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FORCES INFLUENCING INVESTMENT IN BUSINESS ENTERPRISE AFTER THE TRANSITION PERIOD

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The continuance of a high level of employment after the war is the publicly expressed desire of many businessmen. What are the financial problems which must be met if that desire is to become a reality? Data from which such a question can be answered by individual businessmen for their own companies are presented in "Forces Influencing Investment in Business Enterprise after the Transition Period." This is the fourth in a series of reports on current and postwar finances written by Charles Cortez Abbott, Associate Professor of Business Economics at the Harvard Business School. (April, 1944)

The following statement is a brief digest of the report.

The author estimates that, if a satisfactory level of employment is to be achieved, something like 17% more jobs need to be furnished than in 1940. Such a level of employment probably requires a gross national product of \$150 billion, compared with \$93 billion in 1929 and about \$88 billion in 1937 and 1939.

Will the condition of the fixed assets and the quantity of the current assets at the end of the war be adequate to produce this volume of output? The great bulk of the tremendous expansion in manufacturing facilities has taken place in a relatively few industries, and only a small portion of this new plant and equipment will be convertible to peacetime use. The majority of manufacturing concerns will emerge from the war period with their fixed assets inadequate for this purpose. There will be need of rehabilitation, expansion, and relocation.

Not only will funds for investment in fixed assets be required by business, but also additional working capital. In 1943 the government directly or indirectly supplied nearly half the assets used by industry for working capital purposes.

Two significant implications of this need for funds are: (1) A considerable portion of the financing should be in the form of equity financing or ownership. (2) Ownership therefore must be made more attractive than it has been recently.

Will the funds needed by business be available? Some of the forces influencing investment after the transition period will have sprung from prewar developments. Even before the war equity capital was not readily available, particularly for the moderate-size manufacturers in need of a relatively small amount of equity funds. Furthermore, the number of persons to whom business management could look to perform the function of ownership was declining, not only proportionately but perhaps also absolutely. These trends may continue into the postwar period.

The greatest single change in the supply of capital during the prewar period was the rise of "institutional savings" as shown by the increase in the assets of life insurance companies, investment trusts, savings banks, and pensions and retirement funds. Businessmen who must raise capital will look with interest on the tremendous amounts of funds annually becoming available for investment by these institutions.

The increasingly great emphasis placed on depreciation in business practice was another outstanding development in the 20 years ending in 1943. The new importance attached to depreciation, entailing as it does new psychological attitudes and new considerations in the making of business decisions, will continue to have far-reaching social and economic consequences. Two further changes of far-reaching significance for businessmen are the tremendous decline both in the volume of commercial loans since World War I and in the loans on securities of commercial banks since 1930.

Some of the forces influencing investment will come also from developments in the general field of government: (1) the Federal regulation of securities, (2) the continuation of government lend-

ing agencies, (3) the need of the Treasury, in view of the tremendous postwar debt, to maintain low and stable interest rates, (4) the "fiscal policy," i.e., the suggestion that the Federal Government fit into a coordinated and consistent policy the whole range of its activities that influence investment and expenditures by consumers.

Furthermore, there will be many legacies from the war. Just what all of them will be is hard to forecast. But certainly taxation belongs at the top of the list. Although after the war the country will have to pay heavier taxes, measured in terms of dollars, Professor Abbott holds out the possibility that the burden can be less onerous than the present or perhaps even the prewar load. But in order to bring this about, businessmen must make every effort to see that the postwar national income remains close to present levels, and framers of public policy must devise a postwar tax structure that will stimulate enterprise and must administer it in such a way as to impose on the taxpayer a minimum of hardship in compliance.

The accumulation of liquid funds in the hands of individuals may prove to be the single most important legacy of the war in the field of finance. From the point of view of society, it would appear most desirable that these new accumulations of capital should be invested in business enterprise, particularly in the form of equity.

Professor Abbott stresses the importance of motives, especially the distaste of individuals for the risks and responsibilities of ownership and the tremendous desire on the part of business managers to be free of debt. The effect of these two conflicting attitudes is a bar to investment expansion and hence militates against the provision of jobs.

The report closes with a statement of the necessity that ownership be made more attractive:

This matter, it seems clear, is one which is of vital and of equal importance to business management, to financiers, to labor,

and to framers of public policy. Ownership is the heart of the investment problem. It is the center of the employment problem. It is the basis on which credit is extended. It is the foundation on which the whole scheme of things in the American economy rests. If ownership is unattractive to potential investors, if owners are weak and irresponsible, if ownership as a function falls into disrepute, if directors and executives of business concerns fail to fulfill their responsibilities to owners, credit inevitably contracts, investment expenditure automatically declines, and unemployment necessarily develops.

(Division of Research, Harvard Business School, Soldiers Field, Boston 63, Massachusetts, 50 cents)

**FORCES INFLUENCING INVESTMENT IN
BUSINESS ENTERPRISE AFTER
THE TRANSITION PERIOD**

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PREFACE

This study, "Forces Influencing Investment in Business Enterprise after the Transition Period," is the fourth of a series of special reports dealing with the financial problems of business during the war and immediate postwar periods. The purpose of this series is to show the character of the financial problems which business concerns may face during the transition from war to peace, to develop the background against which these problems will appear, and to deal with a number of specific topics such as V and VT Loans.

The first report published in the series was "The Financial Situation of Industry after Two Years of War," by Charles Cortez Abbott (December, 1943); the second was "The V and VT Loan Arrangement and Termination Financing," by Charles Cortez Abbott and Walter G. O'Neil (January, 1944); and the third was "Business Finances during the Critical Transition from War to Peace," by Charles Cortez Abbott (February, 1944).

The author wishes to acknowledge the many helpful suggestions made by his colleagues, particularly those made by Professor Melvin T. Copeland, Director of Research of the Harvard Business School. The author is also grateful for the aid of Mr. Walter G. O'Neil who acted as his research assistant while this study was being prepared. The opinions in this report are the author's own, and errors and deficiencies are his responsibility.

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April, 1944

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FORCES INFLUENCING INVESTMENT IN BUSINESS ENTERPRISE AFTER THE TRANSITION PERIOD

One of the significant developments during the war has been the interest shown by businessmen in the continuance of a high level of employment after hostilities end, and the evident willingness of many businessmen not only to work actively and constructively toward that goal but also to assume some responsibility in this connection. If a satisfactory level of employment—which may be defined as the provision by business of about 17% more jobs than were furnished in 1940¹—is to be reached and maintained after the war, American business will need to produce and distribute an amount of goods and services far in excess of any quantity attained in the best peacetime year. A gross national product of \$150 billion in terms of 1942 prices, as compared with a national product of \$93 billion in 1929 and about \$88 billion in both 1937 and 1939, is a rough indication of the task involved.

When the ability of business to achieve and maintain the needed volume of output and of employment is considered, two questions with far-reaching financial implications, both of which can be considered independently of the demand for goods and services, at once present themselves. First, will the plant, equipment, and physical facilities of American business—as these fixed assets will be at the end of the war—and the quantity of the net current assets of American business—as these assets will be at the end of the war—be adequate and sufficient to produce and distribute this volume of output necessary to a high level of employment? Secondly, a continuing substantial volume of expenditure by business enterprise for investment purposes and a continuing substantial volume of investment in business enterprise by individuals and financial institutions are necessary conditions if a high level of employment is to be achieved, as is generally agreed upon both by practical men of affairs and by theoretical economists. Thus, what are the forces, so far as they can now be foreseen, which will be of controlling importance in the thinking of persons in the business world responsible

¹See Charles Cortez Abbott, *The Financial Situation of Industry after Two Years of War* (Harvard Business School, Division of Research, December 1943). A very similar estimate of the needed postwar employment has been made, quite independently, by Karl T. Schlotterbeck, *Postwar Reemployment* (Washington, Brookings Institution, 1943).

for decisions regarding investment expenditures by business firms, and within what framework of pertinent and related material and statistics do these forces need to be considered, in order that they be seen in their proper perspective?

The importance of these two questions to individual companies and to the economy as a whole requires that certain of the terms employed in these questions be defined with some care.

"Expenditure by business firms for investment purposes," a term which will be frequently used throughout this report, signifies the conversion of cash or cash items into fixed assets of an expected life of three years or more, and/or the absorption of cash by financing the volume of inventories or the volume of receivables a firm finds necessary in view of its current or prospective level of business. That is, the definition recognizes that a substantial portion of a firm's inventories and receivables are as much a "fixed asset" as are its land and buildings.

As is indicated further on, funds used for investment expenditure by a firm may be derived from a variety of sources. They may be funds set aside for certain cash operating costs, such as repairs and replacements, they may be funds reserved to cover depreciation charges, they may be retained earnings, they may be borrowed funds, or they may be sums raised by the sale of additional capital stock.

Where the term "investment in business enterprise" is employed, either one or both of two processes is meant: the purchase by investors of the stock or long-term obligations of a company, or the retention by a firm of net earnings.

The acquisition of assets that result in an increase of the book value of the assets of a firm (barring write-ups of asset values) can come in an "ultimate" sense only through new "investment in business enterprise," as defined above. By use of short-term debt, firms can and do acquire assets that enhance the book value of the firm's assets, but the short-term debt can be repaid only through the use of earnings retained for that purpose, through the use of funds acquired by the sale of stock or long-term obligations, or through the proceeds received from the liquidation of some other asset.

The use of funds charged as repairs or maintenance or as other tangible operating costs, or of funds arising from depreciation charges, results in the acquisition of "new" assets but not "additional" assets. Often the "new" assets are of greater productive capacity than the old, but that fact does not of itself increase the book value of the assets of the firm.

In order to give some perspective to these two concepts, namely, expenditure by business firms for investment purposes and investment in

business enterprise, it is to be noted that the volume of investment expenditure necessary to produce a high level of employment depends upon the current volume and pattern of expenditure by consumers for consumption purposes. Much theorizing regarding the volume of investment necessary to produce a high level of employment is predicated on the belief that the volume and pattern of such expenditure fluctuate less than does the national income as a whole. So that, it is argued, this residuum of income not expended for consumption purposes, which should be invested, or "offset" by expenditure of business firms—or by government agencies—for investment purposes, fluctuates more widely than does the national income as a whole. This relative constancy of the volume of consumption expenditure may or may not continue in the postwar period. Here it may be noted, first, that the phenomenon commonly designated as a "flight from the currency" is by definition a rapid distortion of the usual volume and pattern of expenditure for consumption purposes; secondly, that the volume of government expenditure during the war for consumption purposes, as distinct from investment purposes, has been sufficiently great to produce a high level of employment even in the period—latter 1943 and early 1944—in which expenditure for investment purposes by the government and by business firms dropped off.

Although this digression on definitions may appear academic and remote from day-to-day operations of business firms, these matters have in fact a very direct bearing on the problems facing financial officers of companies.

Comptrollers and treasurers of business concerns, as well as presidents and directors, looking forward not only to the transition period¹ but more especially to the succeeding period, and contemplating the possibility or the necessity that the operations of their firms be expanded, are faced with three questions: What amount of funds will their companies need in order to finance postwar business? From what sources may these funds be secured? On what terms may the financing be obtained?

For example, where and on what terms will chemical companies, paper manufacturers, and railroads acquire the funds needed to rehabilitate their plants in the event they are unable during the war to accumulate sufficient cash resources to accomplish this purpose? Conversely, commercial and investment bankers, officers of finance com-

¹The transition period has elsewhere been defined, for an individual company, "as beginning with the first substantial termination of war contracts and as ending when a satisfactory cash inflow from ordinary civilian production is once more reestablished." Charles Cortez Abbott, *Business Finances during the Critical Transition from War to Peace* (Harvard Business School, Division of Research, February, 1944).

panies, executives in charge of the security portfolios of insurance companies, and other persons in strategic positions as regards the flow of capital and credit into business enterprise need to consider in what ways wartime developments may force or induce changes in their methods of financing business undertakings. For instance, to what degree and in what ways will their operations be affected by the development of the government-guaranteed loan technique, the probable large increase in the number of small retailers in the immediate postwar period, and the likelihood that many individuals will wish to sell some of their government bonds after hostilities end?

ASSETS OF BUSINESS AFTER THE WAR

To return to the first of the two questions raised above: Will business assets at the end of the war be adequate to produce the great volume of output necessary for a high level of employment? First, consider the fixed assets. The evidence suggests that the plant and equipment available to business on the termination of hostilities will not be adequate—without considerable rehabilitation, renovation, expansion, and relocation—to give a high level of employment to the then existing labor force, particularly if production largely reverts to a one-shift basis as compared with the double and triple shifts common during the emergency.¹

But from the point of view of creating a high level of employment in the immediate postwar period the probable deficiencies in the fixed assets of business, notwithstanding the tremendous wartime expansion in manufacturing facilities, are an encouraging factor. For if the investment expenditures needed for expansion and rehabilitation are made, these expenditures will go a long way toward creating the desired volume of employment. Although a tremendous increase has been made by the government and by private industry during the war in manufacturing facilities, the great bulk of this expansion has taken place in a relatively few manufacturing lines. Apparently only a relatively small portion of this new plant and equipment will be convertible to peacetime uses.² And the great majority of manufacturing concerns will emerge from the conflict with their fixed assets in worse repair than when hostilities began. To put the point in an extreme form, it is evident that the fact that great expansion has taken place in the produc-

¹For further discussion of this point see *The Financial Situation of Industry after Two Years of War*.

²For further discussion, see *ibid.*, and *Disposal of Government-Owned Production Facilities* (Machinery & Allied Products Institute, Research Memorandum No. 4, January 14, 1944).

tive capacity of shipyards, aircraft plants, and ordnance factories does not mean that makers of building materials, food processors, and glass manufacturers will have the facilities they will need in order to play their part if and when the peacetime national product is in the neighborhood of \$150 billion.

