THE EQUITY CAPITAL SITUATION

A personal statement by Thomas B. McCabe, Chairman of the Board of Governors of the Federal Reserve System, prepared at the request of a Subcommittee of the Committee on Banking and Currency of the United States Senate

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Until recently there has never been a general unwillingness on the part of investors in this country to take reasonable risks with their savings. At times we have experienced an actual shortage of savings, but rarely a significant lack of interest in risking those that were available if there was a prospect of sizable return. Such risk-taking had long been an American tradition. It resulted in the rapid development of our resources, expanding production, and a steadily rising standard of living.

At times the desire for speculative gains became so great that serious social problems arose, as, for instance, in the case of the common stock boom of the twenties, and it was necessary to adopt measures to protect the economy from such over-exuberance.

During the last two years we have been faced with the opposite situation. In spite of a large flow of savings, the market for common stocks has been sluggish in its response to what historically were stimulating circumstances of inflation and high earnings. Stock prices have continued low in terms of dividends as well as in terms of earnings. As the following table shows, common share values, measured in relation either to cash dividends or to earnings, have undergone a radical change since prewar:

INTEREST RATES, AND BOND AND COMMON STOCK YIELDS

	1949*	1948	1939	1929
Rates on commercial loans of banks, per cent	2.7	2.6	2.8	5.8
Bond yields (Aaa), per cent	2.7	2.8	3.0	4.7
Industrial common stocks:[1]				
Yield, per cent	7.1	5.9	3.9	3.8
Price/earnings ratio	7.0**	6.8	15.7	16.4

[1] From Moody's Investors Service and based on 125 stocks.
* First half.
** First quarter.

When the apathy to risk-taking reflected in these figures first became apparent it was ascribed to a natural "burnt fingers" reaction to the 1929-32 stock market collapse. Later a plausible reason seemed to be investors' fears of a serious postwar depression. However, by now it appears that this apathy may go much deeper. Clearly its persistence is to be viewed with concern.

As everyone recognizes, the supply of equity or ownership capital is of vital importance to a dynamic, expanding economy. By equity capital I mean those funds supplied to a business which do not involve any fixed lien or debt obligation and on which no fixed return is guaranteed. Equity capital is essential to a business because it permits growth and risk-taking without fear that a temporary period of poor earnings will mean hardship. The use of equity rather than borrowed capital by industry renders the economy less vulnerable to debt liquidation. Moreover, enterprises which maintain high equity ratios are better able to get credit if it is needed under any economic conditions. Thus the sources, availability, and flow of equity capital are of primary importance as they relate to the national objective of economic stability at high levels of production and employment.

Stock financing by business corporations has been particularly low since the fall of 1946. New common stock issues have averaged only about 10 per cent of total new corporate security issues. In earlier periods of expanding economic activity the ratio averaged approximately 15 per cent. Since the fall of 1946 businesses have obtained funds for capital outlays primarily from bank and insurance company loans, and new bond issues and retained earnings, rather than from sales of stock on the market. In the interests of economic stability it is always better if both large and small business enterprises finance more of their investment expenditures with equity and less with borrowed capital.

I should like to discuss three major aspects of the equity capital situation as follows:

(1) Why are individuals not buying more shares in business enterprises?

(2) Why are business enterprises not obtaining more funds through stock sales?

(3) What, in my judgment, can be done about the situation.

WHY ARE INDIVIDUALS NOT BUYING MORE SHARES IN BUSINESS ENTERPRISES?

Desire for Security. There is no single reason why investors do not buy equity shares in business.

[1] A personal statement by Thomas B. McCabe, Chairman of the Board of Governors of the Federal Reserve System, prepared at the request of a Subcommittee of the Committee on Banking and Currency of the United States Senate.
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We know that the volume of individual savings today is tremendous, and it is not therefore a shortage of available funds that prevents people from buying stock. I am firmly convinced that an important reason for people not buying common stocks is the increased emphasis which they place upon security and safety of their savings rather than upon prospects of gain. Security rather than opportunity has recently become more and more a part of our national philosophy. The disappearance of the frontier and the end of geographic expansion, the unsettled state of international affairs since the turn of the century, and the dark memories of financial collapse and depression in the early thirties have caused people to seek security in investment as well as in Government intervention to mitigate economic and social disparities and instability.

