Saving, Investment and Capital Shortages

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The importance of saving and investment to the American economy are discussed.
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by

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To meet the challenges of the future—they come upon us in the new year—our country needs an economic environment more conducive to private saving and investment, and economic policies and legislation that will bring it about.

Engineers usually understand the pivotal role of capital investment in providing the basis for the future standard of living—for increasing productivity and thus giving society an opportunity to dampen inflationary pressures as real income rises. Regrettably, a great many of our fellow citizens lack that economic sophistication, at least for the present.

As an educator, I find it amusing when my students discover Maoist economists writing about the need to hold down consumption in the Chinese economy to free up the capital resources needed to invest in the future growth of that economy. “Why, they are not even a capitalistic society,” they will note in wonderment. Then the thought will sink in—sometimes with a little faculty assistance—that a rising stock of capital is necessary for any growing society, capitalistic (i.e., private enterprise or market-oriented) or otherwise. It is really a basic matter of how much we want to eat, drink, and be merry today—and how much we want to set aside for the future. Boiled down to its fundamentals, assuring an adequate flow of saving and investment is little more than demonstrating a proper concern for the future.

But a more technical set of problems faces the serious student of what I call “capital adequacy” in the United States. Frankly, it is very awkward to talk about capital shortages at a time when so many American industries report excess capacity. After all, current manufacturing output is about one-fifth below the potential it could be at normal operating rates. It is no less awkward to urge reducing emphasis on consumption at a time when the average consumer has experienced a marked reduction in his or her real living standard. Despite the recovery to date, real consumer outlays per capita fall below what they were at the start of the recent recession.

Moreover, at least one prestigious New York City financial institution deplores the very notion of capital shortages, noting that in every period the total flow of saving inevitably winds up equal to the amount of investment made. Meanwhile, a large Washington-based research organization tells us that, for a very considerable future period, sufficient savings are likely to be forthcoming to meet anticipated investment requirements.

Given the well-nigh universal propensity of virtually every element of the society to advocate cutting its taxes—and/or increasing the expenditures devoted to the causes that it favors—should we not dismiss the continued pleas for national policies to foster more saving and investment as merely misguided or self-serving appeals on the part of higher-income segments of the population? Certainly, many will respond to that question with a loud and unequivocal “Yes.”

Those familiar with my views know that I believe that there are important reasons to be concerned about the future adequacy of saving and investment in the United States. Yet, in passing, I feel obliged to point out that the naivete and exaggeration on the part of some of the proponents of the capital-shortage notion inevitably have triggered adverse reactions.

In what follows, I take up four key aspects of capital formation: First, a necessary distinction between short-term conditions and longer-term needs; second, a basic understanding of the process by which a sluggish potential flow of saving is made to equal what appears to be an excessively robust set of investment demands; third, an excursion into the never-never world of long-term economic forecasting; and fourth, the role of public policy, both in influencing the flow of saving and investment and in meeting other national priorities.

Short-Term Glut Versus Long-Term Shortage?

First, to clear the air, I would say that, as a general proposition, under most conceivable cir-
circumstances, there will not be widespread shortages of productive capacity in the U.S. in the coming year or two. In effect, I am saying, let us not cry wolf.

But by its very nature, capital investment is much more a matter of the future than of the present. If, for example, we are to meet the likely growth in power needs during the 1980s, this nation must make the necessary investments in new capacity today (some would have chosen yesterday).

Capital investment surely is the prime example of that extended economic process where it is foolish to hold your fire until you see the whites of their eyes, or the green of the consumer's demand.

Viewed in a more fundamental way, new investments of various kinds—physical capital, so-called human capital in the form of education and training and R&D—provide the rising productivity and output which in turn fundamentally support sustainable increases in consumer living standards.

To a very considerable extent, the economic policies to be followed in the coming year will be major determinants of the economy's ability to avoid widespread shortages, at least for the period until 1980. To the extent that monetary and fiscal policy will remain on the relatively modest course that has now been set, existing and planned increases in plant and equipment should generally be adequate to the economy's demands through most of the 1970s. To be sure, sporadic shortages of specific industrial supplies are likely to arise from time to time, as they have in the past. After 1980 the prospects seem less optimistic, and will depend on the enactment of some of the specific proposals that I will present a little later.

