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Statement by  
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Before the  
Committee on Banking, Housing and Urban Affairs  
of the  
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It is an honor to appear before this distinguished Committee to present comments, on behalf of the Board of Governors of the Federal Reserve System, on the "Investment Policy Act of 1976." The Board endorses this legislation and wishes to identify several considerations relevant to the formulation of a national investment policy.

The bill stresses the need to "provide sufficient incentive to assure maximum investment in private enterprise in order to increase the production of goods, the providing of services, the employment of workers, the opportunity for profit, and the payment of taxes." The proposed legislation gives particular emphasis to investment in plant and equipment, but it also points to the importance of the allocation of resources to education and training and the desirability of an "environment in which each citizen has the opportunity and is encouraged to achieve his or her full economic potential." In addition, the importance of human, financial and material resources in international competition is stressed.

#### Some Recent Investment Trends

The American economy is one of the most productive in the world. Nevertheless, as the bill states, "business enterprises in other nations have made very large and significant investments in proportion to their nation's gross domestic product..." In a number of countries the share of GNP devoted to saving and investment substantially exceeds that share in the United States. Comparisons

of this sort are difficult to make with precision, and inferences drawn from such comparisons are necessarily tentative. Moreover, we should bear in mind that in the United States a very substantial investment is made in human beings through the high proportion of American citizens who have benefited from higher and advanced education. But it would be difficult to controvert the view expressed in the bill that "many non-United States business enterprises..." have been able to "... improve their competitive positions vis-a-vis similar United States enterprises." It should be noted also that while investment in physical facilities is by no means the sole determinant of the rate of economic growth, it nevertheless is an important one, and one over which national policy can exert a favorable influence.

In recent years, trends in the area of capital investment have not been particularly favorable in the United States. For instance, over the years 1948-1966, the productivity of capital was nearly constant, falling only 2.5 per cent over the entire period. From 1966-75 however, it fell 15 per cent, or at an average annual rate of 1.7 per cent. Thus in the later period, more capital was required, or at least being employed, to produce a unit of output, than during the earlier period. This result would not be materially affected if one were to base the calculation the real gross stock of capital. The recessions of 1969-70 and 1974-75 may have contributed to this outcome, but the data nevertheless suggest that our capital needs, relative to output, have tended to increase of late.

A similar impression is obtained when we look at the improvement in the productivity of American labor that can be expected from more and better plant and equipment. Over the years 1947-1966, productivity per hour increased at a 3.4 per cent annual rate. During 1967-1974, productivity advanced at only 1.6 per cent. While in part this slowing of productivity no doubt reflects the onset of the recession of 1974-1975, it may also suggest that additions to the capital stock have been insufficient. And, indeed, it should be noted that, using a different set of data and different time spans as dictated by data availability, while during 1960-1969 the net capital stock rose at 3 per cent per year relative to the labor force, during 1969-1975 this increase was only 1.1 per cent per year. These data suggest that American workers enjoyed greater improvements in the amount and quality of the equipment with which they were working during the earlier years than they did of late.

The impression conveyed by these data of a diminishing adequacy of investment in recent years is supported by new data on manufacturing capacity and capacity utilization developed by the staff of the Board of Governors. For the period 1955-1976, manufacturing capacity on average seems to have grown at a rate of 4.3 per cent per year, roughly commensurate with the rate of growth of GNP of which manufacturing represents about one-third. The average, however, is deceptive. For instance, during 1960-1969, manufacturing capacity rose at 5.2 per cent per year. During 1969-1976, this growth diminished to 3.4 per cent per year. To some extent, the apparent slowdown in

capacity growth may be misleading, because businessmen during the period of controls and shortages of the early 1970's may have scaled down their perception of how much they could produce. Nevertheless, the general thrust of the data on manufacturing capacity is in line with the findings mentioned earlier with respect to the total capital stock.

The Federal Reserve Board has recently revised its estimates of manufacturing capacity and its rate of utilization. The new data indicate that capacity had been overestimated, and that consequently utilization had been understated. The revisions show that utilization has been substantially higher than earlier believed. For the third quarter of 1976, capacity utilization in manufacturing is now estimated at 80.9 per cent, in contrast to the formerly published rate of 73.6 per cent. The quarterly high point of utilization for the new series, achieved in 1973, was 87.8 per cent, contrasted with a previous estimate of 83.3 per cent. Since bottlenecks were widespread in 1973, one must conclude that a peacetime utilization rate of 88 per cent may be exceeded only with considerable difficulty and with seriously adverse consequences for price stability. At the present time, the gap between current capacity utilization and the peak rate reached in 1973 is about 7 percentage points.