Furthermore, business will need working capital. Very nearly half of the assets used by industry for working capital purposes during 1943 seem to have been supplied, directly or indirectly, by the government, and this situation suggests that business currently does not possess sufficient net working capital to finance the contemplated high level of production.¹ Although the net current assets of many business concerns will doubtless increase before the coming of peace, this development will not necessarily signify that business will be able to finance the volume of output requisite for a high level of employment. For distribution through normal trade channels of an amount of goods and services comparable with the amount now being produced, an amount which has engendered something very close to full employment or perhaps something more, will require that inventories be considerably augmented, that trade receivables be financed, that advertising and selling expense be accommodated, and that the many peacetime uses of working capital which have disappeared under war conditions be met.

To summarize this discussion, it seems probable that business, with the assets which it will have at the end of the war, will not be able without additional financing to produce and distribute the volume of goods and services necessary to provide full employment. The needed increased expenditure by business concerns for investment purposes, which implies an enhanced volume of investment in business, is itself one of the principal circumstances requisite for the attainment of a high level of employment. Should this needed investment take place, it will go far toward producing the desired level of employment.

Ownership

Two points are pertinent here. First, some portion, perhaps a considerable portion of this financing needed by business, for reasons which will not be explored at the moment, should be in the form of equity investment. Certainly it is difficult to contemplate that all the required financing could or ought to be supplied through the creation of debt. Secondly, equity financing implies ownership, and ownership of American enterprise seems to have been for some years, and currently

¹*The Financial Situation of Industry after Two Years of War.*

to be, distinctly unattractive to those individuals and financial institutions that control large portions of the funds available for investment in the American economy.

Much present investment philosophy and practice, both of individuals and of financial institutions, seek the security thought, often fallaciously, to be afforded by a preferred or creditor position. Such policies and practices are based on the assumption that someone—someone who is often imperfectly defined so long as he is someone else—will own American enterprise and assume the risks and responsibilities of ownership. But clearly such philosophies, and the actions based on them, ultimately frustrate themselves and fall of their own weight if ownership is unattractive and owners are not forthcoming in society.¹

If a high level of employment is to be achieved and maintained in the postwar period, one of the major objectives of both business policy and public policy must be to make ownership more attractive than it has been recently.² On this point must unite, if they adhere to the logics of their respective positions, both those persons in the business world who of late years have been critical of many governmental policies on the grounds that such policies allegedly threatened property and property ownership, and those persons in the government service and the academic world who have been critical of the functioning of the financial and investment process and the activities of property owners on the grounds that insufficient investment was taking place to provide a satisfactory volume of employment.

PURPOSE AND FRAME OF REFERENCE

Purpose

The balance of this report will be devoted to surveying and bringing into focus major considerations relevant to the second question

¹See, for instance, E. E. Chase, "Problems of the Ownership, Management and Finance of New England Business Enterprises," *New England War Bulletin*, Supplement, October, 1943, New England Council.

²There is no question that ownership is made attractive by increasing the income which owners receive from their property. But there can be little doubt that the perquisites and responsibilities of ownership can be made attractive in other ways as well. Space limitations preclude exploration of the various steps which public authority and business management might take in this connection.

Currently, much attention is being given to the possibility of improving the position of the owner through the reduction or elimination of double taxation of corporate income, through revision and strengthening of the proxy machinery, and through the issuance of attractive, informative, and interesting reports to stockholders. The importance of developments in these directions is very considerable. But surely developments in these areas do not exhaust all the possibilities available to public authority and business executives for stimulating responsible, active, and interested ownership, of a character that will add strength to individual companies and increase the effectiveness of business management.

raised at the beginning of this discussion: "What are the forces, so far as they can now be foreseen, which will be of controlling importance in the thinking of persons in the business world responsible for decisions regarding investment expenditures by business firms in the period following the transition from war to peace,¹ and within what framework of pertinent and related material and statistics do these forces need to be considered, in order that they may be seen in their proper perspective?"

Limitations of space prevent the inclusion, let alone the exhaustive treatment, of every topic that might be brought within the orbit of this subject. Comprised within the study are only those considerations which seem likely to be of critical significance to businessmen, together with the material which seems essential for comprehension and appraisal of investment in business enterprise. If this report furnishes the individual business manager with some perspective on the position and problems of his company in relation to the economy as a whole, and provides him with some rough indication of the character of future problems, it will have served its purpose.

Prewar and Wartime Developments

It is clear that numerous happenings during the 1920's and 1930's will continue after the war to affect the thinking and actions both of investors and of businessmen when making decisions regarding expenditures for investment purposes. Such of those occurrences as seem likely to be of special significance will be considered below. It is also clear that many developments during the war will exert a continuing influence after peace returns upon the financial practices and policies of business firms, financing institutions, and investors, and attention will be given to these wartime developments further on.

Accounting Techniques: Statistical Measurements: Savings and Investment

Superficially, the conversion of cash into an item of plant or equipment seems a relatively simple operation, as does the related process, the absorption of cash by the volume of inventories and receivables requisite for carrying on business. Offhand, it might appear that businessmen and economists could be assumed to comprehend thoroughly both the various kinds of accounting entries involved in these processes and the significance of the operations for the economy as a whole. That is, on first impression, it might seem that misunderstand-

¹The period to which this discussion is applicable is thought of as beginning sometime before the transition period, as previously defined, is concluded, and as continuing for a number of years, say for one full business cycle.

ing would not arise regarding the investment process. The disputes and controversies which have raged over and around this subject, however, show that this assumption is not valid.

Much of the misunderstanding seems traceable to the fact that charges to any one of a considerable number of a firm's accounts may reflect expenditure for investment purposes, notwithstanding the widely varying effects produced on a company's balance sheet and income statement as one account or another is debited. For example, it makes no immediate difference to the machine tool builder whether his customer charges the purchase of a new tool to repairs and replacements, uses retained earnings to buy it, or raises new capital for the purchase. But the buying company is very differently affected, depending on whether the funds expended are allocations of gross income or applications of net income, are acquired through the liquidation of assets or the increase of current liabilities, or are the proceeds of security issues.

Actually, investment expenditures in the sense here intended may and do take place through outlays for repairs, maintenance, betterments, or replacements, through the use of funds arising from depreciation charges and other intangible costs, through the expenditure of retained earnings, through the employment of money borrowed on either short or long term, and through the employment of funds raised by the sale of capital stock. In short, the funds spent by business concerns for investment purposes are acquired in a variety of ways and are accounted for differently on the books of the firm.

The argument regarding savings and investment seems to have been further confused by the deficiencies in the statistics and other material available in society for the measurement of these processes, and by the fact that the imperfect statistics which are available are subject to differing interpretations. Consequently, disagreements among competent observers, perhaps inevitably, have been common. Nevertheless, since the matter of savings and investment is of such moment not only to the economy as a whole but also to the financial management of the individual enterprise, the material available for the measurement of these processes, however imperfect, is relevant in an attempt to place the investment process in its proper perspective.

Expenditures by business firms for investment purposes may be and are charged to a variety of a particular firm's accounts, operating as well as capital. Only two capital accounts, however, long-term debt and equity, reflect investment in business enterprise and the absorption of the savings made in society, both those made by individuals and those made by business firms. Nevertheless, businessmen and economists seem to have had great difficulty in understanding or at least in reaching

agreement regarding the relationship of the investment process to the savings process, even though it is common knowledge that both processes are closely related.

Thus, the precise nature of this relationship has been and is the subject of considerable controversy among economists and, to lesser degree, among businessmen and makers of public policy. Although such theoretical disputes may seem far removed from the realm of practical business operations, the outcome of these arguments affects business management in a number of ways. To take but four instances, these discussions exert considerable influence on tax legislation, on the regulation of banking operations, on the rules and rulings of the Bureau of Internal Revenue, and on the form, character, and intent of government investment in productive facilities—such as the investment in the Tennessee Valley Authority.

Motives

The motives which lead both to the accumulation of savings—by business concerns as well as by individuals—and to investment expenditure by business firms, and the changes which take place in such motives over a period of time, do not seem to have been thoroughly understood either by economists or by businessmen and financiers. This apparent fact has had two effects. On the one hand, it has still further complicated the savings-investment controversy. On the other hand, it has perhaps served to divert the attention of businessmen and financiers making investment decisions away from some of the critical factors present in concrete situations.

It is, for example, evident that the reasons which induce an expenditure for repairs, or for an increase in inventory, generally are quite different from the motives that lead to the sale of a new stock issue and to the spending of the proceeds to acquire new assets. It is equally apparent, to take an extreme illustration, that the motives which a firm would have found compelling in deciding to renovate its equipment in 1933 or 1934 would have been substantially different—in all probability—from the considerations dominant in 1941 or 1942.

In short, in some quarters the motives that lead to investment in business enterprise and to expenditure have been greatly oversimplified, and the processes have been too readily assumed to be quasi-automatic and to take place almost spontaneously whenever and wherever a "profit opportunity" was discovered or was thought to be discovered. On the other hand, men of affairs and business managers, familiar with the obstacles, fears, uncertainties, inertia, and legal technicalities that may prevent investment, have in general not made the significance of

such matters clear and explicit even in their own thinking. Consequently, it is not surprising that these factors, sometimes—erroneously—called “extraneous” to the investment process, have received less attention in economic thought and in public policy than they deserve.

Summary

In summary, this report will attempt to bring together and fit into a pattern, first, those war and prewar developments which will exert an influence on the financing of business enterprise in the postwar period; secondly, the various types of cash outlays—different in an accounting sense—which must be grouped as investment expenditures by business concerns, and the bearing of this and related material regarding saving and investment on the financial management of particular business enterprises; and, thirdly, a summary of the motives which appear to be important in a discussion of investment in business enterprise and of expenditure by business concerns for investment purposes.

LEGACIES OF THE 1920's AND 1930's

What legacies from the 20 years before Pearl Harbor will continue to affect in a significant way the financing of business enterprise after the war? Admittedly individual judgments will differ here. In this study, the answer will be divided into four sections: the supply of capital and credit; financial attitudes and practices; commercial banks; and government activities.

Supply of Capital and Credit

In the interval between the two world wars, perhaps the greatest single change in the supply of capital and credit was the rise of so-called “institutional savings,” as shown by the increase in the assets of life insurance companies, investment trusts, savings banks, and pension and retirement funds, including the various government trust funds.¹ This change is significant both qualitatively and quantitatively in appraising the supply of capital and credit. To businessmen looking forward to raising capital, the tremendous amounts of funds annually

¹G. Griffith Johnson, Jr., lists nine principal government trust funds concerned with pensions or other types of benefit, namely: Old-Age Reserve Account; Unemployment Trust Fund; Railroad Retirement Account; Civil Service Retirement and Disability Fund; Foreign Service, Canal Zone and Alaska Railroad and Retirement and Disability Funds; District of Columbia Teachers' Retirement Fund; Longshoremen's and Harbor Workers' Compensation Fund; District of Columbia Workers' Compensation Fund; and Government Life Insurance Fund. “The Significance of the Government Trust Funds for Monetary Policy,” in *Public Policy* (1940) (Cambridge, Harvard University Press, 1940).

becoming available for investment in the hands of these institutions, and the investment policies of these bodies, are matters of real moment.

To be sure, the increase in the assets of these agencies did not take place continuously or at a constant rate. But the over-all growth during the last 20 years, both in the aggregate assets of these institutions and in the volume of new funds in their hands which annually seek investment, has been tremendous. A few selected statistics will show the magnitude of the change. In 1921 and 1922 the annual increases in the admitted assets of all life insurance companies were of the magnitude of \$600 to \$700 million; by 1943 the figure had risen to \$2,744 million.¹ Deposits of mutual savings banks in 1920 were about \$5 billion; by 1930 they had approximately doubled; during the 1930's the deposits declined slightly, if allowance is made for annual dividend payments; but in 1943 they advanced sharply by more than \$1 billion.² In the early 1920's postal savings deposits were declining, but during 1943 the monthly average was better than \$300 million above the comparable figure for 1942, and more than 10 times the 1920 figure.³ In 1920, investment trusts had only a fraction of their present assets; of recent years it has been estimated that the new funds becoming available to them annually for investment have been of the magnitude of \$200 million.⁴ No reliable data are available on the growth of pension and retirement funds, but it is common knowledge that savings in this form have greatly increased during the last 20 years, and government trust funds, which hardly existed in 1920, are estimated to have had accretions in 1938 of about \$1,150 million,⁵ and this figure has probably grown subsequently.

The depressed security markets of the 1930's reduced the flotations of new security issues to very low levels.⁶ In particular, small concerns, without a national market for their securities and needing money in small chunks—in the range of \$50,000 to \$500,000—experienced difficulty. The revival of the markets in the late 1930's did not in the case of the small company significantly alleviate the situation, notwithstanding such moderate assistance as was afforded by the development of "private placement"—the sale of securities direct by a company to an

¹Franklin D. D'Olier, "Looking Forward with Life Insurance," address before the 37th Annual Meeting of the Association of Life Insurance Presidents, December 2, 1943.

²*Federal Reserve Bulletin*, December, 1943, and *New York Times*, February 1, 1944.

³*Survey of Current Business*, 1942 Supplement; March, 1943; December, 1943.

⁴As of 1937. *Investment Trusts and Investment Companies*. Report of the S.E.C. Pursuant to Sec. 30 of the Public Utility Holding Company Act of 1935, Part I, "The Nature, Classification and Origins of Investment Trusts and Investment Companies" (Washington, 1939).

⁵G. Griffith Johnson, Jr., *op. cit.* This estimate is subject to careful interpretation and cannot be viewed as representing in its entirety cash savings made and contributed by individuals and business concerns.