Should, however, the President and the Congress adopt a far more expansionary set of policies, then we might soon find the economy pushing the limits of industrial capacity, particularly in such key sectors as steel. Allen Sinai and Roger Brinner have estimated the consequences of a more stimulating policy—one characterized by average annual growth rates of 9-10% in the money supply and a fiscal policy eased by $15 billion of additional tax cuts in 1976. Under that alternative, they estimate a capital shortage by 1978, in both the financial and physical senses.

Short- and long-term interest rates, under the "stimulation" scenario, would soar to double-digit levels. The accompanying bottlenecks in production would rapidly push prices up in chemicals, plastics, lumber, paper, textiles, metals, metal products, machinery, and transportation equipment.¹

Those who scoff at the possibility of a capital shortage and simultaneously urge a more expansionary economic policy would seem to be plainly inconsistent in their analysis.

Equating Saving and Investment

Some economists, as well as others, seem to be offended by studies that show—for some future year—a yawning gap between the amount of saving that will be available and the amount of investment that will be desired. They note, quite properly, that we are dealing with an accounting identity. Unlike many of the speeches based on it, the often-cited study by the New York Stock Exchange does clearly and properly distinguish between the gap that they show between forecasted saving and investment flows and the equality—at some level—of the actual saving and investment that will take place.²

The equality between actual saving and actual investment resembles the equality, on business balance sheets, of assets and liabilities (including net worth). Yet, at the company level, we do not let that simple accounting identity inhibit serious analysis. We understand that the Assets = Liabilities relationship is true alike for bankrupt concerns as well as the most profitable corporations. Similarly, we need to remind ourselves that, for a national economy, Saving = Investment, both for a rapidly growing economy and a stagnant or even declining one. There are serious questions to be considered: At what level does balancing of saving and investment take place? What investment needs are rationed (or "crowded") out in the process? What types of investments are actually funded?

As Henry Wallich has pointed out, capital inadequacy can show up in various forms. First, it can manifest itself in bottleneck situations, with some industries not having enough capacity to serve their customers when the economy as a whole is operating at a high level. Second, an overall shortage of capital with respect to the labor force is possible, even if capacity is fairly evenly distributed among industries. Under such conditions, there would not be enough jobs to provide full employment even when industry is operating close to capacity.³ The joint concern of business and labor in increasing productivity capacity in such an event would be obvious.

A more specialized definition of capital shortage has been developed by Sinai and Brinner.
They use the term to refer to an economy which meets either of two conditions:

1. The financial system fails to provide the necessary funds to finance the economy’s expenditures at reasonably stable rates of interest.

2. Capital expenditures are insufficient to generate enough capacity to meet the demands of the economy at reasonably stable prices.

Wallich contends that during periods in 1973 and 1974 the American economy experienced the two sets of symptoms of capital shortage that he describes. Sinai and Brinner warn us about the possibility of experiencing their two definitions of capital shortages within the very few next years.

The newer and smaller businesses, rather than the larger and better established companies, usually get crowded out of credit markets during periods of financial stringency. That should be of concern to all who favor a competitive economy. And the available data are striking. Of the $6.4 billion of bonds issued by the companies listed in the Fortune 500, $5.1 billion was raised by the top 100 and $1.3 billion by the next 400. The top 100 companies reported 28 bond issues in 1974 and the bottom 100 only 1.

It is not my purpose to provide yet another set of computer runs of future capital supply and demand. But there are important reasons to expect that saving in the years ahead will be weak by historical standards and investment needs and demands quite strong.

On the supply side, several basic factors will be dampening down the potential for generating savings in the coming decade. In absolute terms, of course, there will be large increases in funds available for investment. Important forces, however, will be exercising a depressing effect on the growth rate of saving. Consumers, a basic source of savings in the economy, will be experiencing some adverse factors. The changing age distribution of the United States population suggests that, if past savings patterns are maintained, the personal saving rate (although not the absolute amount) could decline over the coming decade.

Just compare the anticipated trends in the low-saving age groups with the high-saving age brackets. That does not require much forecasting ability because we are talking about people who are already born and living in the U.S. The prospects are very unfavorable. The number of Americans in the high-spending, low-saving age brackets (20-34) will be rising substantially, from 46 million in 1972 to 60 million in 1982. These are the young people who borrow heavily, particularly to finance and furnish new homes. Most of the people who shift from renting to buying a home are under 35. In striking contrast, the high-saving age brackets (40-54) will show a decline in absolute numbers, from 36 in 1972 to 34 million in 1982.

