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Statement by

Henry C. Wallich

Before the

Committee on Ways and Means

United States House of Representatives

Washington, D.C.

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It is a great pleasure to address this distinguished Committee on the subject of taxes and capital formation. I do so purely in my personal capacity.

There is widespread concern that the United States is approaching a period of capital shortage. More capital for investment will be needed in the future than has been in the past. Savings to finance this investment, on the other hand, have been diminishing.

Fortunately, the demand for capital is likely to increase by only a small margin. Business investment, which in the past had averaged approximately 10-1/2 per cent of GNP, probably will have to average 11-1/2 per cent in order to provide needed jobs, protect the environment, assure health and safety of the labor force, and meet energy needs. Meanwhile the capital requirements of homeowners and of various types of urban construction may diminish thanks to declining population growth, and less investment in inventory may be needed as inventory control methods improve.

The supply side of capital, on the other hand, presents more serious difficulties. The continued ability of the individual saver to supply capital equal to a historic 4-5 per cent share of GNP, to be sure, does not call for serious questioning. The ability of corporate business, however, to contribute to the flow of savings has been hurt by the diminishing share of corporate profits in the GNP and by the deteriorating quality of these profits. Taking demand for and supply of capital for the private sector as a whole, a deficit very probably is ahead. To this private capital deficit there may well have to be added a deficit in the accounts of State and local authorities.

The Federal Government therefore will play a decisive role in balancing the demand for and supply of capital. If the Federal Budget produces a sufficient surplus, this will offset private plus State and local deficits. An over-all capital shortage will have been forestalled. If the surplus is too small or if, as has happened before, the Federal Budget is in deficit, we shall confront a shortage.

The corporate sector suffers, in addition to its weakened earnings, from serious financing constraints that may impede financing of investment even if adequate savings are available.

Corporate liquidity has been drained. The capital structure of corporations has deteriorated, with debt rising relative to equity, and short-term debt rising relative to long-term debt. Both conditions could be remedied by a variety of measures that would improve corporate cash flows and enable corporations to improve their capital structure. Among them are such familiar proposals as an enlarged investment tax credit, depreciation facilities more realistically recognizing inflation, an outright cut in the corporate tax rate and, at the individual taxpayer level, adjustment of capital gains taxes for inflation and a reduction in the capital gains rate for longer holding periods. All these techniques have advantages. They mostly share the disadvantage, however, of reducing the Treasury's revenue and of shifting the distribution of income in the direction of greater inequality, or at least of partly reversing a move toward greater equality that may have occurred. A loss of Treasury revenue, besides, means more Treasury borrowing and to that extent does not help resolve the capital shortage.

If we want to avoid a loss of revenue and a shift in the income distribution, it would still be possible to improve the capital structure of corporations and facilitate financing. This could be done by removing or reducing the bias in favor of debt as against equity that is a familiar feature of the corporate tax system. Two methods are available:

(1) To eliminate the deductibility of interest payments by nonfinancial corporations and so to tax net operating income (income after depreciation but before interest) instead of, as now, net income (income after depreciation and interest). The tax rate then could be lowered substantially without losing revenue.

(2) To make dividends deductible, the same as interest, and therefore to tax only retained income, at a rate substantially higher than the present rate.

Of these two approaches, I regard the first -- taxation of net operating income -- as preferable, because the second is essentially a tax on undistributed profits which would require a number of complex provisions to keep it from becoming detrimental to capital accumulation and growth. For the implementation of the tax on net operating income, two methods are available in order to avoid the severe impact on corporations with above-average debt that would result from sudden non-deductibility of interest, even at a moderate rate. These are:

(1) To phase in the change over a number of years, a growing fraction of interest paid becoming nondeductible over time and a growing fraction of dividends being taxed at the reduced rate.

(2) Application of the tax change to debt and equity issued after enactment.

Method (1) (phasing in gradually) exerts only limited pressure toward more equity financing in the early years and for that reason seems less desirable, even though it has administrative advantages. Method (2) would immediately end the existing bias in favor of debt financing. It poses administrative difficulties because in effect there would be two tax rates, one on old debt and equity and another on new. Regulations would have to be written with a view toward closing the obvious loopholes that such a situation presents.

Financial intermediaries, whose principal business consists in receiving and paying interest, could be covered by either alternative only by means of complex arrangements and it seems preferable to give them entirely separate treatment. This would seem appropriate also in view of the lack of uniformity of the present taxation of financial intermediaries.

The foregoing tax changes would improve the structure of corporate capitalization and thereby ease corporate financing. They would not, by and of themselves, increase the supply of saving. The number of devices that have been suggested to increase saving is large, and most of them have been so thoroughly discussed that there is no need here to pass them in review. As noted already, they share for the most part the defect of making the distribution of income more unequal. Among those that would have the desirable effect of pushing the economy in the direction of greater equality is the type of plan which tries to convert employees into stockholders. Here again, a wide variety of models have been presented. In my judgment, such plans are desirable if they meet the following criteria, in addition to giving the individual employee a share in the flow of corporate profits:

(1) An increasing flow of equity funds for the firm,

(2) A tax arrangement that allows firms to treat contributions made on behalf of its labor force as part of tax deductible wages, even though these contributions were made in the form of stocks,

(3) Diversification of holdings for the benefit of the stock-owning employees, to reduce the risks of particular stock investments,

(4) Protection against excessive concentration of voting power in the hands of any particular group,

(5) Ability of the stock-owning employee to sell his stock, subject to some minimum holding period.

I believe that plans of this kind deserve examination as part of the effort to increase the supply of capital.