⁶See Exhibit 1, pages 34-35.

insurance company, or a group of insurance companies and banks, without the formality of a public offering.

There is abundant evidence to show that capital, particularly equity capital, in relatively small amounts has not been readily available. The evidence ranges from published studies¹ to the seemingly tortuous methods followed by some concerns in raising money. Reference is here made to such practices as: distributing a security issue purely on an intrastate basis; splitting a single piece of financing into an intrastate placement and an interstate offering of less than \$100,000, in order to avoid registration with the Securities and Exchange Commission; the use of debt financing—because debts could be sold—when the exigencies of the situation called for stock financing; and the use of term loans secured from banks—rather than the sale of bonds to the same banks—because it was believed that the examining authorities would “pass” a loan to the firm concerned when they would not “pass” its bonds.

Various explanations have been advanced as causes of the problems which have induced practices such as those just indicated. Commonly mentioned are the difficulties, and particularly the costs, involved in registration under the Securities Acts; the lack of interest on the part of the public in securities of small companies, because such securities tend not to have a ready market; lack of capital, and of courage, among investment banking houses; the disinclination on the part of executives of small companies located in small cities and towns, where the type of accounting and legal assistance needed to “clear” a registration statement with the Securities and Exchange Commission was not available, to establish the needed new legal and accounting connections; and the rise of the government lending agency. No one explanation by itself seems entirely adequate.

But whatever the reasons for these problems of small companies and small security flotations, the moderate-size machinery manufacturer looking forward to the necessity of raising \$100,000 after the war for the replacement of equipment, the textile firm needing \$50,000 to \$75,000 for repair and extension of facilities in the postwar period, the retailer or wholesaler anticipating that increased postwar volume may

¹See, for instance, *Small Business Problems*, “Small Business Access to Capital,” Senate Committee Print No. 15, and *Problems of American Small Business*, Part 15, “Long-Term and Equity Capital,” Special Committee to Study Problems of American Small Business, 78th Cong., 1st Sess.; also Charles Cortez Abbott, “The Availability of Equity Capital,” *American Economic Review*, Supplement, March, 1942; John H. Cover and Associates, *Problems of Small Business*, T.N.E.C. Monograph No. 17. See also related material regarding flotation costs in *Cost of Flotation for Small Issues, 1925-1929 and 1935-1939*, Securities and Exchange Commission May, 1940; and *Cost of Flotation for Registered Securities, 1938-1939*, Securities and Exchange Commission, March, 1941.

require an additional investment of \$250,000, may all need to consider whether capital after hostilities end will be more readily obtainable than it would have been in the years immediately preceding the war.

Stock Ownership. The businessman and the security dealer, looking ahead to the flotation of securities, will also need to give attention to the question: "Who will buy the stocks or bonds?" Particularly is this the case if equity financing is being considered, or if placement with individuals rather than with institutions is desired. The fact that ownership of business enterprise has recently not attracted investors has already been noted; and this general subject will be touched on again below in connection with the changes induced by the war in the ownership of liquid, investable funds. At this point attention will be given only to the distribution of stock ownership.

During the entire period 1900-1929, the aggregate number of stock holdings¹ appears to have increased at a rough annual rate of 10% to 13%.² As the depression deepened between 1929 and 1932, seemingly the dispersion of stock ownership as measured by stock holdings spurted sharply. Actually, this change is probably to be attributed almost entirely to the closing out of margin accounts and the transfer of securities from "straw" names to those of the beneficial owners.

In striking contrast to these earlier periods, the dispersion of stock holdings seems to have ceased to grow in the decade 1932-1942. The measures used in this analysis indicate an average annual increase during these 11 years of only 0.4%.

This virtual cessation of growth is contrary to much prevalent opinion. The available statistical material is very imperfect. Nevertheless, the general conclusion that stock ownership stopped expanding in 1932 seems to be substantially correct. So radical a change signifies not only stagnation but actual retrogression, for certainly some increase in stockholdings would be a normal expectancy in a country with a growing population. Inheritances and gifts alone are forces continuously working toward a greater dispersion of stock ownership, quite aside from the effects of purchases made through new savings. Moreover, there was during this period a significant reduction in the holdings

¹It seems necessary to measure the distribution of stock ownership in terms of holdings, i.e., the number of individual stockholders shown on the books of particular companies, rather than in terms of owners in the aggregate, because of the fact that many owners own shares in more than one company, and elimination of duplication of this kind is not possible in over-all estimates.

²This discussion is based on H. T. Warshaw, "The Distribution of Corporate Ownership in the United States," *Quarterly Journal of Economics*, November, 1924; Helene Granby, *Survey of Shareholdings in 1,710 Corporations with Securities Listed on a National Securities Exchange*, T.N. E.C. Monograph No. 30; on material in *Exchange*, March, 1943; and on unpublished research by the author.

by individuals of corporate bonds, since many of the issues which were refunded were replaced by issues sold largely to institutions; and some portion of the funds received by individuals in this connection presumably was invested in stocks.

In short, during the 1930's the number of persons who sold out their stocks in order to use the proceeds for other purposes, seems to have been greater than the number of new investors who came into the market for stocks, when proper allowance is made for the effects of death and gifts. The number of persons in society to whom business management could look to perform the function of ownership seems to have been declining, not only proportionately but perhaps absolutely.

Reduction in Debt. In 1920 total net¹ private indebtedness of corporate and noncorporate business firms and of persons was about \$93.2 billion; in 1930 it reached its peak of \$142 billion; by 1942 it had fallen to \$113.5 billion.² The constituent elements in total net private indebtedness at these three dates are shown in billions of dollars in the table below. It is to be noted that between 1930 and 1942 short-term debt declined, percentagewise, more than did any other type except farm mortgages. The various kinds of short-term debt, such as commercial and industrial loans of banks and consumer credit, are intimately related to the production and distribution of goods, that is, to the business process.

	Total	Long-term Corporate Debt	Farm Mortgages	Urban Real Estate Mortgages	Short-term Debt
1920	\$ 93.2	\$31.2	\$10.2	\$12.2	\$39.6
1930	142.0	45.3	9.6	31.6	55.5
1942	113.5	40.7	6.5	28.0	38.3

Broad interpretation of these over-all statistics must be made in view of changes in the price level during this 23-year period,³ and

¹"Net" indebtedness eliminates intercorporate indebtedness and similar types of duplication.

²The discussion in this and the paragraphs immediately following is based chiefly on R. B. Banks, "Public and Private Debt in the United States," *Survey of Current Business*, May, 1943. The statistics used are taken from this source.

³Monthly Averages of Wholesale Commodity Price Indices, 1920-1943, as compiled by U. S. Dept. of Labor, Bureau of Labor Statistics

(1926=100)				
1920.....	154.4	1928.....96.7	1936.....	80.8
1921.....	97.6	1929.....95.3	1937.....	86.3
1922.....	96.7	1930.....86.4	1938.....	78.6
1923.....	100.6	1931.....73.0	1939.....	77.1
1924.....	98.1	1932.....64.8	1940.....	78.6
1925.....	103.5	1933.....65.9	1941.....	87.3
1926.....	100.0	1934.....74.9	1942.....	98.8
1927.....	95.4	1935.....80.0	1943 (10 mos.).....	103.2

Sources: *Survey of Current Business*, 1942 Supplement, and *Federal Reserve Bulletin*, December, 1943.

attention must be given to the relative changes of different kinds of debt during this interval, a matter which is concealed by these over-all statistics, and to the amount of debt in default at particular periods.¹ For instance, these figures do not show the striking declines in commercial loans made by banks to business firms and in loans made against the security of stocks and bonds, considered more fully further on.² Nor do they show the \$4 billion to \$5 billion decline in consumer credit since the outbreak of war, a drop of almost 50%. These figures do not suggest what appears to be the fact, that the volume of defaulted private debt was almost as great in 1940 as in 1933.

Finally, in the interest of realistic appraisal, against this reduction of liabilities in the form of debt must be set the greatly increased tax liabilities of business concerns and of individuals. For instance, in the aggregate, long-term corporate debt and short-term debt—most of which is business debt of one kind or another—declined some \$22 billion between 1929 and 1942; but the Federal income and excess profits tax liability of business rose about \$14 billion in the same period, and the estimated proceeds of personal income taxes in fiscal 1944 were \$19,422 million³ as against collections from this source of \$1,028 million in 1939.⁴

The precise meaning which an individual businessman should attach to the alterations which have taken place in the pattern of debt either since 1920 or since Pearl Harbor is not entirely clear—in large part because the significance of this development for particular firms will differ widely, depending on their individual circumstances. But the changes appear to have a very real bearing, not only on the financial condition of the individual businessman and that of the firms with which he trades, but also on the ability of the ultimate consumer to borrow. Certainly the load of private debt is an element which cannot be omitted in studying the financial future.

Financial Attitudes and Practices

In the 20 years ending with 1943 greater emphasis was placed on depreciation in American business practice and in the thinking of American businessmen than had been the case before at any place or

¹Estimated Totals of Private Corporate Debt in Default, 1929, 1933, 1940

1929.....\$ 459,000,000

1933.....4,237,000,000

1940.....4,059,000,000

Source: *Indebtedness in the United States*, U. S. Department of Commerce Economic Series No. 21.

²See page 17.

³President's Budget Message of January 13, 1944.

⁴*Annual Report of the Secretary of the Treasury*, 1942.

at any time.¹ There were many reasons for this development. Certainly the institution of the Federal income tax on corporations in 1909 was one cause. Presumably the coming of age of the accounting profession was another, as was the increasing importance of mechanical equipment in business operations. The development of state and Federal regulation of business had a substantial influence. Perhaps the effects of technological change came to be better understood than had been the case hitherto. It may be that the fact that real estate values ceased to grow in many communities, and thus advancing real estate values ceased to be an "offset" to depreciation, was an important factor. And no doubt other causes contributed to this change. The points emphasized here, however, are these: First, the new importance attached to depreciation entailed new psychological attitudes and new considerations in the making of business decisions which had and will have very far-reaching social and economic consequences. Secondly, there is no reason to suppose that the influences centering around the subject "depreciation" will be less important after the war than they have been during the last 20 years.

Another change, which apparently began in the early 1930's and which has had an immense influence on business decisions, particularly financial decisions, is the altered attitude of businessmen, bankers, and investors toward the "liquidity" of loans and investments. Here again many causes have contributed to the greater emphasis placed on liquidity, to the view of that investor who stated: "I would not own a security which I could not sell promptly." Many persons were greatly shocked by the tremendous declines in security values in 1929, 1930, and 1931, and such shocks have been a major contributing factor to the high value placed on liquidity. Another major factor has been the growth of inheritance taxes, and the consequent necessity that many estates be planned in such a way as to permit the prompt disposal of a substantial portion. New types of bank examination since 1933 have played their part. The necessity that open-end investment trusts buy, almost exclusively, securities with a ready market has been a not inconsiderable element in the change. It is conceivable that the importance currently attached to liquidity in almost every field of financial endeavor will diminish in the postwar period. But in any event, security dealers and financial officers of business concerns cannot overlook this immensely important psychological factor in their plans for postwar financing.

Another matter to which men of affairs must give attention, which is closely related to this subject of liquidity, is the greater utilization in

¹It is intended that the significance and far-reaching consequences of this development will be explored more extensively in a subsequent report.

recent years of schematic plans for the systematic reduction of debt. The most striking examples are to be found in the field of real-estate mortgage financing, where the Federal lending agencies have developed and popularized various amortization arrangements. But similar attention to so-called "regular" debt reduction can be found in other fields, in the term loans of commercial banks which became common in the late 1930's, in the greater use of sinking funds and bond issues with serial maturities of late years, in the various arrangements offered to the individual in the newly developed personal loan field, and in plans approved in recent corporate bankruptcy reorganizations.

Commercial Banks

So far as business executives are concerned, two changes in the commercial banking field overshadow all others, namely, the tremendous decline since World War I in the volume of commercial loans of banks, and the tremendous decline since 1930 in the loans on securities of commercial banks.¹ The magnitude of this change is indicated in millions of dollars in the following table.²

	1920	1929	1943
Commercial loans of all national banks, as of June 30	\$10,026	\$7,583	\$4,172
Loans on stocks and bonds of all national banks, as of June 30	3,128	5,134	681

It is to be noted that the volume of commercial loans in each of the years shown was below that of the preceding year, and that the volume of loans on stocks and bonds in 1943 was about one-fifth of the figure for 1920 and little more than one-tenth of the 1929 figure.

It is commonly alleged that the decline in commercial bank lending in recent years is largely attributable to the increased number and stringency of the bank examinations made by regulatory authorities. Doubtless there is merit in this contention, but seemingly no single factor can account for the revolutionary change of the last 24 years. For a full explanation other avenues must be explored, such as the willingness of businessmen to borrow, the willingness of banks to lend, the terms—other than the interest rate—on which funds are available, and the increased financial resources of many business concerns. Contrary to much opinion, the rise of the government lending agency during the last 10 years has not been a matter of real importance in the field of business lending.³

¹It is assumed here that the great increase in recent years in the volume of government bonds held by commercial banks is not of direct concern to businessmen.

²Material in the table taken from the *Annual Reports of the Comptroller of the Currency*. Commercial loans and loans on stocks and bonds of all national banks are approximately 55% of the total of such loans made by all commercial banks.

³See *Business Finances during the Critical Transition from War to Peace*, especially Exhibit 1, pages 24-25.

Government Activities and Fiscal Policy

Four developments of prewar years in the general field of government will continue, so far as can be foreseen, to be of consequence for business financing and financial executives in the postwar period, and will constitute an important segment of the framework within which the investment process will be carried on.

