12-1-1975

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LOOKING AHEAD: CAPITAL SHORTAGES, TAX POLICY, AND ECONOMIC PLANNING

Lewis D. Solomon* and Irv Belzer**

I. Introduction

In the midst of the immediate economic crisis, analysts have perceived a new, long-term threat to the economic health and stability of the United States. The possibility looms that the United States economy will be unable to provide for new investment required by private businesses during the next decade. Increased dependence of American corporations on debt financing and the problems faced by some corporations in obtaining funds on reasonable terms in debt and equity markets lend support to the increasing evidence that America faces an impending major capital shortfall. Although present plant overcapacity probably negates such fears, at least in the next year or two, eventually this capital shortage problem must be resolved.

Two different means of meeting these future capital needs have been proposed. The so-called free market approach relies on the federal government making additional funds available through a variety of tax devices. In lieu of this approach, various modes of economic planning including credit allocation and government financing of business have been suggested. The solutions should avoid sweeping generalized demands for indiscriminate tax cuts for business, and concentrate on those sectors and firms which require funds either to solve pressing financial difficulties, thereby averting the threat of bankruptcy and the specter of higher unemployment, or to meet future capital needs flowing from a soaring demand for an entity's goods or services. Most importantly, standards are needed to guide policy-makers in using federal tools and allocating resources to meet these capital needs of American business.

Underpinning the technical analyses offered by many observers of the capital shortage problems are a series of difficult value questions, particularly the desirability of growth versus the need to redistribute income. The resolution of these questions may direct the future of American society. Whether economic and social institutions will be adapted to serve human needs constitutes one of the most important issues of our time.²

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The authors gratefully acknowledge the research assistance of James Ewan, third-year student, University of Missouri—Kansas City School of Law, in preparation of this article.


II. The Capital Picture Today

A. Overview

The present capital picture in this country is a starting point to understanding industry's future capital needs and potentials. Corporations have become increasingly dependent upon debt financing and especially dependent upon volatile short-term debt, as internally generated funds have failed to meet corporate needs. With profit margins significantly reduced, the ability of corporations to obtain debt financing and perhaps their ability to service present debts through internally generated funds has decreased.

First, corporate demand for credit today is very high: sales of long-term corporate instruments rose to record-breaking levels in 1974, yet sales of short-term instruments soared even higher. The ratio of debt to equity has also increased. In fact the debt-equity ratio for U.S. manufacturing corporations has more than doubled over the past two decades—from 21 percent in 1955 to 44 percent in 1973. The high demand for debt resulted from three factors: (1) declining business profits, (2) lagging productivity, and (3) increasing corporate dependence on external funding sources.

Business profits have fallen in recent years to a level described by some as a "profits depression." This is a curious description, since the estimated 1974 pretax profits of all nonfinancial corporations from their domestic operations were 16 percent higher than in 1973 and 46 percent higher than in 1972. However, if these profits are adjusted to exclude illusive inventory profits and tax obligations, domestic profits of nonfinancial corporations did not rise at all in 1974. Rather, they declined by 20 percent and were smaller than 10 years earlier when the dollar value of the output of these corporations was about half

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5 Id. at 3.
7 Hearings on Tax Reform Before House Comm. on Ways & Means, 94th Cong., 1st Sess. 30-31 (1975) (statement of Secretary of the Treasury William E. Simon) [hereinafter cited as Tax Reform Hearings]. See also Cairncross, Mr. Benn's Formula Faulty, Manchester Guardian, May 3, 1975, at 8; Clark, Inflation and Declining Profits, Lloyds Bank Rev., Oct. 1974, at 1; Profits: Reaching for the Bottom, Bus. Week, Aug. 18, 1975, at 53 (reporting that perhaps profits have reached bottom and are beginning to move up); What the Marxists See in the Recession, Bus. Week, June 23, 1975, at 86.
8 Goldman, supra note 1; Growth Capital?, supra note 1.
9 These fictitious profits resulted from accounting practices that do not allow for the fact that inventories are used and must be replaced at higher prices during an inflationary period.
10 Burns, supra note 6, at 16. It should be noted that approximately 30 percent of American corporate profits are from foreign operations. R. Barnet & R. Muller, Global Reach 258-59 (1974).
what it is today. In fact, 1974 aftertax profits, adjusted for inventory gains, barely equaled the amount of dividends which the companies paid their stockholders. Furthermore, when allowance is made for the fact that depreciation schedules are also based on historical rather than replacement costs, nonfinancial firms actually paid out more in dividends than they earned from current domestic production.