Another factor dampening down the private saving rate is the repeated liberalization of social security and other government welfare programs. This relationship has been noted by several scholars, liberal and conservative. Recent studies show that the provision of public pensions substantially depresses the rate of private saving. With the Social Security system operating at best on a pay-as-you-go basis, there is not offsetting government saving. Should the system begin to operate at a deficit, there would be government dissaving. [Ed.—The Social Security Commission estimates a deficit of $3 billion this year and $6 billion next.]

I am going to skip over lightly the question of the adequacy of business saving, not because it is unimportant, but because others, notably George Terborgh, already have done such a thorough and convincing job of explaining how inflation has caused substantial overstatements of real business profits, especially as a result of inadequate depreciation allowances and transient inventory profits.

Real corporate profits (adjusted for these factors) declined by over 40% in the past decade, from $37.0 billion in 1965 to $20.6 billion in 1974.

On the demand side, in contrast, there clearly will be many rising needs for capital investment, both to meet new priorities, such as domestic energy reliance, and the requirements directly imposed on business by government. For example, both public and private projections show that rising annual dollar outlays for new pollution-control facilities will be required to meet existing legal requirements. About 5% of industrial plant and equipment investments are expected to be devoted to these purposes. In addition, government-mandated industrial-safety and noise-abatement outlays will be significant, with estimates ranging to $40 billion or more during the coming five-year period. These government-mandated investment requirements help to explain the anomaly of a declining return on capital, which is supposed to be a characteristic of a capital-surplus economy. It is evident that the typical firm realizes little if any return on these involuntary outlays. Thus a larger than average return is earned on the voluntary capital investments that are made.

Economic Forecasting

Intentionally or not, some economists seem to be competing for the role formerly played by the late Jack Benny—first-rate deadpan comedian. I am referring to analysts who tell us, straight faced, that saving flows will be adequate to the investment financing task in the decade ahead, if only the Federal Government learns to operate at a surplus for an extended period of time—an eventuality as likely as my becoming young and handsome tomorrow. To
back that up, they cite several public and private forecasts that show that, by 1980 or some other future year, the Federal Government may be operating at a surplus, and thus adding to the availability of private capital funds. (For example, the President’s January budget estimates a margin of $35 billion by which revenues would exceed outlays on a full-employment basis in 1980.\textsuperscript{9})

Do not be misled by these statistical exercises. I have done them myself and find them very useful—as a form of mental gymnastics. The key to understanding these, as well as any other long-term forecasts, is to look at the underlying assumptions. That is critical in this case. The key assumption, which may not always be apparent to the users of these forecasts, is that no further change will be made in the expenditure programs or revenue structure of the Federal Government.

This is plainly unrealistic. If there is anything that can be forecast with confidence, it is that over the years the Congress will pass laws increasing the scope of existing programs and instituting new spending programs. Likely candidates are not hard to find, ranging from incentives to explore and develop new domestic energy sources to a national health-insurance program.

Do not interpret this as an attack on the projections \textit{per se}, but on their use. They are not intended to be forecasts of reality. Rather, they are a useful input into the policy planning process. They indicate the amount of discretion available to increase outlays and/or cut taxes within the existing budget structure. In the future, as in the past, the public’s appetite for new government services and benefits will likely outrun its willingness to pay for this largesse in the form of higher taxes. Thus, on balance, the Federal Government is likely to run deficits and, on balance, to be not a supplier but an important user of investment funds in years ahead.

The Role of Public Policy

Before considering possible changes in public policy, it is important to understand the impact of existing policies. We frequently hear that our current tax system is biased in favor of consumption and against saving. If you have any doubt about the matter, I believe that you can resolve it quickly with a very simple and straightforward example.

Consider three factory workers, A, B, C, each of the same age, the same work experience and size of family, and same compensation. To keep it simple, assume that each rents the house that he (or she) lives in. Mr. A regularly spends what he earns, no more and no less. Mr. B., a saver, deposits a portion of his paycheck into his savings account each week. Mr. C. not only spends everything he earns, but also borrows to the hilt, buying as much on credit as he can.

The key question: Which of the three pays the most income tax and which pays the least? Clearly, Mr. B, the saver, will have the highest tax bill—paying taxes on his wages as well as on the interest that he earns on his savings account. Mr. C. winds up with the lowest tax bill, as he receives a tax deduction for the interest he pays on his borrowings.

Actual practice of course includes many variations in the tax treatment of financial transactions. Yet, as a general principle, it does seem that, for the average citizen, the existing personal income tax structure favors consumption over saving. In addition, many of the government spending programs operate with a similar effect.