Federal regulation of the securities business, by which is meant, primarily, the provisions of the Securities Act of 1933,¹ the Securities Exchange Act of 1934,² the Trust Indenture Act of 1939,³ and the Investment Company Act of 1940,⁴ will continue to be a part of the financial environment. The incidence of this legislation doubtless will change, as it has changed since enactment, through amendment and through the increasing familiarity of businessmen with the legislation. But expectation of repeal is surely unrealistic.

Government lending agencies, such as the Reconstruction Finance Corporation and the Smaller War Plants Corporation, will certainly continue as a part of the financial structure. It does not seem possible at this juncture to say whether such agencies will play a large or a small part on the financial stage.

The Federal Government, in view of the size of its postwar debt, the magnitude of the interest charge in the Federal budget, and the refunding problems with which it will be faced in the postwar period, will not be in a position to let so-called open-market forces determine the price of government bonds—even if such a policy were in the public interest. Traditionally, the going interest rate on government bonds has been the basis of the structure of interest rates⁵ in the American money and capital markets, and movements of the rate on government bonds have exercised a dominant influence on movements of other kinds of rates. For some years now the rate on government bonds has been rigidly controlled, and measures of control will evidently be maintained⁶ for an indefinite period in the future. Under these circumstances, businessmen and bankers may need to consider whether the rate on government bonds will continue in the postwar period to occupy

¹48 Stat. 74.

²48 Stat. 881.

³53 Stat. 1149.

⁴54 Stat. 847.

⁵By structure of interest rates is meant: (a) the relationships which prevail at any given time between short- and long-term rates, and between the rates attached to long-term obligations of different kinds and different degrees of investment merit, such as municipal bonds, corporate bonds, "first grade" bonds, "second grade" bonds, etc.; and (b) the fluctuations of all kinds of rates over a period of time.

⁶This is not the place to attempt to define "effective control." Nor, even were a definition agreed upon, can it be determined now whether effective control will be achieved.

its traditional dominant position in the interest rate structure, more especially as there have been signs that in some respects the government rate has already lost a part of its accustomed influence.

In the early 1920's the operations of the Federal Government pertinent to business financing were commonly referred to as "measures of credit control." Since 1930, perhaps since 1925, the phrase "fiscal policy" has replaced the earlier phrase. By fiscal policy is meant a much larger group of activities and operations than was connoted by the term "measures of credit control." Fiscal policy implies that the Federal Government fit into a coordinated and consistent policy the whole range of its activities that influence expenditures by consumers and investment in business enterprise. That is, integrated into one policy must be, as a minimum for purposes of definition: taxation, particularly income taxation; Federal Reserve policy, including discount rate control, open market operations, and changes in the reserve requirements of member banks; public spending, state and Federal, whether for public works or for other purposes; tariffs; lending operations of governmental agencies; the management of the public debt, including interest rates, the pattern of maturities, and the placement of the debt in the hands of different types of holders; the control of international movements of capital; and last but not least, the way in which the Federal budget is put together, appropriations made, and Federal expenditures audited and controlled, including the work of the Bureau of the Budget, the General Accounting Office, and the several Congressional committees.¹

One statement regarding fiscal policy by a leading authority on the subject, although indicating the wide scope of the phrase, is nevertheless much too narrow to do full justice to the concept.

If this analysis is sound, it points to the conclusion that the public debt, taxes, and changes in the money supply are all part of a balancing mechanism. How much reliance should be placed on each as a means of financing government expenditures depends on a variety of considerations. It involves judgments with respect to the adequacy of the means of payment, adequate liquidity, the importance under certain conditions of using relatively expansionist and less restrictive methods of financing, the appropriate (socially desirable) degree of inequality of wealth and income, the relative desirability of tapping savings streams through borrowing (increasing the public debt) or through taxation.²

¹It is intended in a later report to deal more extensively with the implications for business enterprise of the concept of fiscal policy.

²Alvin H. Hansen, *Fiscal Policy and Business Cycles* (New York, W. W. Norton & Co., Inc., 1941).

In any event, in view of the experimentation with fiscal policy during the last 10 years, and the probable—if not the necessary—continued experimentation with it in the postwar period, it is clear that businessmen and financiers dealing directly with the financial and investment processes must accommodate in their thinking this comprehensive but somewhat imperfectly defined concept.

Summary

In summary, it may be said that it is not evident what the net influence of these prewar legacies will be on employment after hostilities end. But clearly, persons concerned with reckoning the possible number of postwar jobs cannot safely neglect in their calculations the effects likely to be produced by the rise of institutional savings, the apparent check in the growth of stock ownership, the reduction in private debt, the premium placed by investors on liquidity, and—above all—the development of that group of ideas commonly designated by the term “fiscal policy.”

LEGACIES OF THE WAR

It is too soon to see in entirety what financial legacies the two million business firms of the country will inherit from the present conflict. But some of the major bequests are already evident.

Taxation

At the top of the list stands taxation. Evidently the country will have to carry a larger tax burden, measured in terms of dollars, after the war than it carried before. Whether this burden will prove more onerous and restrictive than the prewar or the wartime burden will depend, first, on the postwar level of national income, secondly, on the form of the tax structure itself, and thirdly, on the price level. If businessmen and framers of public policy make every effort to see that the postwar national income remains close to present levels, and to ensure that the postwar tax structure and its administration are so devised as to stimulate enterprise and to impose a minimum of hardship in compliance on the taxpayer, it is wholly possible that the postwar tax burden should be less onerous than the present or perhaps even than the prewar load.

As regards the form of the tax structure, decisions must be made which will be of vital importance not only to the giant corporation but to the corner grocery store.

If it is assumed that the dollar volume of collections must be

considerably larger than before the war, though probably not so great as at present, shall the almost indescribable complexity and confusion that prevail in the existing tax structure also be maintained, along with the many unforeseen results of present legislation that may succinctly be described as uneconomic and antisocial? The present situation, in terms of either sound business policy or desirable social objectives, would be absurd if it were not so serious.

It is ridiculous that one of the principal inducements to a firm to buy out another, or for two concerns to merge, is the increase in the "tax base" acquired by the buying or merging firm, rather than the reduction in costs, the improvement in the organization, or the increase in marketing outlets achieved by the deal. It is laughable that companies so unrelated as a manufacturing firm and a racetrack should be brought under common ownership for "tax reasons." Conversely, it is preposterous that a merger of two paper mills, generally desirable on business grounds in the eyes of both groups of owners, should have failed of achievement because the merging company would not have received sufficient "tax benefits" from the transaction. It is palpably bad that businessmen should be under compulsion to enlarge the indebtedness of their firms in order to take advantage of the "interest deduction," particularly in cases where the increase in debt is contrary to sound business judgment. And how shall a public policy be defended which favors the purchase by profitable companies of bankrupt firms to serve as "tax umbrellas"?

Or take the case of the manufacturing firm which in 1942 and 1943 made considerable money in ordnance contracts, and which, in order to avoid tax payments—in a perfectly legal manner—and in order to secure an asset which would almost certainly have value in the future, purchased oil leases, financed drilling on the leases, and entered into a series of partnership agreements with independent oil companies to drill on wildcat acreage. Expenses of the operations would very largely come out of taxes. Any oil discovered would be held as an asset available in the future when the company needed a cash income. Or consider, as a matter of government administration and as an abuse of the taxpayer's time and goodwill, the instances reported by a Virginia certified public accountant of two clients who were each forced to go through an adjustment of depreciation rates in order to change depreciation accruals for the year by exactly one cent in each case.¹

Assume, to further the argument, that the public interest will require alterations in the tax structure and its administration which go beyond the removal of palpable absurdities and the elimination of pro-

¹Unpublished memorandum of Robert H. Montgomery.

visions that lead to business decisions contrary to sound business practice and contrary to the interest of society. Then other decisions must be made. Shall business firms continue to be, as they now are, the principal tax gatherers of the Federal Government? Shall the proportion of total Federal revenues collected from business firms, including taxes levied on the firms and on their employees, continue to be some 70% of the total tax collections of the government, as is presently the case?¹ Shall the much disputed capital gains tax be retained, and defended primarily—as is now the case—on the grounds that it is not a barrier to investment since the rate of taxation on gains is less than that applicable to many income brackets? Shall the main source of revenue of the Federal Government continue to be, as was the case even before the war, as well as since Pearl Harbor, the income taxes of business concerns?² This is not the place to attempt an answer to these questions,³ but the answers that will be given to them will vitally affect the financing of business enterprise in the postwar period.

Liquid, Investable Capital

Consideration of availability of capital in the postwar period requires that attention be paid to the sources of capital, to the amounts that may be available, to the terms on which it may be forthcoming, to the ability of existing institutions to bring together those who have capital to invest and those who wish to put it to use, and to the possibility that new types of financial institutions will develop in the postwar period.

The importance of "institutional savings" and of the institutional investor has been noted. Attention has not been focused here, however, on the very large amounts of liquid savings that apparently will be in the hands of individuals at the end of the war, and particularly in the hands of persons in the lower income brackets.⁴ The accumulation of liquid investable funds in the hands of individuals, particularly in the hands of individuals making annually \$5,000 to \$6,000 or less, is so large that it seems no exaggeration to say that this development is likely to be the

¹President's Budget Message of January 13, 1944.

²In fiscal 1943, taxes on corporate income and capital stock accounted for 42% of Federal revenues. The comparable figure for fiscal 1939 was 20%. (*Annual Report of the Secretary of the Treasury*, 1939, and President's Budget Message of January 13, 1944.)

³For a discussion of these matters see, for instance, Roswell F. Magill, *The Impact of Federal Taxes* (New York, Columbia University Press, 1943); Lewis H. Kimmel, *Postwar Tax Policy and Business Expansion* (Washington, The Brookings Institution, 1943); *Federal, State, and Local Government Fiscal Relations*, S. Doc. 69, 78th Cong., 1st Sess.; and reports being prepared on postwar taxation for the Committee for Economic Development by Harold M. Groves and Henry Simons.

⁴This point has been discussed in *Business Finances during the Critical Transition from War to Peace*.

single most important development in the field of finance during the war, and since nothing similar to it has ever happened in the history of the country, that it is potentially of almost revolutionary significance in the history of American finance.

As has been noted elsewhere, there is good reason to believe that, in the two years 1942 and 1943, liquid savings—in the form of currency, demand deposits, and savings bonds—accumulated by persons earning annually less than \$5,000 to \$6,000 were in the neighborhood of \$30 billion. These accumulations presumably will grow so long as the war continues. Thousands of war workers in manufacturing plants are earning \$60, \$75, \$100, or more a week. It is not uncommon for merchant seamen when paid off at the end of a single voyage into an active theatre of military operations to receive \$1,500, \$2,000, or more. Very large amounts of these current earnings are being saved. And it seems quite possible that the war will create within the country a substantial group of new, small capitalists. Such a change could be of immense significance to businessmen and to society at large.

From the point of view of society it would appear most desirable that a large part of these new accumulations of capital should be invested in business enterprise, particularly in the form of equity, and that this new group of petty capitalists should become "owners." Ownership, as has been indicated, has been in need of new recruits during late years. The matter has been put succinctly:

As to the \$20 billions of currency in circulation, the economy of the country will be profoundly affected by the way in which the holders of that money employ it. If they should all try to spend all of it at once, we would witness an inflation which no power on earth could control. Fortunately they have not been able to spend it very rapidly, since houses, automobiles, refrigerators and similar items of fairly large cost have not been available. Obviously they can and should spend some of it in the postwar period if the economy is to function, but it is difficult to give the spending public a stop and go signal. *The hope of the country is that a very substantial portion of this immense volume of purchasing power will be invested in the long-term needs of enterprise.*¹ (Italics supplied.)

Dislocation of the Economy

As is commonly said, war places the productive and distributive mechanisms of business under great strains, "dislocates the economy." Concretely, what does this generalization mean as regards the financing of business enterprise in the post-transition period?

¹Paul F. Cadman, before the Rhode Island Industrial Commission and the New England Council, Brown University, January 24, 1944.

In ordinary times, however this phrase may be defined, the forces of competition, the operation of demand and supply, the decisions of thousands of businessmen, are continually adjusting the amount, form, character, and location of the fixed assets of business to the currently existing—or anticipated—needs of the market. A similar process is continuously taking place as regards the working capital of firms, particularly inventories. For example, the production of pianos declined when radios became popular, and retail stores do not long flourish in ghost mining towns.

The war has rudely interrupted this process of continual adaptation by business to a changing peacetime environment. After the war, the type of production and distribution demanded from business by the market will be radically different from the situation during hostilities. The change will come swiftly. Suddenly there will be too much of some kinds of equipment, too little of others, and some will be in the wrong place. Business as a whole will probably be short of working capital. What there is is likely to be maldistributed as between firms, so that some few may have more than they need immediately, and others may be very short in view of the altered pattern of expenditure by consumers, by business itself, and by the government.

The precise meaning which dislocations of this sort have will vary from one business situation to another. But clearly this is a matter which financiers and financial executives must include in their thinking about the post-transition period.

New Types of Financial Institutions and Investment Policies

As might have been anticipated on *a priori* grounds, the war has greatly stimulated discussions that date back before Pearl Harbor regarding the adequacy of existing financial institutions and practices to accommodate the needs of business. And wartime developments have added new elements to the controversy.

The great accumulations of government bonds in the portfolios of commercial banks, the attitudes and practices of bank examining authorities, and the declining ratio of bank capital to deposits have been taken, individually or collectively, as evidence that commercial banks will be severely restricted in their ability to lend to business after the war. On the other hand, the logic of such arguments has been challenged.¹

It has been urged that the legal restrictions on the investments of life insurance companies, and the consequent habits and attitudes of

¹The references on which the discussion of this and the immediately succeeding paragraphs is based are too numerous to be listed here.

their investment officers, are such that these bodies are precluded from extending the type of accommodation which business most needs. Against a relaxation, or perhaps more accurately a reorientation, of the investment policies of these bodies has been urged the responsibility they have to their policyholders.

