In any such plan it would be well to recognize that the willingness of concerns to spend will depend in part on their prospect over a period of years for making good out of earnings depletion of capital. Such a plan to be effective promptly should be made to apply to 1937 earnings.

(3) The new issues market. In addition to current earnings the major source of new funds for business enterprise has been provided in the past by the new issues market. This market used to provide in the 20s something like

$160,000,000 a month for what might be called productive corporate uses as distinguished from refunding or financial issues of one sort or another, in addition to about $100,000,000 a month for capital use by States and cities. The figures for total productive issues are shown in the accompanying diagram. It is an interesting coincidence that this aggregate amount is about the same as the amount contributed to national income by the government in recent years through its net deficit.

9.



Corporate and Municipal New Capital Issues, Excluding Refunding Issues
(Moody's Investors Service data; latest figures are for September)

During the period of the depression the new issues market was, of course, practically closed accompanying general disturbance in the securities markets. But in the past three years there has been some gradual revival of this market accompanying easy money conditions. Most of the issues, however, have been for refunding rather than for new money. The amount of new money, or what may be called productive issues, began to show some increase during the past year, reaching, as the attached diagram shows, an average of about $50,000,000 to $100,000,000 a month, but at the present time the market is practically closed except for relatively short term bonds or notes of the highest grade.

The reopening of the capital market for new money depends on a recovery in the general securities market, partly because the present yield basis on all securities except the highest grade is now so high that new capital is too expensive, and partly because under present conditions in the general securities market it would not be possible to sell substantial amounts of new securities. It is particularly desirable that a considerable part of the new capital which business uses for plant construction and the like should take the form of equity financing to avoid an overbalanced debt structure. It is, therefore, desirable for any considerable program of new capital issues that there be a recovery of the equity market as well as the bond market. For any reopening of the new issues market it is necessary to consider the various factors upon which greater stability in the security markets depends.

(a) The general business outlook. In the main the security markets are now reflecting general pessimism as to the business outlook, and particularly the outlook for the railroads, the utilities, and building construction. Specific action which would improve the situation in any of these fields would be most effective in reopening the capital market.

(b) Availability of funds. In view of the thinness and vulnerability of the market, question may be raised as to the volume of funds potentially available for employment in securities involving risk. As far as institutional buyers are concerned, insurance companies are far and away the chief reliance of the bond market, and the volume of their purchases is steady and increasing. They are increasing their security holdings at the rate of about $1,500,000,000 a year, largely bonds of high rating. Savings banks, ordinarily steady buyers, are now less active purchasers than formerly because of a slower growth of deposits. Both of these types of institutions, however, are strictly limited in the types of their investments, and have recently been more than usually conservative both as to types and amounts of purchases because of lack of confidence in security price levels and other uncertainties.

The commercial banks are ordinarily the most erratic buyers of bonds. At one time they are heavy buyers, at another, heavy sellers, reflecting the changes in the business demand for funds, in their reserve positions, and in the outlook for bond prices. Since July, 1936, they have been sellers.

It should be added that some institutional buyers, like college endowments, and some trust funds which used to confine their purchases to bonds, have in recent years, under what they considered the threat of inflation, purchased substantial blocks of common stock.

Possibly the greatest change in recent years has been in the status of individuals with large incomes who are perhaps the largest holders of common stock. At the present time the total volume of incomes of $10,000 or over, as reported in the Federal Statistics of Income, is about half what it was in the middle or late 20s. For 1936 it may be estimated that this total is in the neighborhood of $5,000,000,000, whereas in 1926 and 1927 it was in the neighborhood of $10,000,000,000. The Federal tax on these incomes now averages 15 per cent, compared with 7 or 8 per cent in the 20s. Thus, smaller amounts of income are currently available for investment in the market, though the number of shares listed has increased some 40 per cent in the past ten years. A smaller volume of these funds currently available, partly because of high individual surtaxes and the capital gains tax, is perhaps one substantial reason for greater sensitiveness of the equity market to other influences.