Let us assume that A, B, and C all get laid off at the same time and none of them obtains a new job. Mr. C, the big spender, will be the first one who will be eligible to receive welfare, food stamps, and related benefits. Mr. A, the pay-as-you-go man, will be next. The last to qualify for Federal assistance will be Mr. B, the big saver. Unlike the good Lord, the Feds do not seem to help those who help themselves.

What can be done to provide greater encouragement to saving and investment? The first and perhaps most important idea that comes to mind is essentially a negative one. The Federal Government should stop being such a large dissaver. That is, it should eliminate or at least reduce the massive extent to which it competes with the private sector for the relatively limited supply of investment capital. As the economy continues to recover from its recession lows, the rising pace of business activity will yield increasing flows of Federal revenues. Unless Congress increases government spending at the same rapid rate, the result will be a substantial reduction in the Federal deficit in 1977 and 1978. The result is not a foregone conclusion. The advocates of economy will have to exert sufficient political pressure to offset the proponents of greater government spending.

There is a related question, which is far more technical, and hence for which there is little public support or even understanding. I am referring to the need to curtail the various off-budget agencies. These are mere subterfuges whereby normal Federal expenditures do not show up in the budget. Not only do these expenditures continue but, because they are no longer subject to the scrutiny of the budgetary process, they are expanding at a far more rapid rate. In Fiscal Year 1972, they totaled $249 million. In the Fiscal Year 1976 budget they are estimated at over $10 billion. That is $10 billion that the Federal Government has to borrow \textit{above and beyond the official budget deficit}. Should the proposal for an off-budget Energy Independence Agency be adopted, the size of this category would more than triple.

It is with very great reluctance
that I call your attention to one specific off-budget agency, the Federal Financing Bank. Unfortunately, like so many government activities, the Bank is performing functions not intended by its original sponsors. It is also buying debt issued by private organizations and other institutions outside of the Federal Government in cases where those issues carry a government guarantee. That's just what we don't need—something that increases the Treasury's borrowing needs further still. The Congress should promptly repeal the authorization for the Federal Financing Bank to provide credit to private (non-Federal) borrowers.

A second useful contribution that the Federal Government can make to ensure capital adequacy in the years ahead is in the area of government controls over business. An increasing number of regulatory agencies impose investment requirements on business firms—stipulate investments which do not generate more productive capacity but are intended to meet various social priorities. I do not propose that all of these social requirements be eliminated, but rather that they be subject to the rigors of a benefit/cost test. These expensive Federal regulatory requirements should only be continued where it can be demonstrated that their value or benefit to the society exceeds the cost that they impose on the public.

I must confess that I am far more enthusiastic about the desirability of these essentially negative approaches than I am about the various possibilities for providing positive incentives to saving and/or investment. In a sense, my advice to the Congress is a variation of an old plea, "Don't just stand there, undo something."

But now let me turn to those more positive possibilities. I see some important and useful lessons to be learned from the past. The more specific the focus of a Federal tax incentive, the more likely that inefficiencies and other unwanted side-effects are going to result. At this point I certainly have no desire to add to the difficulties that the real estate investment trusts (REITs) are facing. But we do need to acknowledge that the situation was made possible by special-interest tax legislation which permits the REITs—unlike most other corporations—to deduct the dividends they pay out from their taxable income.

What is needed is true tax reform of general applicability. To a growing number of economists, both liberal and conservative, the most economically sensible and efficient approach to increasing private saving is to reduce the corporate income tax. That action would have a number of desirable effects. Clearly, a lower corporate income tax rate would increase after-tax corporate profits. That also should increase the amount of business "saving" in the form of retained earnings. But not all of the tax reduction is likely to be saved. Some of the added profits would be disbursed in the form of higher dividends, and that increases individual disposable income and personal saving. To some extent, the tax saving may also be shifted—forward to consumers in the form of lower prices, or rather more slowly rising prices, and backward to labor in the form of higher wages, salaries, and fringe benefits. The widespread nature of these resultant benefits are hardly cause for concern. Their precise distribution would depend on the operation of market forces.

A lower corporate income tax rate would reduce the indirect but pervasive role of the tax collector in internal business decision-making. It would tend to promote more efficient use of resources to the extent that fewer low-priority business expenses would be incurred merely because they are tax deductible. It would soften the double taxation of corporate income. A lower corporate income tax would also reduce current bias in the tax system toward debt financing—because interest paid on debt is deductible from taxable income and in most cases dividends on equity capital are not. Rising debt/equity ratios and declining interest coverages on corporate balance-sheets clearly demonstrate the importance of permitting a greater reliance on equity rather than on debt financing in the future.