It has been said that savings banks were in a fair way to become little more than a repository of government bonds and were performing no business or economic service which could not be performed more economically some other way.

Investment banking houses, it has been alleged, command too little capital to be more than middlemen in distributing securities, and for this reason, as well as because of the predilections of investment bankers, do not so effectively stimulate and guide the flow of capital into the economic system as organizations in their strategic position might reasonably be expected to do. In reply it has been stated that the capital controlled by banking houses is directly related to the profitability of the business, rising and falling as money is made or lost; that bankers, like other businessmen, must carry on those operations which are currently profitable; that they are quick to initiate new activities that show a promise of profit and abandon those which are unsuccessful; and that even if it were possible for them to conduct operations for any considerable period of time at a loss, no real economic gain would result from the dissipation of their capital.

The advantages and disadvantages of the government lending agency in the field of business have been debated, as has the desirability that its operations be extended.

In some circles the possibility that finance companies and factors may greatly expand their operations after the war is a matter of very considerable interest, as is the possibility that investment trusts may initiate new policies in the distribution of their funds.

Recently a very considerable amount of attention has been focused on the possibility of creating some new type of financial institution which would be specifically designed to furnish equity capital or long-term credits to firms, especially small or new firms, which have difficulty in securing accommodation from the existing structure of financial institutions and in view of current financial practices.¹ It has been suggested

¹In this connection, see, among other references: *Small Business Problems, Small Business: Access to Capital*, and *Problems of American Small Business*, Pt 15, *Long-term and Equity Capital*, op. cit.; radio address of Senator James M. Mead, February 8, 1944, over the National Radio Forum; an unpublished memorandum "Rehabilitation Plan" by the Hon. James C. Auchincloss, M. C.; proposal of Henry J. Kaiser, reported in the *New York Times*, December 19, 1943; proposal by Herbert F. Boettler and John W. Snyder, reported in the *New York Times*, January 4, 1944; and "300 Bills, A Digest of Proposals Considered in Congress in Behalf of Small Business, 1933-1942," Economic Series No. 27, U.S. Department of Commerce.

that such institutions should be financed by private money, by public money, or by a combination of the two kinds. Plans have been advanced to organize them on a national scale, on a regional basis, and in other ways. And the individual proposals differ in other respects.

The relative merits and defects of these various views, suggestions, and plans cannot be explored here. But it must be noted that war is a great breeder of innovations, in the financial field as elsewhere. To illustrate, the creation of the Bank of England, the acceptance of government debt as a permanent part of the British economy, the passage in the United States of the National Bank Act of 1864,¹ and the bond selling "campaign" so characteristic of the 1920's were all the direct results of war. It is quite possible that the present conflict may bring changes in the existing financial structure of equal significance, and businessmen and bankers, in looking ahead, cannot afford to overlook this possibility.

Summary

At the beginning of this report it was stated that an attempt would be made to survey forces which it seems likely will be of importance in the thinking of persons making investment decisions after the war. In this connection have been considered the adequacy of the business assets as they will be after the war to produce the output required for a high level of employment, the developments of the 1920's and 1930's which apparently will still influence men's thinking on investment when peace returns, and certain wartime happenings which seem likely to be of continuing significance. It was further stated at the outset that there would also be considered that framework of pertinent statistical material which it is necessary to bring within view in order that the investment process be seen in its proper perspective and in relation to the daily operations of business life. The discussion will now turn to this framework, since such material is fully as important in appraising future investment processes and employment possibilities as are those matters which have been designated legacies of the prewar and wartime periods.

ACCOUNTING TECHNIQUES: STATISTICAL MEASUREMENTS: SAVINGS AND INVESTMENT

Expenditure by Business Firms for Investment Purposes

Expenditure by business firms for investment purposes has been defined earlier as "the conversion of cash or cash items into fixed assets of an expected life of three years or more, and/or the absorption of cash

¹12 U.S.C. 38.

by financing the volume of inventories or the volume of receivables a firm finds necessary in view of its current or prospective level of business."¹ From the point of view employed here in discussing investment expenditures by business firms it is not material whether funds used for such purposes are derived from gross revenue, from net earnings, from the accumulation of short-term debt, from the reduction of cash balances and cash items, or from proceeds of the sale of stocks and bonds. It makes no difference at this point in the argument whether investment expenditure is made from funds received from customers, from investors, or in other ways. In fact, one of the points emphasized in this presentation is the fact that—as every financial manager of a company knows—investment expenditures are made from funds made available to business management by a variety of business operations that from an accounting point of view are quite distinct.

In the eyes of a financial executive, expenditures of his firm for investment purposes are in many ways little more than the purchase or procurement of particular kinds of assets, or of assets destined for particular uses. Such outlays, however, are distinguishable in a number of ways from other expenses—such as payrolls, taxes, or the mere replacement as distinct from the expansion of inventories—both from the point of view of the individual concern and from the point of view of the economy as a whole. And the economic peculiarities of such expenditures give them a special significance.

First, when a company makes considerable outlays of this type and substantially increases its plant and equipment, its inventories, or its receivables, the firm typically anticipates that the assets acquired—in the case of inventories and receivables the values represented by the increases—will remain on its balance sheet some considerable time, say for a number of years. Ordinarily, the mill-owner when buying new looms does not expect to write off the looms immediately, any more than does the wholesaler when building up his inventory in response to an anticipated larger volume expect that this increased value will immediately disappear from his statement. Secondly, the payments for the fixed assets or the inventories typically go to other business concerns and exert a stimulating effect on the activity of these firms and the employment provided by them, as every maker of industrial equipment knows. Thirdly, it has been a matter of common observation that when expenditures for fixed assets, or outlays to increase inventories, were at a high level, the level of employment in the country tended to be high. This observation has been made by practically every investigator of business cycles. Fourthly, when a business concern undertakes a

¹Page 2.

considerable volume of such expenditures, and these expenditures result in a pronounced increase¹ in the book value of the firm's assets—that is, when a firm adds to its land, buildings, and equipment, or because of a change in its prospects expands substantially the amount of its inventories or receivables²—that firm typically must increase the amount of its long-term capital investment, namely, the volume of its long-term debt, its net worth, or both.³

The increases in long-term investment and in the book value of the assets, however, need not take place simultaneously. In fact, the increase in the long-term investment may and often does come some months or years either before or after the actual expenditure of funds for investment purposes. It has been a common practice, particularly in the railroad and public utility fields, for companies to make considerable expenditures on fixed assets, financing such outlays through bank loans, pending the arrival of conditions propitious for a refunding of this short-term debt through an issue of securities. The significance of this time factor has been almost completely neglected in theoretical discussions of the "savings-investment problem."⁴

Commonly the funds immediately used for investment expenditure—a matter dealt with more extensively below—are derived from bank borrowings, a reduction in cash balances, or certain operating charges. But, as has been pointed out, these expenditures by business firms for investment purposes must in an ultimate sense be financed through the use of savings made by business concerns or by individuals, since short-term debts used for such purposes must be repaid, and abnormal reductions in cash balances must be replaced.

Investment in Business Enterprise

Earlier, investment in business enterprise has been defined as either

¹The distinction is made here between an *addition* to the plant, equipment, inventories, or receivables of a firm, which result in an increase in the book value of total assets, and a replacement of an asset, which does not result in such an addition.

²It is recognized that moderate increases in inventories or receivables can be and are made without being financed through long-term debt or equity. That is, they can be financed through increases in short-term liabilities. But there is, normally, a limit beyond which an increase in current liabilities cannot go without an increase in the long-term capital funds of a concern.

³The only exception to this statement, and the reason the word "typically" is included as a qualification, is the case where a firm liquidates some other type of asset and uses the proceeds to finance the acquisition. For example, a company sells an unused piece of land and uses the proceeds to buy new machinery. In this case the decline in the book value of the assets arising from the sale of the land is an offset to the increase in the assets arising from the purchase of the machinery.

⁴For instance, this point is virtually not touched upon in Hansen, *Fiscal Policies and Business Cycles*; testimony of A. H. Hansen, Hearings before the Temporary National Economic Committee, Part 9, "Savings and Investment"; and Gerhard Colm and Fritz Lehmann, *Economic Consequences of Recent American Tax Policy*, Supplement I, *Social Research*, 1938.

“the purchase by investors of the stock or the long-term obligations of a company, or the retention by a firm of net earnings,”¹ or a combination of both processes. That is, it is the process by which companies increase the amount of long-term capital employed in the business. As every businessman knows, such an increase may be derived from the savings of the firm itself, directly from the savings of individuals through the sale to them of the company’s securities, or indirectly through the sale of the company’s securities to financial institutions, such as banks, insurance companies, and investment trusts, that have already collected the savings of individuals.

In order that misunderstanding be precluded, it needs to be emphasized that the retention by a particular concern of its own savings does not necessarily mean that an expenditure for investment purposes will be made immediately,² or even that such an expenditure will be made at all. The funds may, for instance, be used to pay off a bank loan or retire a bond issue, or they may be used to buy the assets or the securities of another firm. Neither the repayment of a bank loan, the retirement of a bond issue, nor the purchase of the assets or securities of another company stimulate directly the sales or the employment of another business concern, as is the case when a firm expends funds for investment purposes. The use by a railroad of retained earnings to retire equipment trust certificates is not an expenditure for investment purposes, for the investment was made when the equipment was first bought; and the employment by an investment trust of its annual accretions of new funds in the purchase of outstanding securities is not in any way reflected in an investment expenditure by a business concern.

One further complication in this investment process must be noted. Even though a firm accumulates funds for investment purposes—either by retaining earnings or by selling securities or through both processes—and expends the funds in the acquisition of fixed or quasi-fixed assets, and thus stimulates the sales and employment of other firms, it does not follow that the values represented by such investment expenditures stay on a company’s balance sheet, either on the asset or on the liability side, for any very considerable period of time. Losses may be encountered, with a consequent decline in assets and in net worth. Or it may become necessary, in addition to the normal provision made for depreciation, to write assets down, with a corresponding reduction in surplus, or capital account, or both. When the *United States Steel Corporation* in 1935 wrote down its plant \$270 million, the company, in its annual report, stated:

¹Page 2.

²See the discussion above.

Broadly, these adjustments are attributable to the developments in the art and mechanics of steel making which have operated to reduce the normally expected life of such facilities, and to changes in plant location based upon shifting markets and transportation facilities.¹

In short, the expectations which the company had when it made its investment expenditure and acquired the assets were, with the passage of time, disappointed.

Investment Expenditure and Investment in Business Enterprise: Conclusions

Savings made by business concerns, that is, retained net earnings, result in an increase in net worth, in the long-term investment of a business concern. In the absence of simultaneous reductions in the valuation of assets, such increases are reflected on balance sheets by an increase in total assets and a corresponding increase in net worth.

Savings made by individuals, when acquired by business concerns through the sale of stocks or bonds, correspondingly increase the long-term investment of business concerns. Such increases are reflected on the balance sheets of companies. In fact, only through an increase in net worth or long-term debt, that is, only through an increase in the long-term capital employed by companies are savings, whether made by individuals or by business concerns, absorbed by business enterprise.

The fact that at any given time some firms are absorbing savings, however, does not mean that the long-term investment in business enterprise is continuously growing, and that business concerns in the aggregate are continuously absorbing savings. Offsetting increases in the long-term investment in business are operating losses, write-downs of assets and consequent diminutions of net worth, retirements of bonds and preferred stocks, and the liquidation of companies. During the 1930's, because of business losses and for other reasons, the net worth of business in the aggregate shrank considerably; moreover, funds distributed by business in the retirement and repayment of preferred stocks and bonds exceeded the funds absorbed through the issue of new securities.

What is the relationship of savings absorbed by business enterprise to expenditures made by business for investment purposes? The fact is that the savings absorbed by business are not the sole source and do not measure the sums spent by business for investment purposes. Funds

¹Annual Report of the United States Steel Corporation, 1935. For a discussion of the effects on income of charges to surplus see W. A. Hosmer, "The Effect of Direct Charges to Surplus on the Measurement of Income," in *Business and Modern Society* (Harvard University Press, Cambridge, 1938).

expended by business concerns for investment are of various types, and the various types are not "parallel"—in fact they are quite different—in an accounting sense. The funds expended come from charges for repairs and maintenance; from charges by some concerns to operations that other companies or industries would capitalize; from charges to depreciation, depletion, and other business reserves; from reductions in cash balances and cash items—notably securities; from increases in bank borrowings; and from retained earnings and the proceeds of capital issues.¹ As was pointed out above, the funds expended for investment purposes may be allocations of gross income or applications of net income; they may be derived from reductions in cash balances and cash items, in inventories, or in other current assets such as receivables; or they may be acquired through increases in short- or long-term debt, or through the sale of shares of stock.

Any man who has been responsible for the financial management of a firm that ran at a loss for a period of years is well aware that funds for the acquisition of new assets do not become available from earnings, from the sale of securities to the public, or in most instances from bank loans. For concerns losing money the only sources, typically, are charges for maintenance, repairs, depreciation, and depletion. If this seems an academic point, it need only be pointed out that firms reporting no net income to the Treasury were 40% of all active corporations in 1929, 74% of all such firms in 1933, and 54% of all such firms in 1939.²

By way of contrast to the numerous sources or types of funds utilized for expenditure for investment purposes it is to be noted that only two kinds, namely, retained earnings and the proceeds of capital issues, represent an absorption of savings. And the use of these two kinds of funds only are reflected in an increase in the long-term investment—that is, the net worth and long-term debt—of business firms.