(c) Capital gains tax. The capital gains tax is cited repeatedly by those in charge of the management of large private funds as preventing the use of those funds in enterprise or securities representing enterprise, and it is generally believed that a modification of this tax would tend to increase the amount of funds available for enterprise and would tend to have a stabilizing influence in the securities market by providing a larger volume of buying when the market was low, and selling when the market was high. There is also some reason to believe that the return to the government would not be materially reduced because there would be more activity and less avoidance with a lower tax.

(d) Restrictions on "insiders." Section 16 of the Securities Exchange Act which places restrictions on trading in securities by directors and officers and principal stockholders has been mentioned by many people as a reason why they themselves would not buy the stocks in which they themselves were interested. In addition to not wanting to tie themselves up for six months, they do not want to incur the notoriety involved in the publication of their names and special inquiries of one sort or another. The S. E. C. has the power by rules and regulations to exempt any transaction or transactions which it may consider as not comprehended within the purpose of this subsection which was "preventing the unfair use of information." The S. E. C. thus has power to give a little more leeway for this class of stockholder.

(e) Market regulations. The detailed regulations by the Board of Governors with respect to margins and of the S. E. C. with respect to other phases of market practice, are frequently mentioned as causes of irritation and impediments to the fluidity and stability of the market. A revision of these regulations in the direction of liberalization would probably have no major effect on the general situation, but would make for a more smoothly operating financial mechanism and lessen the causes of irritation and pessimism. A number of detailed suggestions as to changes in the regulations of the Board of Governors were contained in this bank's letter of September 24, 1937. The Board's action in revising its margin requirements has already proved helpful, not simply for its direct effect but for its indication of an attitude of flexibility, understanding, and cooperation. The Board is understood to be considering the issuance at an early date of revised Regulation T. The existing regulation, and also the draft of the proposed provision sent with the Board's letter of July 28, 1937, include many provisions which have been or would be irritating to the market, and in some instances provisions with which full compliance is difficult. Many of the provisions of the regulation which are objectionable from the point of view of the security markets are of relatively small importance so far as the control of credit is concerned. Events which have transpired since the preparation of this bank's letter of September 24 emphasize further the desirability of a reconsideration of all phases of the regulation with a view to determining whether the results to be achieved from the point of view of the control of the use of credit, which is the Board's primary responsibility, are sufficient to offset the difficulties which they create in the market.

(4) Expansion of bank credit. A certain amount of business spending is financed by bank credit, both directly in the form of commercial loans,

and indirectly in the form of bank purchases of securities through the open market. Through the loan channel a considerable amount of funds has latterly been flowing into business use, but largely for current operations rather than for capital expenditures which are needed now.

Bank investments as indicated earlier have been decreasing and this movement has had some real influence on the bond market. To the extent this is due to uncertainty as to the future of interest rates it is not unusual at this stage of the business cycle, when commercial demand for funds begins to be felt, and the only sound reassurance is the gradual stabilization of yields at a somewhat higher level than that of a year ago. But to the extent that bank sales of bonds may reflect changes in their reserve position the whole question of monetary policy is raised. That goes beyond the scope of this memorandum.

CONCLUSIONS

1. Business spending offers at present the most effective method of avoiding severe business recession.
2. Funds for business spending come from four sources,
    1. Cash on hand
    2. Current earnings
    3. New capital issues
    4. Bank credit.
3. Business concerns hold larger cash balances but not large enough for a large capital program. Willingness to spend cash depends on ability to recoup.
4. The present tax on undistributed profits penalizes the use of current earnings for capital expenditure.
5. To make funds more freely available for business through the capital market the following proposals should be considered:

a. Specific action to relieve difficulties in the railroads, utilities, and building,

b. Revision of capital gains tax,

c. Modification of restrictions on buying of securities by "insiders."

d. Liberalization of Federal Reserve and S. E. C. regulations.

6. Making bank credit available for business through bank investments would raise the question of monetary policy as affecting bank reserves, a subject beyond the scope of this paper.

Federal Reserve Bank of New York
November 17, 1937.