C. Lowell Harriss has also pointed out that the present corporate income tax may contain some of the most regressive elements in the entire tax system. He has in mind the portion of the corporate income tax that reduces the income that would otherwise be available to such "capitalistic" shareholders as philanthropic institutions, foundations, universities, and employee pension funds. Harriss contrasts this with a tax at the personal level which can differentiate among various categories of people on some rational or fair basis.

But, unlike the negative suggestions that I made earlier, I acknowledge that tax cuts would increase the Federal deficit and thus increase the amount of government borrowing that competes with private investment demands. Hopefully, the beneficial impacts on production and employment of a cut in corporate income taxes would generate "feedback" in the form of some significant compensating increases in federal revenues. Unfortunately, in the past, most proposals for reducing the corporate income tax have been defeated by what may be termed demagogic appeals against reducing the tax burden on the "undeserving rich."

Charles McLure of Rice Univ. states unequivocally, on the basis of his examination of the public finance literature, that a separate tax on corporation income cannot be justified under commonly accepted canons of taxation.\textsuperscript{10}
Tilford Gaines offered what may be the simplest and most effective response: "Of the many approaches that might be taken to lower unemployment rates permanently, i.e., to create more jobs, encouragement to capital investment must rank number one." 11

Nevertheless, at least in the past, it has seemed easier to get far-less-efficient special interest legislation into law. If the naive advocates of closing tax "loopholes" have their way, what we will see is the enactment of punitive legislation further reducing the incentive and ability of the private sector to save and invest.

It is ironic that the pressures to increase capital-gains taxation, for example, are far stronger in the United States than in other industrialized nations, although our tax burden on such gains already is so much higher. In France, The Netherlands, and West Germany, for example, capital gains are generally exempt from income tax. If the Congress does take specific action in the corporate tax area, rather than "tightening" up on capital gains, it should give favorable consideration to converting depreciation allowances to a true capital-recovery system. This of course could be done by shifting the depreciation base from historical cost to current replacement cost. Such forward-looking action would go a long way to halting the decline of real saving in the business sector of the private economy.

The depreciation practices of other leading industrialized nations are in general far more liberal. Even including the effect of the investment credit and the ADR, only about 23.5% of a new investment in machinery and equipment can be written off in the first year under our Federal tax system, while France allows 31.3%, Japan allows 37.1, Canada, 50.0, and the United Kingdom a full 100 percent.

Individual, consumer savings could be encouraged through legislation introduced by Senator Paul Fannin (S.4054) and Representative Jack Kemp (H.R. 7240 and H.R. 7241). Senator Fannin's bill would exclude from gross income the first $1000 interest on deposits in savings institutions. Representative Kemp's proposal would provide a 10% tax credit for the first $1000 of funds either deposited into a savings account or used to purchase the stock or bonds of a domestic corporation. It would also eliminate double taxation of common-stock dividends and lighten the tax load on capital gains.

These are attractive proposals which would begin to move the Federal tax structure away from saving and investment so heavily and toward placing more of the burden on consumption. The timing of their enactment no doubt will be influenced strongly by the overall state of the Federal budget.

Concluding Remarks
The government's role as a competitor for and an allocator of investment funds in our economy needs to be restricted substantially. We also need greater public recognition that the government credit device does nothing to expand the volume of capital funds available to the economy. It involves literally robbing Peter to pay (or lend to) Paul. But it is a game that government often likes to play—because it looks so painless to the taxpayer. More fundamentally, an economic environment needs to be created that promotes private saving and investment.

Unless we as a nation act on many fronts to encourage private saving and to dampen down government competition for investment funds—a lower tax burden on saving, less deficit spending, and more realistic regulation—we must seriously consider the very real possibility that this nation will soon be entering a period in which the underlying demand for capital tends to outrun the supply of saving to finance it. In practice, of course, available saving will be allocated one way or another among the various categories of investment requirements. But a high average level of interest rates is likely to be the balancing factor and numerous weaker demanders of capital— notably small and new business, local governments, and individuals—will be elbowed out of financial markets and thus will obtain smaller real shares of the nation's resources.

Hence, gearing public policy to encouraging an adequate flow of saving and investment does indeed show a proper concern for the future.

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