The desire of individuals for safety in investments has been revealed in the Surveys of Consumer Finances conducted in postwar years for the Board of Governors of the Federal Reserve System by the Survey Research Center of the University of Michigan. These surveys suggest that an overwhelming majority of the population as a whole save primarily for security reasons, such as for a rainy day, old age, and emergencies. In the survey conducted early in 1948, covering all groups in the community, 62 per cent of those interviewed were opposed to holding common stock in business enterprises. Twenty-six per cent felt that such securities were not safe, while 30 per cent were not familiar with stock as an investment opportunity. In interpreting these results it should be remembered, of course, that ownership of common stock has never permeated all groups in the community.

The emphasis on safety is reflected in the large volume of individual savings currently being held in the form of Government bonds; of deposits, shares, and reserves in such noncommercial bank and financial institutions as life insurance companies, savings and loan associations, and savings banks; as well as of reserves in private and Government pension and trust funds. A large proportion of individual savings is channeled into these types of investment. In 1948, for example, the flow of individual savings into life insurance companies, savings and loan associations, and mutual savings banks alone totaled almost 6 billion dollars. The flow of funds over the past fifteen years into these channels exceeded 48 billion dollars. For the most part, investment in common stock by these institutions is prohibited or closely restricted by State or Federal statute. For example, the State of New York, home of many large life insurance companies, while permitting life insurance companies to purchase preferred and guaranteed stocks that meet certain tests, prohibits them from purchasing common stocks. The fact that the dollar volume of funds flowing through recognized savings institutions is now greater than ever before has been a major influence in the recent large supply of debt relative to stock money available to business enterprise.

Increased Taxes. The increased rates of taxation imposed to finance the Government's heavy expenditures of recent years is another factor that has affected the flow of individual savings into business equities. High taxation at prevailing levels of national income, however, seems to be affecting the incentives to invest much more than the availability of funds. The dollar volume of individual saving and the volume of such saving in the hands of individuals with relatively large incomes are now much greater than they ever have been. In addition, the proportion of incomes that people save has been considerably greater since the end of the war than it was in prior prosperous years. In 1947, the 10 per cent of individuals with highest income (roughly $6,000 upwards) were still responsible for somewhat over half of the total volume of saving and the dollar volume of saving by these individuals was far above that of earlier prosperous years. However, since the highest rates of the progressive income tax apply to this group, their incentive to invest in risk assets that may yield high returns is outweighed by the advantage of tax-exempt investments.

Tax-Exempt Investments. The investment of upper income savings in State and local government securities and insurance policies has been accelerated by the tax-free status of such securities and, for practical purposes, of all life insurance company investment income. The technical problems involved in applying individual income taxes to State and local security holdings and life insurance investment income are numerous and difficult of solution. There is no question, however, that the current tax-free status of these forms of income has drawn funds of many wealthy individuals away from investments in the common stock of business enterprises.

Small Cash Dividends Relative to Earnings. Some investors are not buying more stock because they observe that many companies are retaining a large proportion of their earnings rather than paying dividends. The new stock money that businesses might obtain if they paid out higher dividends would have to be balanced, of course, against the smaller volume of retained earnings directly available for investment expenditures. More thought and study might very well be given to the relative advantages to the nation of the *form* that equity financing takes, that is, equity financing through the use of retained earnings as compared with proceeds from stock sales. One aspect of the problem is the extent to which the former method substitutes decisions of a board for those of the free market in allocating capital among industries and firms.

Lack of Knowledge. Despite the general trend to safety and security there are many who are willing to take the risks and invest their funds in expectation of gain. Among these are a new group of people with savings, including farmers, skilled laborers, proprietors of small businesses and professional men. Many of these potential investors, however, lack knowledge about stock investment.

Why Are Business Enterprises Not Obtaining More Funds through Stock Sales?

There have been powerful inducements for business enterprises to finance their recent expenditures in ways other than through stock sales.

High Cost of Equity Capital. Perhaps the most important of such inducements has been the low cost of debt money both absolutely and relative to the dividend disbursements prevailing on common stocks. Interest rates on bank loans and long-term bond money, as is indicated in the above table, are currently much below those of previous years while yields on common stocks are exceptionally high. This reflects in part the unwillingness of the public to buy stocks, as previously mentioned.

Availability of Retained Earnings. An especially attractive source of equity funds has been undistributed profits. This form of equity capital has been a very important source of business funds since the end of the war. Undistributed profits can in a sense be considered free of carrying charge, for their volume is determined by management decisions concerning dividend disbursements. In 1948, a year of abnormally high profits in relation to capital investment, business corporations as a group retained over half of their profits after income taxes as compared with less than a quarter in 1929. Inventory profits, however, represented a much larger proportion of earnings in 1948 than in 1929. Inasmuch as these inventory profits were the result of price increases and might be offset in whole or in part by subsequent inventory losses resulting from price declines, they were considered in many cases to be unavailable for distribution as cash dividends. In addition, depreciation charges based on original cost are, because of postwar price increases, insufficient to provide for replacement of fixed plant and equipment at current prices.