#### The Outlook for Investment, Saving, and the Flow of Financing

The investment objectives which the bill enumerates point in essence to three questions:

- (1) What volume of investments will be needed?
- (2) What amount of saving will be available?

- (3) Will private enterprise be able to draw effectively upon these savings in order to employ them in productive investment?

I would like to comment in turn on each of these questions.

Volume of Investment

Numerous studies have been made of the investment requirements of our economy over the next five or ten years. These studies arrive at a very considerable degree of agreement about what is needed. I shall state the conclusions in terms of per cent of GNP, in order to avoid the misleading and quite unnecessary alarm that tends to be generated by cumulating multi-billion dollar figures over long periods of time.

On the whole, the studies conclude that the historic shares of GNP which have been devoted to total private investment and to the sub-category of business fixed investment of about 15 per cent and 10.5 per cent respectively need to be raised moderately. An additional one-half to one percentage point of GNP, or about \$10-20 billion a year, seems to be a reasonable number. The effort required to bring about such a change is not a minor one since in an economy working close to capacity other claims on the GNP would have to be reduced. From the point of view of the bill, it is the share of business fixed investment in particular that needs to be borne in mind.

There are factors that raise investment requirements as well as others that reduce them. Additional requirements are called for by

energy needs, environmental requirements, health and safety oriented installations, construction for the needs of a growing number of elderly persons, and general investment to make up for any shortfalls in recent years as well as possible declines in the productivity of capital. Partially offsetting these new requirements are demographic variables implying reduced construction activity.

If the increases in the rate of investment noted above materialize, the economy should be able to meet the purposes of the bill with respect to production, employment, profit opportunities and payment of taxes, although perhaps at a somewhat lower growth rate of its potential than during the 1960's and early 1970's.

The Supply of Savings

Personal saving, corporate retention of profits, and business depreciation allowances are the principal sources of supply of capital within the private sector, if we abstract from the possibility of net capital imports. The bill notes that "improvements in plant and equipment and the financial resources for working capital are affordable only from savings." The studies of future investment needs and savings availabilities to which I have referred differ more significantly for estimates of savings than for investment needs. The average of these savings projections is very close to the historical average of 5 per cent of disposable personal income prevailing from 1965 to 1974. During 1976, the personal savings rate has been close to 7 per cent. Some students of savings behavior have hypothesized that the savings rate may decline as the relation of assets to income recovers from the attrition that it has suffered through inflation. It has also been hypothesized that the savings ratio has been adversely affected by more satisfactory provision for old age through social security and Medicare.

Corporate savings, including depreciation allowances, have been severely distorted by inflation. Inventory profits do not add to investable funds, and depreciation based on original cost does not cover replacement cost when prices are rising. The bill notes the need for additional financing of inventories and the higher cost of replacement of fixed assets. Corporate profits were severely eroded

during the early 1970's as restatement of profits corrected for inflation indicates. After such adjustments, it becomes apparent that in 1974 domestic nonfinancial corporations paid out in dividends more than they earned so that retentions from profits become negligible. Meanwhile, profits and retentions have recovered significantly. Nevertheless, inflation-adjusted after-tax profits for domestic nonfinancial corporations as published by the Department of Commerce have averaged only about 2.3 per cent of GNP in recent quarters. During the middle 1960's, when capacity was growing rapidly, they averaged about 4 per cent. I need hardly add that these data point a lesson: a revival of inflation would once more do severe damage to corporate cash flow and saving and to private investment. By the same token, one of the strongest contributions we could make to private investment is to bring down inflation so as to achieve reasonable price stability. An optimistic view of the future evolution of corporate profits and dividends, therefore, is needed to arrive at the belief that the sum of personal and corporate savings will be equal to investment requirements. Such a balance of savings and investment will be needed in order to meet the objective of the bill to "create an economic environment in which there will be the incentive to invest sufficiently and to allocate an adequate portion of savings for investment in necessary plant and equipment and in working capital ...."