The second cause of the high demand for debt by American business is the decline in productivity. Output per man-hour in the nonfarm sector of the private economy is lower now than it was two years ago, and the rate of gain during the last 10 years is substantially lower than that recorded in the previous decade. Further, although total corporate financing in the past three years was triple that in 1961-63, manufacturers’ shipments in the past three years were only double that of 1961-63. This decline can be attributed in large part to obsolescence in the nation’s plant and equipment. Despite substantial increases in plant and equipment in the 1950’s and 1960’s, many plants were obsolete almost as soon as they were built. The result was that after 1972 American business operated below full capacity, yet its capital base was insufficient to meet demand.

The third factor contributing to the high demand for debt, increasing corporate dependence on external funding, is largely a consequence of over-
commitment to expansion from the mid-1950's through the late 1960's. Professor John Kenneth Galbraith has noted that during this period corporate giants, often in the form of conglomerates operating in many different industries, edged out the entrepreneur as the dominant American business form.\textsuperscript{23} The primary goal of these giant corporations is growth, not merely profit, as with the entrepreneur.\textsuperscript{24} Their emphasis on growth created an expansion cult beginning in the mid-1950's. Many businesses expanded beyond what they could finance from retained earnings.\textsuperscript{25} The increasing obsolescence of plants and equipment, the soaring costs of replacements due to inflation,\textsuperscript{26} and the expense of environmental protection\textsuperscript{27} exaggerated the problem. To meet their capital needs, corporations turned increasingly to external sources of funding.\textsuperscript{28}

An indication of America's corporate dependence on debt is the increase in the debt-equity ratios of many corporations during the past two decades.\textsuperscript{29} Between 1955 and 1964 the general debt-equity ratio rose slowly because businesses were able to meet capital requirements and finance expansion largely through retained earnings.\textsuperscript{30} But in the decade 1965-75 came a turn for the worse. Cash flow slowed while inflation soared. Debt issues more than doubled those of the previous decade,\textsuperscript{31} and retained earnings could not keep pace.

Two main factors caused corporations to rely on debt instead of equity financing. First, during the boom years of the late 1960's and early 1970's, investors in the stock market tended toward those companies demonstrating the greatest earnings-per-share. This "cult of performance" induced these favored companies to avoid selling equity and to leverage per-share earnings despite their ever-mounting debt.\textsuperscript{22} Second, by 1972-73, the following phenomena inhibited many corporations from seeking new equity financing: 1) small investors fled the equity market,\textsuperscript{32} and 2) institutional investors, which became increasingly

\textsuperscript{23} J. GALBRAITH, ECONOMICS AND THE PUBLIC PURPOSE ix-xiii (1973).
\textsuperscript{24} Id. at 92-99.
\textsuperscript{25} Burns, supra note 6, at 17.
\textsuperscript{26} Clark, supra note 22. According to recent government survey, business can expect new plant and equipment expenditures to total $117.1 billion in 1975, 4.5 percent above 1974. But even if that much money is forthcoming, it represents a relatively small increase in light of inflation's impact on capital spending needs. Id.
\textsuperscript{27} Environmental expense for the next decade is a hotly debated topic. For example, the Council on Economic Priorities, a nonprofit research group, claims that corporate profits in the oil industry will be cut by no more than one percent from 1974-83 for environmental expense. Hill, Anti-Pollution Cost Called 1% Burden on Oil Profits, N.Y. Times, July 21, 1975, at 3, col. 1. But economists at the American Petroleum Institute project that gasoline costs will rise eight times more than CEP projects for the period 1974-83. Cook, Oil Firms Dispute Price Tag Put on Ecology Cleanup, Christian Sci. Monitor, July 22, 1975, at 16, col. 1.
\textsuperscript{28} External sources financed only 29 percent of the total credit needs of nonfinancial corporations in 1950, but by 1973 they supplied 77 percent of the total. Freund, supra note 4.
\textsuperscript{29} Burns, supra note 6; The Debt Economy, Bus. WEEK, Oct. 12, 1974, at 58.
\textsuperscript{30} Debt issues during that period totaled $90 billion, while equity issues came to only $25 billion. But corporate earnings were high enough and dividends low enough that the debt-equity ratio rose only 25 percent above the 1955 figure.\textsuperscript{31} Debt issues rose to $231 billion from 1965 to 1975. Id. See also The Big Squeeze on U.S. Companies, Bus. WEEK, Sept. 22, 1975, at 50.
\textsuperscript{33} Address by J. Bucher, Member of Board of Governors of the Federal Reserve System, Midcontinent Trust Conference, Nov. 21, 1974, at 3; Solomon, supra note 32, at 762.
powerful, concentrated their investments on the strongest growth issues. Those in the so-called second tier became more and more dependent on debt financing.