The argument may be summarized this way. Business firms employ for investment expenditures sums received in a variety of ways—from customers, from investors, from the liquidation of assets, from the creation of debt. These various kinds of funds are accounted for differently on the books of business firms. For example, they are shown as allocations of gross income, as applications of net income, as changes

¹Funds are also obtained through a reduction in trade credit extended and an increase in the trade credit used. Consideration of this source is omitted from the discussion here, since when all firms in the "business universe" are grouped, trade payables and receivables are contra items except for credit received from or extended to parties, such as ultimate consumers, outside the "business universe." In order to simplify the exposition, this minor source of funds for investment purposes has been omitted from the discussion.

²*Statistics of Income.*

in capital accounts—that is, in stock or long-term debt accounts—as reductions in current asset items—such as cash or inventories—or as increases in short-term liabilities—such as bank borrowings.

Only two of these various sources represent absorption of the savings of the community, namely, retained earnings and proceeds of the sale of stocks and bonds. Theoretically, the absorption of savings by business enterprise can be measured by changes in the net worth and long-term debt of business in the aggregate, if allowance is made for reduction in asset valuations, for repayments and retirements of bonds and preferred stock, and for the liquidation of individual companies. But the expenditures of business concerns for investment purposes cannot, even theoretically, be measured by changes in the net worth or long-term debt of particular companies or the consolidated balance sheet of all firms in the aggregate. Investment expenditure by business concerns, so far as it can be measured, is reflected from year to year in the changes in the fixed assets and inventories of business concerns in the aggregate. In order to relate the changes in net worth and long-term debt, on the one hand, to the changes in inventories and fixed assets, on the other, account must be taken of variations in other balance sheet items, and also of certain items that appear only in income accounts. Among the balance sheet changes which are especially important in this connection are variations in cash and cash items and bank borrowings. Of particular significance on profit and loss statements are charges for repairs, maintenance, depletion, and depreciation.

Statistical Measurements

Exhibit 1, "Sources of Business Funds Available for Investment and Tangible Investments Made by Business Enterprise, 1920-1939," attempts to present, in so far as statistics are obtainable, an historical record by years for the period 1920-1939 of the sources and quantities of funds that have been available to finance expenditures by business firms for investment purposes, together with estimates of the magnitude of such expenditures as indicated by increases in inventories and plant equipment. (See pages 34-35.)

The purpose of the exhibit is fourfold. First, it is intended to present in visual form factual or statistical material designed to illustrate and to summarize in part the argument of the preceding sections regarding expenditures by business firms for investment purposes and investment in business enterprise, in order that the discussion there may be exemplified in as concrete a way as possible. Secondly, the exhibit is designed to indicate the types of statistics needed to give a

reasonably true picture of the conversion of cash by business enterprise into fixed assets, including increased inventories—even though the available statistics here employed are quite inadequate for the purpose.¹ The exhibit begins with the sources of funds (columns 1 through 9) and ends with the type of assets acquired for cash² (columns 10 and 11). Thirdly, the exhibit is intended to suggest the relative magnitudes of the different sources of funds and to place in some perspective funds available to business for investment purposes acquired through retention of earnings (column 6) and the issue of new securities (column 9). The exhibit has the final purpose of illustrating the gross deficiencies in the statistics available for measuring the volume of funds annually available to business for investment purposes, the equally gross defects in the data available for measuring the magnitude of investments actually made, and the consequent shortcomings of theoretical generalizations and rationalizations based on this and similar material.

The first nine columns in the exhibit—which cover charges for repairs and maintenance, capital items charged to operations, depreciation, depletion, income credited to other business reserves, retained earnings, changes in cash and government securities, changes in bank borrowings, and new capital issues—attempt to summarize the sources of funds available to business enterprise for investment purposes.³ It may again be emphasized that these various sources are quite different in an accounting sense, since some are allocations of gross income, some are applications of net income, some are reductions in asset items, and some are increases in liability items.

The last two columns attempt to summarize the magnitude of the investments actually made, and to divide such investment into increases in fixed plant and changes in inventories. If the statistics were adequate, the totals of columns 2-9 would roughly check with

¹Although from the point of view of the individual firm a persistently higher volume of receivables is as much a fixed asset as additional machinery, as has been noted earlier, when all business concerns are viewed in the aggregate, receivables and payables are mainly contra items, as is noted in footnote 1, page 38; and for the reasons indicated there, receivables are not brought into the discussion here.

²It is not pretended that the statistics in the exhibit, even though the best available, do in fact give a reasonably true picture. Some of the deficiencies in the statistics are discussed below.

³Note that columns 1 and 2 are not additive, even in the theoretical way that columns 3 to 9 are. The purpose of column 1 is to show the magnitude of repairs and maintenance in a limited field; the purpose of column 2 is to indicate that part of repairs and maintenance which represents capital outlays.

There are two major defects in the statistics of column 1: (a) not all business is included; (b) certain items included in the data, such as painting, are not capital outlays.

If all types of business were covered by column 1, comparison of the figures in column 1 with the figures in column 2 would give an approximation of the portion of outlays on account of repairs and maintenance that are capital expenditures.

Exhibit 1. Sources of Business Funds Available for Investment

Italics signify minus figures

Year	Sources of Funds Available for					
	Gross Income Received from Customers to Cover Charges Noted Below				Net Income Applied to Items Indicated Below	
	1	2	3	4	5	6
	Repairs and Maintenance Railroads and Public Utilities Only	Capital Items Charged to Operations All Business, Corporate and Noncorporate	Depreciation Corporate and Noncorporate Business through 1935; Corporate Thereafter	Depletion Corporate and Noncorporate Business through 1935; Corporate Thereafter	Income Credited to Other Business Reserves ¹ Corporate and Noncorporate Business	Retained Earnings Nonfinancial Corporations Only
1920	2,983	...	3,585	...	...	...
1921	2,338	...	3,632	...	...	...
1922	2,297	...	3,949	...	...	...
1923	2,592	...	4,044	...	...	2,282
1924	2,372	...	4,154	...	...	1,208
1925	2,392	...	4,386	522	...	2,244
1926	2,485	...	4,86r	614	...	1,855
1927	2,423	...	4,877	539	...	496
1928	2,341	...	5,175	553	...	1,548
1929	2,413	800	5,498	595	1,000	1,759
1930	2,082	800	5,549	493	1,100	3,466
1931	1,656	600	5,481	289	1,300	5,546
1932	1,210	400	5,119	262	1,500	6,096
1933	1,156	400	4,879	264	1,400	2,799
1934	1,281	500	4,745	330	1,300	1,855
1935	1,364	600	4,721	370	1,100	1,405
1936	...	800	3,286	437	1,300	710
1937	...	800	3,342	524	1,000	636
1938	...	500	3,352	437	500	1,355
1939	...	800	3,443	438	800	38

Footnotes: ¹It is recognized that income credited to other business reserves may be either a charge to gross or net income.

²Note that reductions in Cash and Government Securities and increases in Bank Borrowings provide funds for investment purposes, whereas increases in Cash and Government Securities and decreases in Bank Borrowings signify that funds are not being used for investment purposes.

³Note that only increases in inventories represent funds spent for investment purposes; decreases in inventories signify "disinvestment," a freeing of funds for other purposes.

Sources: Column 1 — Solomon Fabricant, *Capital Consumption and Adjustment* (New York, National Bureau of Economic Research, 1938).

2 — Milton Gilbert and R. B. Bangs, "Preliminary Estimates of Gross National Product, 1929-1941," *Survey of Current Business*, May, 1942.

3 — Data for 1920-1935 from Solomon Fabricant, *op. cit.*; for subsequent years from *Statistics of Income*. Depletion figures 1920-1924 not available.

5 — Milton Gilbert and R. B. Bangs, *op. cit.*

and Tangible Investments Made by Business Enterprise, 1920-1939

(In millions of dollars)

Investment			Tangible Investments Made by Business		Year
Balance Sheet Changes Providing Cash for Investment Expenditure ¹					
7	8	9	10	11	
Changes in Cash and Government Securities Nonfinancial Corporations Only	Changes in Bank Borrowings Corporate and Noncorporate Business Borrowing from National Banks Only	New Capital Issues Public Offerings of Corporate Business Only	Plant and Equipment Corporate and Unincorporated Business	Changes in Inventories ² Corporate and Unincorporated Business	
...	...	...	8,327	...	1920
...	1,239	864	5,233	47	1921
...	1,056	1,335	5,784	514	1922
...	403	1,624	7,902	2,964	1923
...	34	1,941	7,650	1,056	1924
...	38	1,824	8,189	1,523	1925
...	279	1,801	9,126	1,246	1926
364	201	1,781	8,777	308	1927
840	291	1,495	8,846	102	1928
242	836	1,787	10,157	2,146	1929
438	319	1,939	8,340	631	1930
1,318	803	796	5,123	1,190	1931
33	1,637	203	2,799	2,327	1932
245	1,334	106	2,371	1,114	1933
22	161	63	3,436	1,748	1934
1	69	94	4,349	1,145	1935
467	339	379	5,783	2,300	1936
756	855	635	7,570	4,196	1937
890	152	428	5,471	1,250	1938
870	680	191	...	...	1939

Column 6) — *Statistics of Income*. The data in this column cover nonfinancial corporations only.

7) — Changes in Loans "commercial in form" of National Banks, from Pearson Hunt, *Portfolio Policies of Commercial Banks in the United States, 1920-1939* (Harvard University, Graduate School of Business Administration, Bureau of Business Research, Boston, 1940).

8) — "Productive Issues," *Moody's Bond Survey*, February 1, 1943.

9) — George Terborgh, "Estimated Expenditures for New Durable Goods, 1919-1938," *Federal Reserve Bulletin*, September, 1939.

10) — *Hearings Before the Temporary National Economic Committee, Part 9, Savings and Investment*, p. 4011. In terms of 1929 dollars. Prepared by Dr. Lauchlin Currie on the basis of studies of Solomon Fabricant in *Capital Consumption and Adjustment*.

the totals of columns 10 and 11. If the check on a year-to-year basis were not very exact, it probably could be made more precise by the use of three-year moving aggregates.

In short, were the data reliable the algebraic sum of the sources of funds available to business for expenditure for investment purposes could be expected to be roughly equivalent to the balance sheet changes resulting from the expenditure of such funds. But in fact, for many reasons, some of which are noted below, the data in the exhibit do not check out.

Many of the deficiencies in the material are evident on inspection. Figures are not available for each of the columns in all years; only for the years 1929-1935 can all the columns be completed. To be homogeneous, and even moderately comparable, the figures in each column should cover all types of business, corporate and unincorporated, but such is not the case. Repairs and maintenance charges in column 1 were only those of public utilities; the retained earnings data in column 6 and the changes in holdings of cash and security holdings in column 7 include only nonfinancial corporations; the new capital issues figures in column 9 are applicable only to public corporate offerings, and omit capital raised by unincorporated concerns and capital raised privately by corporations; the depreciation figures through 1935, but not thereafter, include unincorporated as well as corporate business; while the series of capitalized items charged to operations in column 2 include unincorporated as well as corporate business. And other reasons for lack of comparability as between the columns can readily be found by checking the descriptions of the statistics in the sources from which they have been taken.

Furthermore, the data are very uneven in quality. The figures for changes in holdings of cash and government securities in column 7, for changes in bank borrowings in column 8, for new capital issues in column 9, and for depletion in column 4, appear to be reasonably reliable—at least for the purposes of the original compilers of these data. The statistics for depreciation in column 3 and for retained earnings in column 6 are somewhat less reliable; the other data can best be described as approximations subject to wide margins of error.

There are, moreover, other difficulties of a more subtle character involved in the use of this table. Only three of these difficulties will be mentioned here. First, as every businessman knows, there are wide differences in the practices of individual industries and particular companies regarding depreciation charges, and the character of items charged to operations in distinction to those that are capitalized. The data in the table conceal but do not eliminate such differences in prac-

tice. Secondly, the annual figures of new capital issues, valid so far as they go, do not by themselves represent the annual demand for new savings placed by business enterprise on the capital markets. For there must be offset against these figures the repayments and retirements of bonds and preferred stock which release old savings for reinvestment. Thirdly, still other questions of comparability arise. For instance, the plant and equipment figures in column 10 allegedly include only capitalized items, and such items thus exclude, supposedly, materials and other costs incurred for maintenance and repairs. Consequently the expenditures for maintenance and repairs in column 1 cannot, theoretically, be viewed as being one of the sources of cash used to purchase the items comprised in column 10.

In view of the deficiencies in the data in this table, and the difficulties inherent in using it, the questions may arise: Why compile it? What use can be made of it? To these questions three answers may be given.

Statistical Measurements: Conclusions

First, notwithstanding the deficiencies in the data employed, the table indicates in a relatively simple manner a way of looking at the relationship of corporate and individual savings to the other sources of funds available to business enterprise for investment purposes, and the relationship of the balance sheet changes in fixed asset and inventory accounts that result from the expenditure of funds available for investment. This way of looking at these relationships is reasonably in accord with the facts of business life. Thus the investment process is described more concretely and placed more nearly in its proper perspective than can be the case if discussion is confined to verbal exposition.

Secondly, the table sharply focuses attention upon the deficiencies in the statistics available for measuring this investment process. As a result, it emphasizes the lack of reliability of abstract theorizing which relies upon these statistics for validity and verification.

Thirdly, so far as possible, the table permits observable accounting practice and everyday actions of controllers and treasurers in managing particular companies to be related to the so-called savings-investment process. The various sources of cash in a firm are placed in juxtaposition with those dispositions of cash that result in investment. As noted earlier, both businessmen and academic economists agree that this savings-investment process is the basis not only of fluctuations in business activity in general but of variations in the gross sales and net profit of individual business concerns.