As was mentioned earlier, these decisions of corporate managements to retain a larger proportion of earnings have probably had some effect on the failure of stock prices to rise. Had dividend disbursements been larger, undoubtedly stock prices would have been more attractive and more new stock issues would have been sold.

Study of stock market behavior over the period 1895-1946 indicates the prices of stocks have fluctuated more closely in relation to dividends than to earnings. This suggests that investors attach more significance to dividends derived from stock ownership than to reported earnings. In the recent inflationary period investors have been especially uncertain as to whether undistributed earnings would eventually result in higher dividends and capital gain.

Tax Advantage of Debt Financing. The tax structure has also affected the businessman's choice as between debt and equity financing. In the case of corporate enterprise, interest on debt is a business expense and therefore a deduction in determining earnings subject to taxes. After these earnings have been reduced by the full amount of the component income tax, any dividends paid from the remainder to individuals are included in their taxable income. These aspects of the tax structure provide a strong inducement for corporations to finance their expenditures with debt rather than equity capital. The fact that interest payments are, and dividend payments are not, deductible from corporate income in computing taxes means that the spread between the cost of stock and bond financing *after* allowing for the tax advantages of bond financing is appreciably greater, as the following illustration shows:

COST OF $5,000,000 OF NEW EQUITY VS. DEBT CAPITAL

	Company A	Company B
Capital Structure (after flotation)		
Bonds—3% coupon*....	$ 0	$5,000,000
Common stock.........	9,500,000	4,500,000
Surplus...............	500,000	500,000
Total Capital........	$10,000,000	$10,000,000
Earnings for current year		
Before taxes and fixed charges..............	$1,000,000	$1,000,000
Less: Bond interest.....	0	150,000
Before Federal income taxes...............	1,000,000	850,000
Less income taxes (38%).	380,000	323,000
After Federal income taxes...............	620,000	527,000
Less Dividends on common stock at 7%*....	665,000	315,000
Balance transferred to surplus..............	$−45,000	$212,000
Charges applicable to new capital		
Interest on bonds......	$ 0	$150,000
Additional income tax..	57,000	....
Dividends on additional stock...............	350,000	....
	$407,000	$150,000
As a % of new capital raised..............	8.14%	3.00%

* Current yield, as per table, page 1.

MY SUGGESTIONS AS TO WHAT CAN BE DONE ABOUT THE SITUATION

I should like to make certain suggestions which I think will help solve this problem of the impediments to businesses which might wish to sell, and the reluctance of investors who might be induced to buy, common stock. As such, these suggestions do not necessarily represent the views of the Board of Governors.

Taxation. My first suggestion is that Congress initiate a thorough review of the tax situation from the point of view of its effect, frequently inadvertent, upon the availability of equity capital. Unfortunately there never seems to be a convenient time for such a basic review of the tax structure. Last year, when we had a substantial surplus, we elected to reduce taxes without revamping the tax structure. Now with deficit financing facing us, we naturally do not want to do anything that will cause even a temporary loss of revenue. Therefore, a fundamental study that would lead to reform of the tax system tends to be neglected and postponed in times of receding business as well as in times of prosperity. We should, however, realize that basic inequities may exist, and decide upon a long-term corrective program. The indicated changes can be made as the opportunity occurs. Among the many suggestions that have been made, the ones discussed below seem to me the most important.

There is no doubt that some additional investments in corporate equities would result from a reduction of income tax rates, particularly those applicable to the higher brackets. It is difficult to tell how much additional investment would be induced by a given lowering of tax rates. Since the aggregate amount of income in the high tax brackets is relatively not large, only a small volume of funds out of current income would be directly made available for new investment by a reduction in the personal income tax rate in those brackets. However, the indirect effects in attracting previously accumulated wealth that is now held in forms other than equity investment, might be significant.

Some attention should also be given to the problem of tax exemption of individual income derived from State and local government securities and the tax status of life insurance company investment. Revision of this type of exemption might divert some individual savings from such securities, annuities, and insurance to listed stocks or small business enterprises.

There is another type of adjustment of the personal income tax structure that should be considered in connection with the equity capital situation, that is, more liberal provisions for carrying forward and backward losses growing out of business operations. Such a change in the tax structure would encourage direct investment by owners of small unincorporated enterprises and partnerships.