Another indicator of the extent of corporate debt dependence is the short-term borrowing market. Recently, blue chip companies such as Dupont and General Motors tapped the public debt market for the first time in years. The resulting increase in competition for debt funds heightened the problems of less creditworthy corporations, many of which could no longer obtain long-term credit and therefore were forced to rely increasingly on short-term funding sources. Reliance on short-term debt financing, however, subjects corporations to the vagaries of the capital market which tends to favor highest quality, lowest cost, concentrated investors.

34 This growth of institutional investors has been deemed responsible for the two-tier secondary securities market in which a few dozen corporations favored by the institutional investors sell at very high price-earning multiples. Solomon, supra note 32, at 776; See also Jones, Some Contributions of the Institutional Investor Study, 27 J. OF FINANCE 305, 317 (1972). But see Wall St. J., May 23, 1973, at 1, col. 6; cf. DEP'T OF THE TREASURY, PUBLIC POLICY FOR AMERICAN CAPITAL MARKETS 13 (1973): "Although such trades (relatively large volumes of individual securities) may have a larger impact on the price of an asset that is small in size, they may have a larger impact than they did previously when institutions were of less importance. The market has not become less liquid; the demands upon the liquidity of the market have become greater."

The institutions which many feel dominate the stock market today are bound by the Prudent Man Rule. See A. Scott, TRUSTS §§ 611, 612 (Supp. 1975).

Section 404 of the Employee Retirement Income Security Act of 1974 most recently provides that fiduciaries must act "with the care, skill, prudence and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims." This rule will probably impede the flexibility of pension funds and other large institutional investors. See Shakin, Tough on Fiduciaries, BARRON'S, Dec. 16, 1974, at 11, who states: "[T]he requirement of prudence in selecting securities for a pension portfolio may incline managers to pass up those of many smaller companies—or even larger ones—which do not possess the solid balance sheet of a Campbell Soup, for instance. It appears that the need for investment caution will accelerate the tendency—which has already been under way for some time—to shy away from smaller, unseasoned companies."35


To correct this trend away from investment in small companies, the authors support the following proposals: (1) the Prudent Man Rule should be applied with regard to the entire portfolio; see Belliveau, Dispersion or Indication, INSTITUTIONAL INVESTOR, Aug. 1972, at 65; Cohen, The Suitability Rule and Economic Theory, 80 YALE L.J. 1604 (1971); Lipton, An Analysis: Prudent Man Test in Investments, N.Y.L.J. Jan. 15, 1975, at 1, col. 2; (2) a pension fund managers should be allowed to invest up to one percent of the assets of any one pension plan in smaller companies, without regard to the Prudent Man Rule; see Address of Paul Kolton, Chairman, American Stock Exchange, Nat'l Conference on Capital Investment and Employment, May 20, 1975, at 11; S.2842, 93d Cong., 1st Sess. (1973) (submitted by Senator Bentsen); and (3) the law should force pension funds to put money directly into the corporation rather than simply buying the corporation's stock from a third party; see To the Rescue?, FORBES, July 1, 1974.

35 Schmitz, supra note 17.
36 Bulkeley, supra note 17.
37 In 1974 alone, the major credit rating services downgraded more than 50 companies. Bus. WEEK, Oct. 15, 1974, at 10. The ratio of long-term indebtedness to short-term debt has declined from 1:4 to 1:1 since 1967. Freund, supra note 4. Where long-term exceeded short-term debt by 40 percent in 1967, the two sources of corporate indebtedness were approximately equal by 1973. Id.
risk obligations.\textsuperscript{38} The stress on the short-term debt market has generated concern about the adequacy of resources of the American banking system, particularly the liquidity of banks.\textsuperscript{39} Continued corporate reliance on debt could produce a general liquidity crisis.\textsuperscript{40} Although economists are at odds as to the chances of the occurrence of such a scenario,\textsuperscript{41} at least one indicator suggests that the American economy faces a liquidity problem. “Interest coverage,” the relationship between private companies’ earnings and their interest obligations, is weak.\textsuperscript{42} On the other hand, corporations do not need such large cash balances today because of improved communications, faster banking services, and computerized inventory management.\textsuperscript{43} Whether such technological developments have altered the level of desirable liquidity divides sophisticated observers.