Savings and Investment

Thus far the discussion has described the connections which exist between the funds available to business firms for investment purposes and the balance sheet changes which result from the expenditure of such funds. The discussion has also indicated the place which savings made by business firms and by individual persons—as measured by retained earnings and new security issues—hold among the various types of funds available to business for investment purposes.

There remains the problem of describing the relationship of savings absorbed¹ by business enterprise and spent for investment purposes to total savings accumulated by persons and business concerns during some period, say a calendar year. In other words, to place the savings-investment process in its proper perspective and relate it to the daily happenings of business life it is necessary, first, to relate—as has been done—funds expended by business firms for investment purposes to savings absorbed by business firms, and then to relate the savings absorbed by business enterprise to the total savings accumulated in the community. The discussion now turns to this second point.

Make two assumptions. First assume that during some calendar year the sums becoming available to business enterprise in the aggregate for investment purposes from maintenance and repair charges, from charges for depreciation and depletion, and from income credited to other miscellaneous business reserves were such that these sums were wholly adequate to satisfy the need of all business firms for investment expenditure, so that retained earnings were used either to repay bank loans or were accumulated as idle cash balances. Assume further that in the same year retirements of bonds and preferred stocks were just equal to the volume of new capital security issues. Under such circumstances it is evident that business would not in that year absorb any of the savings currently accumulated by individuals.² Under this hypothetical set of conditions it is also clear that such portion of the savings of individuals as was not invested in the construction of housing or used to acquire assets in foreign countries would accumulate as idle balances, either in the hands of the individual savers or in the hands of the financial institutions to which they had been entrusted. Furthermore, it seems extremely likely, if such a condition as has been outlined prevailed during a calendar year, that as the year progressed business would find the market for its products reduced. In that event profits would tend

¹By "absorbed" is meant both retained earnings (business savings) and savings of individuals acquired by business concerns through the issue of securities.

²This statement is equally true whether the savings are visualized as being in the hands of individuals or turned over by them to financial institutions such as savings banks.

to decline and unemployment to grow. In passing, it may be noted that statistical proof of the existence of such a set of circumstances, or that these circumstances existed in any stipulated past year, is virtually if not absolutely impossible.

"Oversaving" and Business Recession

To many businessmen this hypothetical series of assumptions may seem to bear little resemblance to the business process as they have observed it. But those persons who attribute depressions and unemployment to "oversaving" believe not only that something happens very like the situation outlined in this hypothetical set of circumstances, but that it tends to happen persistently.

In general, the thesis is supported by three main lines of argument. First, it is stated that the economy of the United States has reached maturity, and that in a "mature economy" investment opportunities are too scarce to absorb all savings, and thus savings are not put to work, and consequently they become hoards of unused purchasing power. Secondly, it is argued that the annual depreciation charges of business—especially of big concerns—are so large, and the earnings retained by business firms so substantial, that these sums nearly if not entirely satisfy the requirements of enterprise for funds for investment purposes. Consequently business, and particularly large concerns, needs to seek only very moderate amounts of new money in the capital markets, and thus the outlets for savings are further reduced. Thirdly, it is argued that the savings of persons, individually and in the aggregate, are made, not in response to investment opportunities and the needs of business for funds, but because of the predilections of many persons for saving. In fact, the larger an income a person has, it is said, the more he tends to save. Thus most of the savings are said to be made by persons with substantial incomes. And the fact that "oversaving" and consequent unemployment occurs, is, as it were, the fault of persons in the upper-middle and high income brackets.

Three quotations summarizing many of these contentions are apposite.

For upon one thing all modern economists, of whatever school of thought, are agreed: *the amount which the community wishes to save at full employment income levels must somehow be offset or income will fall until the community is so poor and wretched as to be unwilling to save more than can be offset.*¹ (Author's italics.)

¹Paul A. Samuelson, "Full Employment After the War" in *Pastor Economic Problems* (New York, McGraw-Hill Book Company, 1943).

Full employment of labor and other productive resources depends, in a capitalist economy, on the maintenance of an adequate flow of investment expenditure. What is adequate depends, in turn, on the way the community divides its income between saving and spending on consumption goods. To support a particular level of income, investment must always be sufficient to balance the saving the community chooses to do at that level of income. If investment falls below this amount, income necessarily declines to the point where saving is sufficiently reduced to fit the smaller volume of spending.¹

The concentration of individual saving within the higher income brackets is so striking that it needs no extended discussion.²

Commentary

The pros and cons of the "mature economy" argument are not a part of this discussion. Furthermore, consideration of the adequacy, significance, and uses of depreciation charges would constitute an unwarranted digression from the point of view of this report.³ Although it is germane to point out that whatever the situation was regarding depreciation charges during the 1920's and 1930's, the same situation is hardly likely to be the case at the end of this war, for reasons that have been earlier discussed.

Space limitations preclude discussion of the grounds for belief that the bulk of savings, and thus the great bulk of any "oversavings," are commonly accumulated by persons in the upper-middle and high income brackets, or of the qualifications that should be appended to any proposition of this general character. Nevertheless, two comments are pertinent here.

First, as has been indicated earlier, much the larger portion of the tremendous volume of liquid savings during the war has been accumulated, so far as can be determined, by persons in the lower income brackets, not by persons in the middle or upper income brackets. Secondly, one of the major pieces of statistical evidence commonly used to support the contention that the upper income groups furnish the majority of savings is the study of the National Resources Committee covering a single year, *Consumer Expenditures in the United States—Estimates for 1935-1936*.⁴

In this study it is estimated that during the twelve months in 1935-1936 covered by the study 110,135 families and individuals with

¹Alan Sweezy, "Secular Stagnation," *ibid.*

²Oscar L. Altman, "Savings, Investment, and National Income," TNEC Monograph, No. 37, Washington, 1941.

³As indicated earlier, it is intended that the subject of depreciation will be dealt with in another report.

⁴Washington, National Resources Committee, 1939.

annual incomes of \$20,000 and over accumulated 39.5% of the total savings made by all persons and families in that year, and that 926,648 families and individuals with annual incomes of \$5,000 and over accumulated 79.2% of the total savings made by individuals. However, this judgment regarding families and individuals with incomes of \$20,000 is based on a sample containing *only* 15 cases, of which 14 had incomes in the range of \$20,000- \$25,000, leaving only a single instance to represent income recipients with incomes in excess of \$25,000. These 15 cases were about four one-hundredths of one per cent of the 42,876 cases used in the entire sample covering the whole income range, and an infinitesimal portion of the estimated 110,135 families and individuals within the group. The judgment regarding families with an income of \$5,000 a year or more was made on the basis of a sample containing *only* 966 cases, which is slightly over 2% of the entire sample, and about one-tenth of one per cent of the estimated 926,648 families and individuals thought to have had annual incomes of \$5,000 or more. In short, the basis used for estimating, in one case, about 40% of the total savings of individuals, and in the other case about 80%, was so small as to be microscopic. Moreover, various of the statistical procedures used in the study were such that—even if the sample had been larger—the conclusions would nevertheless have been extremely dubious.¹

More careful and complete investigation might support the contention that the bulk of the saving during some periods of time is done by persons in the upper income brackets. The evidence afforded by this inquiry of the National Resources Committee is, however, at most very doubtful, and many of the uses commonly made of the findings of the inquiry are wholly unwarranted.

As a matter of further comment on the savings-investment process it may be noted that the man of affairs, surveying the economic literature on this subject and attempting to relate it to the world with which he is familiar, commonly is surprised at what appears to him a neglect in the analysis of the part played by loans of banks to business concerns for commercial purposes. Almost equally striking is the small amount of attention paid in such discussions to the position of bank loans made for the purpose of purchasing or carrying securities, and the particular importance such loans have in relation to new security offerings.

Much investment expenditure by business concerns is made with the proceeds of bank borrowings. Such outlays stimulate business

¹For instance “. . . the basic data available for determining spending patterns of families with incomes beyond \$20,000 was exceedingly limited, and it was necessary to rely primarily on ‘extrapolating’ the curves of expenditures and savings shown by the more adequate sample data for the lower income levels.” (Ibid., p. 21.)

activity just as much as do the use of retained earnings, for it makes no difference to the contractor who is employed to put up a new wing on the factory whether he is being paid out of funds received by his employer as profits or whether he is being paid out of the proceeds of a bank loan. An increase in bank borrowings, used for investment purposes, "offsets" uninvested savings elsewhere in the economic system just as surely as does government expenditure on public works. Pertinent to this point is the tremendous drop, commented on earlier, in bank loans to business concerns during the last twenty years. This decline is one of the major financial developments in the period elapsing since the First World War. Should this decline be reversed after present hostilities end, it seems quite likely that much less attention would be paid to the need for "offsetting" idle savings through public expenditure or in other ways.

During the 1920's new security flotations at times were large and ran ahead of the market's ability to absorb them. That is, capital issues were offered in the market more rapidly than savings appeared to take them off the market. Under such circumstances security loans of banks were used to carry new issues—not to mention old issues—until such time as the new flotations could be "placed." When buying power in the form of savings appeared, the security loans were reduced or repaid. In other words, in the period 1920-1930 security loans had an important function in adjusting the supply of securities to the demand for them, in adjusting the rate of investment to the flow of savings. Since 1930 the security markets have been depressed, and one of the most far-reaching changes in the financial world has been the virtual disappearance of the security loan. If after this present war investors, investment dealers, and even speculators should take an optimistic view of the future, and through the medium of security loans supply business enterprise with funds needed for investment purposes, such funds might also go a long way toward "offsetting" idle savings in the hands of less venturesome individuals and institutions.

MOTIVES

So far this report has concerned itself with the forces that will shape the *problems* of financing business enterprise in the post-transition period. What are the forces which will give form to the *solutions* that will be found for these problems? The dominant force shaping these solutions will be the motives that will actuate investors, borrowers, bankers, and financial officers of business firms in the period after hostilities end. And particular significance will attach to those motives which will

distinguish this interval from others in the country's history. Although an attempt to survey in any comprehensive way the motives which will in fact actuate men some years hence clearly can be only conjecture of an extreme type, nevertheless it may be possible to set forth some bench marks or points of reference useful to businessmen when considering their future actions.

General

At the outset it may be posited that in general it is unrealistic to assume that human beings in any particular situation will act contrary to the way they commonly do act in similar situations. The forces of habit and inertia are very strong. This generalization is pertinent to the future significance of legacies from the prewar or war periods, such as the rising importance of institutional savings, the emphasis placed by businessmen on depreciation, the attention paid in many fields to plans for systematic reduction of debt, and the evident preference of many persons at the present time to hold their savings in liquid rather than in invested form. In short, it is unreasonable to imagine that the textile machinery company which has not had a bank loan for 20 years will readily be induced to borrow after the war in order to expand operations, no matter how large the prospective profit resultant from the larger volume; or that the individual investor who has never bought foreign bonds can rapidly be educated about their merits.

As a brief digression, it may be said that mental attitudes and habits are in general more easily by-passed than overcome by direct assault. For example, a businessman who has an aversion to bank borrowing may under some circumstances be willing to borrow from an insurance company or to use the facilities of a factor. Or an investor who dislikes foreign bonds may be quite willing to buy the bonds of a domestic corporation whose income is largely derived from foreign business.

But to return to the main argument, this generalization that people are largely actuated by habit is useful in connection with prophecy regarding the future effects of the great changes which the last 15 years, and the war, have brought in the financial world. Beginning with the stock market crash of 1929 and the failure of the Bank of the United States, continuing with the institution of the Federal Deposit Insurance Corporation and the Securities and Exchange Commission, the rise in the public debt and in rates of taxation, including the abrogation of the gold clauses, the silver purchase experiments, the devaluation of the dollar, and many other happenings that readily come to mind, the circumstances within which financial and investment processes are carried on have been subject to a long-continued series of rapid and

fundamental changes. That is, the environment within which financial decisions have been made has been subject not only to alterations of a fundamental and far-reaching character but—more important—to a rate of change so rapid as to be almost revolutionary in character.

What is the effect of a very rapid rate of change in conditions, in the environment, upon the motives and actions of men? Montague Norman once pointed out that trade, given time, will accommodate itself to any tariff, no matter how high the barrier, so long as the tariff does not change too often. Much the same can be said about business activity. Business can adapt itself to and can function effectively under almost any set of conditions—provided these conditions are not changed too often. For a rate of change too rapid to permit adjustment breeds confusion, confusion begets distrust, and distrust produces a kind of creeping paralysis throughout business and economic activity. As in the field of biology, if the environment changes too rapidly to permit the organism to adapt itself to the new conditions, the organism dies. If 10 years are necessary in order that the capital laid out in an investment be recovered, and if it is suspected that conditions during the 10 years will change so rapidly that the capital invested cannot be recovered, the investor—or the business executive—evidently will not make the investment.

Furthermore, many of these changes have been of such a character as to carry the suggestion of public disapproval of many of the beliefs, activities, and principles of numerous businessmen. This fact, irrespective of whether the disapproval was deserved or not, has unquestionably been disheartening to many executives, and exercised a restrictive influence on business activity, even though such influence has not been subject to statistical measurement.

Thus it might be that one of the policies most stimulating to business, which public officials and business managers could pursue in the post-transition period, would be a reduction of the rate of change and a continuance of established conditions and ways of doing business. For in terms of motives, change too rapid to allow adjustment breeds stagnation; whereas progress is accomplished by a rate of change that permits business practice and mental attitudes to adapt themselves to it.