Another feature of our income tax structure to consider is the double taxation of corporate dividends. There is little reason on equity grounds to tax both the corporation and the individual investor on the same income. However, there is the practical problem of levying a tax on that part of corporate income not paid out in dividends and therefore not received and taxed as personal income. One solution to this problem that has been proposed is to continue a moderate corporate income tax and permit corporations to deduct from their taxable income the dividends they pay to stockholders. An alternative solution, one which was previously advanced by the Magill Committee, is that of allowing individual taxpayers credit for taxes paid by the corporation in computing their tax liability.

If the basis of corporate income taxes were to be changed in the manner suggested Government revenues from this source would undoubtedly decline somewhat, though not by an equivalent amount. The Congress would of course have to devise alternative taxes to offset their decline in revenue, but the potentialities for stimulating productive investment of equity capital are sufficiently promising to warrant such action.

Attention might also be directed toward a revision of the tax laws which would permit more rapid depreciation of plant and equipment. Allowing business concerns to amortize the cost of additions and betterments over a relatively short period of time, and to deduct these depreciation charges in computing their taxable net income, would provide a stimulus to business investment at this time. Moreover, by permitting larger tax-free recovery, through increased depreciation charges, of funds invested in plant and equipment, the short-run contraction of internal sources of funds that characterizes a downward drift in business activity would be lessened.

A final feature of the income tax problem is the treatment of capital gains and losses. The volatility of capital gains over a period of time deserves more consideration than it has received. From an investment point of view some of the objections to the capital gains tax might be met if a method were devised enabling individuals to average their capital gains and losses over a number of years in order to determine their taxable income. However, I mention this only in passing, as it is a complicated question and one which would require careful study.

Life Insurance and Fiduciary Investments

My second major suggestion for alleviating the equity capital problem would be that consideration be given to a liberalization of the investment opportunities open to fiduciary institutions, particularly the life insurance companies. In view of the large volume of individual savings flowing into private pension and insurance reserves, the legal restrictions on insurance companies and other fiduciaries which prohibit them from investing in corporate stocks should be reviewed. These restrictions, rightly established many years ago as safeguards needed at that time, may, in the light of changed savings and investment patterns, now be out of date. I recommend that the life insurance companies, in cooperation with the proper State authorities, explore fully the opportunities for investing in common stock with the aim of modifying these restrictions.

Two of the most common arguments against relaxing the legal restrictions on the investment opportunities of life insurance companies and fiduciaries are:

(1) The risks of equity investments.
(2) Possibility of a concentration of industrial control in large life insurance companies.

I agree that there is a certain element of risk involved in the ownership of equity shares. Yet there is little ground in past experience to support the broad premise that many permitted bond investments involve less risk than carefully selected common stock. In general I feel that informed and flexible investment policy together with sound judgment are much to be perferred to rigid legal restrictions. The experience of endowment funds of educational institutions, as well as of the fire insurance industry, which operate under more liberal investment regulations, has demonstrated that diversified investment in common stocks along with other types of securities can produce better than average return.

In order to prevent domination by the life insurance companies of individual companies or industries, or unwarranted risks of investment loss through common stock ownership, such investment should be carefully prescribed by appropriate legislation. Some such formula as the following might be employed, e.g., investment of any one life insurance company in the common stock of a business enterprise might be limited to one per cent of the outstanding voting shares or $1,000,000, whichever is larger.

Education and Merchandising

I would like to urge those engaged in marketing securities to give extraordinary consideration to ways and means of informing the public more fully about the investment opportunities in stock ownership. It should be recalled that 30 per cent of the individuals interviewed in the 1948 Consumer Finances Survey conducted for the Board of Governors of the Federal Reserve System said they were against holding common stocks because they were not familiar with them. Moreover, some of the largest gains in income since the prewar period have been among groups like farmers, skilled laborers, proprietors of small businesses and some professional people whose knowledge of common stocks is very limited. These facts pose an educational and merchandising challenge to those engaged in marketing securities.

There are, of course, many problems involved in the merchandising of risk investments to the general public. We do not want the overselling of stocks to receivers of small incomes that characterized the years of the late twenties. There are many small income recipients who should not assume the risks of business ownership. But it seems clear that certain merchandising adjustments can and should be made. There should be an adjustment to a changing market and more adequate attention given to the majority of upper-middle-income savers who invest, rather than focus on the minority who trade in equity securities.