In assessing the impact of increased debt dependence, it is insufficient to look only at the private sector. Some commentators argue that the federal government, which was responsible for lowering interest rates in 1975, may also “crowd out” private borrowers.\textsuperscript{44} So far, there appears to be room in the debt market for both blue chip issuers and the federal government to raise funds. However, the federal government will apparently continue to stimulate economic

\begin{itemize}
\item \textsuperscript{38} \textit{Bus. Week}, Oct. 12, 1974, at 54.
\item Large banks, which have had difficulty finding money to lend, are now experimenting with new financing techniques, such as lease-backs and variable interest loans. \textit{See Kelly, New Financing Techniques on Wall Street}, Financial Executive, Nov. 1974, at 30; Stabler, \textit{The Big Float}, Wall St. J., July 5, 1974, at 1, col. 8; Thomas, \textit{Offbeat Financing}, Barron’s, July 8, 1974, at 11; Wall St. J., July 31, 1974, at 20, col. 1. \textit{See Address of Henry Kaufman, Partner of Solomon Brothers, New York State Bankers Ass’n}, Nov. 22, 1974. \textit{But see} Foldessy, \textit{Loosening Up: Bank Lending Officers Begin Easing Credit for Blue-Chip Clients}, Wall St. J., Mar. 21, 1975, at 1, col. 6.
\item \textsuperscript{40} Liquidity is a word which is not susceptible to easy definition. When used as a synonym for solvency, liquidity refers to a firm’s capacity to raise the needed funds to meet its debts as they come due. Goldman, \textit{supra} note 1. Critical to the measurement of a company’s liquidity is neither the absolute quantity of its cash nor the short-term investments which can be quickly and cheaply converted to money, but rather the company’s ability to repay debts which are due and owing. \textit{Id.}
\item \textsuperscript{42} In 1959, corporate earnings were still 10.5 times greater than interest payments. But since then, the deterioration has been rapid with earnings only 3.5 times greater than interest in 1971. Freund, \textit{supra} note 4, at 3.
\item \textsuperscript{43} Goldman, \textit{supra} note 1.
\end{itemize}
looking ahead: capital shortages, etc.

recovery and simultaneously to incur deficits. In financing these large federal deficits, the U.S. Treasury may preempt a large share of the funds available for private borrowers. The result, according to advocates of the "crowding out" theory, will be one of the following situations, or, more likely, a combination of both: (1) interest rates will rise and some business borrowers will be pushed out of the debt market; (2) the Federal Reserve System will be forced to supply enough funds to meet the needs of the federal government and business. If the second situation should occur, the swift growth of the money supply is likely to refuel inflation, forcing interest rates upward.

Some analysts, however, do not accept the "crowding out" theory. They explain that private corporate capital spending, even after adjustment for inflation, reached peak figures in 1973 and 1974. Although capital spending declined in the first quarter of 1975, it still accounted for 10.4 percent of the gross national product—a percentage which has varied little since World War II. In fact, total private savings in savings accounts, bonds, and other forms of investment have for the past two decades remained consistently at about 15 percent of the gross national product. However, such statistics do not reveal that capital investment in the United States constitutes a substantially smaller proportion of the gross national product than capital spending in other industrialized nations.

In response, some commentators argue that other industrialized nations have higher investment rates only because they have not yet experienced economies of scale which have occurred in the United States. The key issue, however, is not whether this country can match the saving rates of other nations. Rather, it is whether this country's saving patterns over the past two decades, if continued, will be sufficient to meet capital demands in coming years. It is this question which has spawned several major studies of projected capital requirements and supply in the United States for the coming decade.

45 Hawkins, supra note 44; Vartan, supra note 44; Investment: How to Afford the Future, Time, July 28, 1975, at 45, col. 3; see Topic A: The Capital Gap, Newsweek, Aug. 11, 1975, at 58 [hereinafter cited as Topic A].