Although many of the writers on the savings and investment process pay lip service to the motives that actuate businessmen, investors, and bankers,¹ by and large these intangible but often decisive factors

¹For example, “. . . economic prosperity is excessively dependent on a political and social atmosphere which is congenial to the average businessman. If the fear of a Labour Government or a New Deal depresses enterprise this need not be the result either of a reasonable calculation or of a plot with political intent;—it is the mere consequence of upsetting the delicate balance of spontaneous optimism.” (Footnote continued on next page.)

do not seem to form a real part of their thinking. One eminent commentator in the field states:

The high savings economy (i.e., such as the United States), barring government intervention, can escape a fall in income and employment only through the continuous development of new outlets for capital expenditures. As far as private investment outlets are concerned, this requires continuous technological progress, the rise of new industries, the discovery of new resources, the growth of population, or a combination of several or all of these developments.¹

The failure to include in the list of requisites for the continuous development of new outlets for capital expenditures the necessity that "government intervention" be of such a character as to permit potential borrowers and investors to adapt themselves to the new conditions—or even of such a character as to reassure them and to stimulate them to perform their essential economic functions—seems to show that the motives which influence the individual persons actually making investment decisions were not thought to be of significance. The omission of any real consideration of the effect upon savers, investors, bankers, and business managers of "government intervention" *per se*, without stipulation as to the kind, suggests a most unrealistic view of the investment process.

Ownership

Various of the legacies of the prewar period, and of the war, when considered in terms of motives, achieve a special and noteworthy significance. For instance, when placed in conjunction with each other, the use of institutional savings, the difficulty of selling small issues of stock, the check in the growth of stock-ownership, the decline in loans made to carry securities (particularly equities), and the wartime accumulation of savings in liquid rather than in invested form—these suggest a large and continuing distaste by individuals for the risks and responsibilities of ownership. This point has been made before, but it is

(Footnote continued from preceding page.)

"For a large increase in the quantity of money may cause so much uncertainty about the future that liquidity-preferences due to the security motive may be strengthened."

(John Maynard Keynes, *General Theory of Employment, Interest and Money*.)

"In a state of grave mistrust people will live from hand to mouth; if they do, changes in the rate of interest (the moderate changes we are talking about) can have little influence on their conduct. In a state of confidence, on the other hand, risk allowances are much smaller; and a space will probably be left between the extremes where interest is ineffective, within which it can have a significant influence." J. R. Hicks, *Value and Capital* (New York and London, Oxford University Press, 1939).

¹Hansen, *Fiscal Policies and Business Cycles*.

of sufficient importance both to businessmen and to makers of public policy to warrant repetition, particularly when financial plans for the post-transition period are under consideration: Who will own American business in the postwar world? For whom will the executives work? Who will pay the income taxes levied on business earnings—the major source of Federal revenue? Who will provide the jobs which are furnished, in the last analysis, by the owners of business enterprise?

No doubt there are many causes for this apparent distaste for ownership, of which the present form of taxation is not the least. This is not the place to trace the deterrent effects on investment of such provisions in the tax structure as progressive rates of taxation, double taxation of corporate income, and tax-exempt securities. But in passing it may be noted that the expectation of a continually changing tax structure—a prospect to which taxpayers were being rapidly conditioned even before the war made higher taxation imperative—has deterring and restrictive effects upon investment which are quite as important as the particular provisions of any specified tax code.

Financial Self-Sufficiency

What is the significance of the strong emphasis placed in current business practice on depreciation, of the increasing number of vehicles for systematic debt reduction, of the large proportion of earnings typically retained by the majority of business firms, of the general reduction in all types of private indebtedness during the last 14 years, and, in particular, of the tremendous decline in commercial loans of banks since the First World War? When these various matters are placed in conjunction with one another they convey a strong impression of a tremendous desire on the part of business managers to be free of debt and to be financially self-sufficient through the use of retained earnings and of funds accruing from depreciation charges.

Whatever the motivating forces behind this apparently deeply ingrained business policy, it seems probable that this policy will continue to be operative in the future. And one seemingly major basis for this effort to be free of debt, and financially self-sufficient, which bankers must take into account when considering their operations in the post-transition period, is the deep-seated dislike of many businessmen to assume the obligations and responsibilities incurred in a bank loan.

There are numerous businessmen, particularly among those who have had what they consider "unfortunate" experiences with banks, who would rather do a smaller volume of business and make less money than expand their operations and increase their earnings through the aid of bank credit. The fact that the six leading concerns in a manufac-

turing city of moderate size have never had a bank loan within the memory of the bank carrying their primary accounts would seem to be the result of conscious action rather than of fortuitous circumstance.

In this connection it may be noted that low short-term money rates, a condition which seems likely to prevail for some time to come, can easily be greatly overexaggerated as an inducement to borrow. Risk factors, when the future is obscure and the outlook uncertain, far outweigh considerations of 0.5% in the interest rate, or even variations of 1% or 2%. Moreover, when corporate tax rates are at such a level that they absorb 40% to 80% of net earnings, it is surely unrealistic for businessmen or bankers to haggle over a fraction of a per cent in the rate on a bank loan, at least in the case of firms "in the black," when somewhere between 40% and 80% of the interest paid by the borrower will in fact be borne by the government as an income tax deduction. Finally, it may be pointed out—though there is perhaps hardly a need to do so—that interest rates, at least for prime credits, were very low during the 1930's, but commercial borrowing nevertheless steadily declined.

This distaste for *owning* and this dislike for *owing* suggest a wide—and a serious—divergence between the points of view of persons and institutions with capital to invest and businessmen seeking capital for investment purposes. The combined effect of these two attitudes clearly serves as a bar to investment and business expansion, and militates against the provision of jobs.

Short-Term Interest Rates

When short-term interest rates are low and tax rates high, the commercial borrower is ordinarily influenced far more in his borrowing operations by the repayment schedule stipulated by the borrower, by the positive and negative covenants in the loan agreement, and by the bookkeeping work involved in the arrangements, than he is by the interest rate exacted. Under the conditions which seem likely to exist over the next few years the difference between 3% and 4% in a rate attached to a loan will not—or in a realistic view should not—be a decisive factor in negotiating a loan. Of more weight in a borrower's mind will be clauses restricting managerial discretion, covenants designating the amounts and kinds of working capital to be maintained, pledges stipulating the way in which books are to be kept, restrictions imposed on the payment of salaries and dividends, the schedule or formula worked out for the repayment of the loan, and the powers granted to the creditor in regard to the debtor's executive personnel.

Bankers, when looking at the course of commercial loans over the

last 20 years, and when pondering what the next 20 years may bring and who their customers will be at that future time, may well give attention to the motives and considerations—other than interest rates—which will be of moment to their customers and potential customers. For low interest rates mean not only that credit is plentiful, but also that business concerns are not willing to borrow.

Long-Term Interest Rates

The fact that long-term interest rates in recent years have been low, both the yields obtaining on outstanding issues and the rates attached to new flotations, and the likelihood that a continuing low rate on Federal securities may in the future keep observable market rates low, must be interpreted with great care when these rates are related to the motives that lead businessmen to seek new funds in the capital markets for investment expenditure purposes. Low rates, even low rates on new securities, do not mean that all kinds of capital are either cheap or easy to obtain.

In the first place, the promised return, whether a coupon on a bond or a dividend rate on a preferred stock, does not measure the cost to the issuing company of raising capital. Other costs of securing capital, particularly in the case of small issues, may be high, even prohibitively high. In 1935 and 1936, when the coupon rates on bond issues were low and the cost of raising capital apparently moderate, the costs of flotation, not measured or measurable by interest rates, were between 4% and 5% of the proceeds of bond issues of less than \$5 million, slightly over 10% for preferred stock issues of the same size, and in the case of small issues of common stocks as much as 20% or 30% of the proceeds.¹

Moreover, the costs of flotation varied tremendously, depending upon the method of distribution employed and whether a particular issue was underwritten, not underwritten, sold to the company's securityholders, or sold to the public. In 1939,

Cost of flotation absorbed \$2.60 out of each \$100 to be realized from the sale of underwritten bonds, or about 2.6 per cent. Cost of flotation averaged 6.3 for underwritten preferred stock, 16.0 per cent for nonunderwritten preferred stock, 16.9 per cent for underwritten common stock and 19.0 per cent for nonunderwritten common stock.²

¹*Cost of Flotation for Small Issues 1925-1929 and 1935-1938* (Washington, Securities and Exchange Commission, 1940).

²*Cost of Flotation for Registered Securities 1938-1939* (Washington, Securities and Exchange Commission, 1941).

Typically, a business concern does not have a free choice of the various methods of distribution; it must employ those which are feasible; and the costs involved in the one or two feasible methods of distribution are commonly of at least as much importance in its decision to seek new investment as is the coupon or dividend rate attached to the securities offered.

Of still more importance is the fact that the rates of return attached to new issues and their costs of flotation measure only the costs of the issues actually sold—they do not measure the costs of the issues not brought out. And the character and quality of new flotations change from year to year, so that interest or dividend rates of new issues and flotation costs over a period of time are not a homogeneous statistical series. They do not measure the same things in all years. The fact that the average cost of flotation for underwritten bond issues in 1938 and 1939 was only 2.6% does not signify that the costs of raising capital were low for all types of bonds, for practically all the issues floated at this time were high-grade, refunding issues. When all the facts concerning the issue of securities in these years are put together, they suggest that the costs involved in raising certain types of capital, such as new money raised through a second-grade bond, were so great that businessmen needing such kinds of financing were not willing to incur the necessary expense.

Conclusion

Finally, when the various sources of funds available to business for investment expenditure are considered—repairs and maintenance expenditures, sums spent on capital items charged to operations, depreciation, depletion, funds arising from income credited to other reserves, retained earnings, changes in holdings in cash and government securities, bank borrowings, and the proceeds of new capital issues—it is quite evident that the motives dominant in the expenditure of one type of funds will be quite different from the motives dominating the expenditure of sums derived from other sources. Forces of competition; the desire of a firm to maintain its place in the industry; the effects of taxation; the necessity that improved methods and equipment be introduced; the wish to be independent of bank loans; the necessity that the earning power of fixed assets be maintained—these and many other forces, ponderable and imponderable, will affect decisions regarding expenditure for investment purposes. The general range of subject matter can only be indicated here, not explored. But individual businessmen and bankers, contemplating their own concrete situations

and the feasible courses of action in the future, cannot omit from their considerations the possible amounts of funds which will or might become available from one source or another and the motives which will control the uses made of such sums.

SUMMARY

This report first questioned the adequacy of the fixed assets and working capital of American business, as these assets will be at the end of the war and in the absence of substantial additions, to produce and distribute the volume of output necessary for a high level of employment. The report then attempted to summarize the various forces which after the war may affect significantly the thinking of persons investing in business enterprise and the decisions of business executives responsible for their firms' capital expenditures. In this endeavor were surveyed the developments of the prewar period which, it seems likely, will still have vitality after the transition is over, as well as those wartime occurrences which, it seems probable, will continue to have an influence on the course of events. Side by side with these factors were placed certain materials regarding the expenditure of funds by business firms for investment purposes, together with a summary of some of the motives that may affect importantly the financial decisions of investors and businessmen after the transition period.

Various of the financial legacies from the 1920's and 1930's, such as the rise of institutional savings, the difficulties of selling small equity offerings, the check in the growth of stock ownership, the emphasis placed on liquidity in investment practice, and the great accumulation by individuals of liquid, investable savings during the war, suggested a strong disinclination on the part of many persons to assume the risks and responsibilities of that necessary business and economic function—ownership. Other of the legacies, such as the tremendous decline in the loans of banks, the reduction of other types of debt, and the growth in many financial fields of mechanisms for the systematic repayment of borrowings suggested an almost equally strong distaste on the part of many individuals and business executives to incur the limitations and responsibilities of a debtor position.

This apparent distaste for owning and seeming dislike of owing, although no doubt enhanced by the prospect of the high tax burden and the dislocation of the economy that will result from the war, seem to have originated prior to the outbreak of hostilities. These habits of mind, when placed in conjunction with the types and magnitudes of funds available to business enterprise for investment purposes—a matter

dealt with at some length in the report—seem to achieve a special importance, even though their full significance is not clear. Probably these attitudes in part explain the interest currently exhibited in many quarters regarding new financial techniques and new types of financial institutions. Certainly they rank high among those motives of investors and businessmen which seem likely to be of moment in the post-transition period.

This survey has not attempted to forecast the amount of funds that will in fact be available to business enterprise after the transition period, nor to place a dollar figure on the sums that will be needed by business. But the evidence brought together strongly suggests that if a high level of employment is to prevail after the transition period, a substantial volume of investment in business enterprise must be made by private investors. The potential supply of private funds available for investment seems ample for the needs of business. Thus, the question arises whether these funds will in fact be attracted by enterprise. The answer to this question will largely depend on the inducements offered—both by business managers and by public policy—to potential investors. There seems little doubt that one of the great needs of the economy is the creation of a large class of investors in business, particularly small investors. Certain of the conditions necessary for the creation of such a group will, it seems evident, be present. Whether these investors will in fact appear after the war will largely be determined by the inducements offered them at that time.

A great part of the material surveyed in this study has emphasized, first in one way and then in another, the importance, even the necessity that the ownership of American business be made more attractive. This matter, it seems clear, is one which is of vital and of equal importance to business management, to financiers, to labor, and to framers of public policy. Ownership is the heart of the investment problem. It is the center of the employment problem. It is the basis on which credit is extended. It is the foundation on which the whole scheme of things in the American economy rests. If ownership is unattractive to potential investors, if owners are weak and irresponsible, if ownership as a function falls into disrepute, if directors and executives of business concerns fail to fulfill their responsibilities to owners, credit inevitably contracts, investment expenditure automatically declines, and unemployment necessarily develops.