I doubt if the great majority of small investors are familiar with investment trust shares. Investment trusts have diversified holdings of preferred and common stocks and other securities, and thus can offer the small saver diversification of risk together with the higher income to be derived from equity shares. There has been a great increase in the amount of new money placed in investment companies since the passage of the Investment Company Act of 1940. During the four years 1945-48 sales of new open-end investment company shares totaled almost 700 million dollars. Although investment company funds are rarely used to buy new issues of securities, purchase of existing issues supplies sellers with funds for the purchase of new issues and by helping to maintain a strong market may encourage the sale of new stock issues.

Considerably more attention could be given by corporations themselves to cultivation of the market for future equity financing. Certain ones have gone to great lengths to prepare their future market by giving the general public, particularly their stockholders, more information about their operations, their financial position and their earnings. Some companies have also cultivated equity ownership by their employees. Such ownership can improve working relationships and enhance community goodwill toward the company as well. This and other measures of developing good public relations in the areas in which the company's plants are located often results in a high percentage of stock ownership in those areas.

New Financing Agencies

There might still remain a long-run equity capital problem for business even if legislative changes in regard to taxation and investment outlets for fiduciary institutions were feasible and if distributors of common stock and businesses themselves did a more aggressive job of informing the public about the advantages of stock ownership. Many individual concerns, particularly small ones, do not at present have convenient access to the savings potentially available for investment in equities and others have no access to such funds at all. In the long-run, there may be a need in this country for new types of financing agencies to meet this problem, particularly for the channeling of equity capital to small and medium-sized enterprises. At least three types of financing agencies have been suggested and deserve further consideration:

(1) Private financing companies;
(2) Special community funds and development corporations; and
(3) Capital banks.

Examples of the first two types of financing agencies are already functioning. An illustration of the type of private financing company I have in mind, which I shall not mention by name, is a corporation which obtains money from insurance companies, trust funds, research and educational foundations, established investment companies, and individuals, and invests such funds in equities of new and established business concerns that have some product or process to be developed that is of scientific importance. Thus, the corporation provides a channel whereby equity risks can be pooled and financed, in part at least, by previously unavailable funds of fiduciary institutions.

Community development corporations are usually privately sponsored and obtain their funds from leading citizens and established business enterprises in the community. Their primary purpose is to bring enterprises that need capital into contact with a pool of funds composed of small amounts of money that might separately not be available for investment. These plans have the advantage of diversifying risks and yet at the same time leaving the financing decisions with local individuals who are familiar with the capabilities of the business men in their communities. Among the communities with prewar plans that are still operating are Baltimore, Maryland; Louisville, Kentucky; and Easton, Pennsylvania. More recent plans aimed at aiding the reconversion or relocation of business concerns after the war have been developed at Albert Lea, Minnesota and Ashtabula, Ohio.

The capital bank proposal has been advanced by many individuals and organizations in the past and most recently by the Committee for Economic Development. The general purpose of the proposal is to add to our present banking structure a set of new banks to provide long-term loan and equity capital to business, particularly to small enterprises.

Concluding Remarks

Thus far I have treated debt and equity financing largely as alternative means of raising capital for a business enterprise. This emphasis may create a somewhat distorted impression of the part which each plays. Debt and equity are actually complementary ways of financing business though they must be properly balanced in order to achieve a sound financial structure.

There is another aspect of the relationship to which attention should be directed. We generally assume that debt expansion increases the financial resources of a business, and that debt repayment reduces those resources. This is a correct view in the short-run, but over the longer-run, debt financing may be a means of building up equity. I have reference to debt incurred on a basis that calls for its gradual repayment out of the retained earnings of enterprise. Thereby, resources originally acquired with borrowed capital are gradually refinanced out of equity capital. Over the past two decades, there have been important technical developments along these lines in the credit field. The five to fifteen year term loan extended by many larger banks and most insurance companies, with repayments budgeted in accordance with expected earnings, is an illustration of this type of credit. Another example is market borrowing through the convertible debenture. This type of obligation offers important incentives to management to retain earnings in order to expand operations and build up profits so that holders will be induced to convert their bonds into the company's common stock.

As you will gather, I am a confirmed optimist regarding the future of America. I firmly believe that the basic characteristics of our economy are expansion and growth. Economic expansion today presents a strikingly different challenge from that of a hundred years ago. Then, the frontier of development was the opening up of our great western resources. The geographic frontier is gone, but we still have a frontier of development. That frontier is technology—the technology of producing more and better goods with the resources we know are available and the technology of distributing those goods on a mass basis for the constant improvement of the standard of living of all. To realize our potential sustained expansion, we need to be concerned with assuring a steady and adequate flow of savings into equity ownership. I sincerely believe that if we are in earnest, ways and means can be found for accomplishing this purpose that are fair and equitable to everyone concerned.