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Statement by

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and the

Senate Select Committee on Small Business

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I am happy to have this opportunity to appear before the Joint Economic Committee and the Senate Select Committee on Small Business to present my personal views on some financial issues of concern to small businesses. In accordance with indications received from the Committee, I intend to address myself to problems concerning the overall supply of and demand for capital.

For small business, this overall supply and demand situation is of course of great importance. In my opinion, based on the evidence, the United States faces the danger of a possibly serious capital shortage. Over 9 million small business firms, according to data supplied by the Small Business Administration, must compete with other sectors for the available supply of capital. For all users of capital -- small businesses, homeowners, other consumers, large businesses, State and local authorities, and last but by no means least the Federal Government -- an adequate supply of capital is important.

Historically, the total volume of gross savings and investment in the American economy has averaged about 15 per cent of GNP, to which one might add perhaps another 2 per cent to allow for public construction. This rate, of course, is modest compared to the savings of many European countries, ranging around 25 per cent of GNP, and even those of some developing countries, surpassing 20 per cent in quite a few instances, to say nothing of Japan, which at times has saved and invested as much as 40 per cent of its GNP. But our comparatively modest rate of saving and investment is deeply embedded in the structure of our economy.

Major changes do not seem to be in prospect. What we have to be concerned about are small but nevertheless critical increases and decreases in particular sectors of the economy.

First I would like to review briefly the factors influencing the demand for capital. Most of the new investment needs that add to our regular capital requirements and thus may call for an increase in total saving are familiar, although not easy to quantify. The most important of them relate to energy and to the restructuring of parts of our economy reflecting higher energy costs to the environment, health and safety on jobs, and mass transit. Some of these additional investment outlays are required by political decisions that we, as a nation, have made. Some declines in sectoral investment requirements also seem ahead, especially in the areas of housing, urban construction such as schools and hospitals, and inventory investment. These, for the most part, reflect demographic and economic influences. On balance, I believe that the required increases in investment will outweigh the cutbacks by a margin of the order of 1 per cent of GNP.

It has been argued that the high existing excess capacity in industry will allow us to invest less in plant and equipment over the next few years than we have on average in the past. This, some observers have said, means a cutback in our total investment requirements. I regard this view as unfounded. A capacity utilization rate in manufacturing of 69 per cent, as experienced recently, does not mean that almost one-third of our effective capacity stands idle. In 1973 and

1974, severe and widespread shortages were experienced while that index stood only a little above 80 per cent. Moreover, the changing price of energy is bound to have made some of our capacity obsolete, while changing consumption habits, technological advances and environmental factors probably have rendered another part inoperative.

Our labor force has increased dramatically in recent years, and I very much doubt that we have enough capacity to supply jobs for everyone even if the demand were there. The peak rate of labor force growth seems to be behind us, but rates of labor force growth of 1.6-1.8 per cent per year are still projected through the early 1980's. Thus, once the effects of the recession are overcome, our capital stock, in view of our growing labor force and the need for more jobs, may well turn out to be too small rather than too large.

Allow me to turn next to the sources of supply of capital. There are essentially three: personal savings, business savings, and government savings (which could be positive or negative). The aggregate of these savings, of course, is equal to aggregate investment.

Personal savings in recent years have amounted to about one-third of total savings. They have varied with the business cycle but have otherwise been fairly stable at about 5 per cent of GNP. At the present time, personal savings have tended to rise above these long-term savings rates, probably reflecting concern of savers about the stability of their jobs, inflation-induced uncertainty about future living standards, and an effort to make up for the loss in the purchasing power of past savings. As inflation abates and the economy recovers, personal savings, if precedent is a guide, are likely to move back to their long-term rate.

Corporate savings have trended downward in recent years, if we correct for the overstatement of profits resulting from the inclusion of inventory gains, which contribute no investable funds. In 1974, this overstatement amounted to $35.1 billion.

For the small business sector, these macroeconomic profit data find a concrete counterpart in the behavior of after-tax earnings per dollar of sales in manufacturing. For firms with assets of less than $1 million, profits per dollar of sales have moved approximately in the very modest range of 1.5-3.5 cents. The high second figure reflects in part the difficulty many small businesses encounter in protecting themselves against the appearance of spurious inventory profits -- and the taxes thereon -- by resort to sophisticated accounting techniques such as LIFO (Last In First Out). I might add that small business profits, besides supplying resources for expansion, perform an important social function in diffusing profits among a large number of claimants. Thus, making more accessible to small business simplified forms of LIFO and accelerated depreciation would produce significant benefits in terms of greater small business savings.