The precarious balance at which these projections arrive between the demand for and the supply of capital in the private sector leaves the public sector and especially the Federal Government in a key position as the marginal supplier -- or user -- of savings. At a time of low investment, as at present, a large deficit in the public sector can and indeed must be accommodated. Under conditions of high investment, such as are anticipated by the studies referred to and by the bill, a public sector surplus will probably be required in order to supplement private sector savings and to meet the requirements of the legislation. A budget surplus adds to the nation's savings, just as a deficit absorbs savings. It may well be that the increase in investment that seems to be needed will have to be matched by a corresponding Federal surplus in order to allow the added investment to be financed. I would interpret the provision of the bill calling for an investment policy report by the President as part of the annual Economic Report to the Congress as dealing in part with this subject.

#### The Flow of Financing

Given an adequate overall supply of saving, there remains a need to channel an appropriate part of these savings into business investment and working capital. This is the process referred to by the bill in the passage cited above calling for "an economic environment in which there will be the incentive to invest sufficiently and to allocate an adequate portion of savings for investment in necessary

plant and equipment and in working capital ...." Until very recently, this process was suffering from severe distortions that, unless halted and indeed reversed, would interfere seriously with the smooth flow of saving into business investment, i.e., with the process of business financing. Over many years, external financing of business increased relative to internal financing. Within the growing component of external financing, the share of debt rose relative to the share of equity financing, and within debt financing short-term debt rose relative to long-term debt.

A good start has been made over the last year or two in correcting these conditions. Internal financing has increased thanks to better profits and cash flow. The relative weight of short-term debt has been reduced through consolidations into long-term debt and also thanks to the relative reduction in inventories. Business has also made efforts to shore up its equity capital positions through the sale of additional corporate stock. But conditions have not been propitious and the dollar amount of new issues of common and preferred stock have not yet duplicated the pace prevailing in 1971 and 1972 although nominal GNP may be about 44 per cent higher in 1976 than in 1972. The stock market, in real terms, i.e., making allowance for inflation, currently is at approximately the level of 1958-1959, as measured by the Standard and Poor's 500 stock index. Contributing to this has been a shrinkage in equity ownership, particularly on the

part of individuals. The share-owner population, as shown by the New York Stock Exchange 1975 census, declined from 30.7 million persons in early 1970 to 25.2 million in 1975. Mutual funds, another important vehicle for common stock participation, have posted net redemptions almost continuously since 1971. Price/earnings ratios, as measured by Standard and Poor's 500 stock index, declined from more than 17:1 during the 1960's to less than 13 in most of 1976, despite the fact that this index represents by and large the stronger sector of public corporations. Legislation that pursues many highly desirable purposes, such as ERISA (Employee Retirement Income Security Act), has had the unfortunate side effect of discouraging equity investment by pension funds. The market has been notably unreceptive to new issues of small, venture-type enterprises and of other than financially strong firms generally. Conditions such as these are unlikely to be supportive of the purposes of the legislation.

The Congress has set in motion efforts to improve conditions of equity financing through legislation favoring the growth of employee stock ownership plans (ESOP's). The Javits-Humphrey "Employee Stock Ownership Fund Act of 1976" was introduced as a means of broadening this effort. A study sponsored by the Joint Economic Committee, Broadening the Ownership of New Capital: ESOPs and Other Alternatives, examined the European institution of wage-earners' investment funds, which permit contribution of a firm's stock to a diversified national fund in lieu of money wages as part of a collective bargaining agreement.

The tax system could be employed to implement the investment goals of the bill. Investment and saving could be stimulated by appropriate tax measures. Stock ownership could be broadened, capital mobility could be increased, the present bias of the corporate tax against equity financing could be reduced, research and technology that help to propel investment could be favored. Needed stimulation of investment could work through the influence of tax reform on the amount that households and corporations can save, on the volume of savings invested in common stock, on the ability of capital to move from less productive to more productive uses, and in favor of reducing the tax-law's bias toward debt and against equity financing.

A variety of tax devices could be employed for these purposes and I list a few that are frequently suggested because I believe that they call for closer examination. A look could be taken at the capital gains tax and its influence on capital mobility, willingness to purchase equities, and the supply of savings. The integration of the corporate and personal income tax offers opportunities with respect to the same objectives. The potential of the investment tax credit to stimulate investment and perhaps encourage research and innovation may not yet have been sufficiently examined. Changes in the tax status of dividends and interest could contribute to a better structure of corporate finance. It would seem appropriate that the

Investment Policy Report required by the bill which is to review Federal programs and other economic conditions affecting capital investment in the United States examine the feasibility of proposals of this kind.

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