The conclusion with respect to the outlook for saving is simple: with personal savings likely to return to historical levels, and with business saving, realistically stated, at a lower level, the key to an adequate flow of savings is in the hands of government, in particular the Federal Government. Historically the Federal Government has shifted back and forth between surplus and deficit with deficits preponderating by far in recent years. Thus the Federal Government has occasionally been a saver and supplier of capital to the economy, while more often it has been a net borrower, drawing capital from the private sector. In recessions, of course, the latter stance often has represented an appropriate fiscal policy. The danger that a Federal deficit might compete for savings with the private sector and "crowd out" some would-be borrowers rises as the limits of the private sector's ability to generate savings are being approached.

The full employment surplus is one measure of the stance of the Federal Budget, useful if correctly interpreted. It tells us what the surplus, i.e., the savings, of the Federal Government would be at a benchmark level of economic activity. At the present time, a plausible estimate of this hypothetical magnitude reveals that the full employment surplus is in fact a deficit of $10 billion. This estimate, which suggests that the Federal Government would be competing severely for capital with the private sector if we now were at full employment, does not, of course, tell us what would happen hereafter once the economy recovers from recession. If expenditures are held down, and taxes are not reduced further, the budget would move into substantial full employment surplus. But if expenditures increase at the pace of recent years while revenues rise only in response to rising economic activity, the prospect in my opinion is for a full employment deficit even at high levels of economic activity.

It may be useful to the Committee to note very briefly the results of a number of quantitative studies made by various experts concerning the outlook for the balance of demand and supply of capital. My reading of these studies is that a real concern is in order over the prospect of a capital shortage, although most of the authors would not agree with me and are in no way responsible for my conclusions.

Most of these studies essentially fall into two categories. One group arrives at fairly high estimates of the capital needs of the private sector, for much the same reasons that I have given in this testimony. Most of these authors, however, tend to assume that the government will produce a surplus and thus cover the capital deficit of the private sector. A second group, more realistically in my view, projects a Federal deficit. At the same time, however, this group tends to envisage a lower rate of investment in the private sector, which would make room for the government deficit. If the second group is right with respect to their expectation of a Federal deficit, a high rate of investment in the private sector clearly would produce a capital shortage.

A significant capital shortage clearly would be adverse to small business, as it would be for all sectors. This prospect, as I have noted, hinges essentially on the outlook for the Federal Budget.

In addition, however, there are problems of a financial order that need to be overcome if small as well as large businesses are to have adequate access to the flow of financing.

Today many businesses find it harder to finance because their liquidity has been drained. They have seen their capital structure deteriorate, with debt rising relative to equity, and short-term debt, at least until very recently, rising relative to long-term debt. A variety of measures has been suggested that would improve both conditions by raising cash flows and enabling enterprises, large and small, to improve their capital structure. Familiar proposals of this sort involve an enlarged investment tax credit, depreciation facilities more realistically recognizing inflation, tax deductibility of dividends, an outright cut in the corporate tax rate and, at the individual taxpayer level, adjustment of capital gains taxes for inflation, reduction in the capital gains rate for longer holding periods, and integration of personal and corporate income taxes. All these techniques have advantages. However, they mostly share the disadvantage 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 it is our objective 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. In order to accomplish this, I would suggest a sharp reduction in profit tax rates while at the same time including interest in the tax base. The same revenue could then be raised, as with the present higher rates under which interest remains tax exempt. This would diminish the present bias of the tax system in favor of debt financing. It would favor equity financing at no cost to the government, improve capital structures of business, and permit easier financing.

Implementation of such a tax on net operating income (interest plus profits before taxes) would, of course, require a phasing in process, to avoid the severe impact on enterprises with above-average debt that would result from sudden non-deductibility of interest, even at a moderate rate. This could be done by phasing in the change over a number of years, so that a growing fraction of interest paid would become nondeductible over time and a growing fraction of dividends would be taxed at the reduced rate. Alternatively, it could be done by applying the tax change to debt and equity issued after enactment.

The first method -- 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. The second method -- application to new debt and equity only -- 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.

It should be stressed once more that the foregoing tax changes would do no more than to improve the structure of business 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. Most of them share the defect of making the distribution of income more unequal. It seems desirable to emphasize tax and other reforms that would facilitate financing without such consequences.

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