47 Hawkins, supra note 44.

48 Id.


51 Id.

52 For the period 1960-73, capital investment in Japan was equivalent to approximately 35 percent of its GNP; in West Germany, 25 percent; in France, 24 percent; in Canada, 22 percent; in Italy, 20 percent; in the United Kingdom, 18 percent; in the United States, 15 percent. See Tax Reform Hearings, supra note 7, at 18 (statement of Secretary of the Treasury William E. Simon); id. at 156-57.

53 Tax Reform Hearings, supra note 7, at 156-57; Clark, supra note 49, at 19, col. 1.
B. Capital Gap?

In recent months, a number of economists have attempted, by various analytical methods, to estimate the capital investments that will be required if in the future we are to have full employment and an increasing growth rate. Their numerical results vary, but nearly all of the studies indicate that present growth and saving patterns will be insufficient to meet future capital requirements of American business.

1. Projections of Capital Needs, 1974-85

Two major studies project capital needs for the period 1974-85, one by the New York Stock Exchange (NYSE), the other by General Electric Corporation. NYSE economists chose to compare estimated capital needs with estimated private savings by using a scenario approach. After presenting a “base case” scenario outlining the “most likely” projection of investment and savings, the NYSE analysts proposed alternative scenarios to test the stability of the “base case” conclusions. Throughout the study the NYSE analysts assumed a 3.6 percent annual rate of real growth and a 5 percent annual rate of inflation.

In their “base case,” the NYSE analysts first projected the total domestic demand for funds between 1974-85. They considered each of the economy’s component parts—gross private domestic investment and net government financing operations (deficit financing and net borrowings from the public). They determined the value of gross private domestic investment during the period by aggregating estimates of business plant and equipment expenditures, residential construction, and investment spending by farms, nonbusiness, and nonprofit institutions (including investments in inventories). Basing their conclusions on specific industry forecasts and on governmental studies, they projected an increase in gross private domestic investment from $202 billion in 1973 to about $560 billion in 1985. The driving force behind these projections is the expected need to accelerate real business capital spending for both modernization and new capacity by nearly 85 percent over aggregate expenditures for the period 1962-73.

In addition to their aggregate figures, NYSE economists broke down their capital need projections into the following sectors: energy, basic materials pro-

55 See Tax Reform Hearings, supra note 7, at 47 (App. A) (statement of Secretary of the Treasury William E. Simon).
56 Capital Needs, supra note 54.
57 Econ. Growth Hearings, supra note 22.
58 Capital Needs, supra note 54, at 3.
59 Id.
60 Id. at 7-9.
cessors, transportation, communications and services, and all others. However, they did not consider the needs of individual industries. On a cumulative basis for the period, the energy sector alone—the gas and electric utilities, oil, and mining industries—are expected to require capital investment expenditures of $800 billion, or double their needs over the past decade. But while this area’s needs are most dramatic, other sectors also have substantial requirements. It is projected that the basic materials industries—iron and steel, aluminum, paper, cement, glass, and others—will spend nearly $330 billion from 1974-85, primarily to overcome the capacity shortages currently limiting their output. The transportation sector may require $225 billion, and housing demands will cumulatively total $1 trillion. Nonbusiness capital spending in the private sector—e.g., farms, hospitals, educational institutions—while expected to increase more slowly than in recent years, will still account for close to one trillion dollars in cumulative demand for the next decade.

Governmental requirements for capital funds could not be projected with nearly the precision of private investment because of the uncertainty of congressional and executive actions during a period which will include three Presidential elections. However, the NYSE estimated that the combination of budgetary shortfalls, other federal demands, and state and local credit requirements will come to at least $175 billion during 1974-85 period.

An aggregate of all the major projected capital expenditures by private and public sectors indicates that the cumulative demand for capital through 1985 will be $4.7 trillion. Unless these demands are reduced, the economy over the same period must generate $4.7 trillion in business and personal savings to avoid a capital shortage. NYSE analysts were unable to make such a happy prediction as to business and personal savings.

General Electric economists used a computerized econometric model to estimate capital needs and savings potentials from 1974 to 1985. Their assumptions were similar to those of NYSE analysts in all areas except for projected annual growth. This difference accounted for the slightly lower General Electric projection of capital needs for the period of $4.5 trillion.

2. Projected Capital Sources, 1974-85

With regard to the ability of projected savings to meet the huge capital needs during the 1974-85 period, both NYSE and General Electric paint a bleak picture. The NYSE analysts based their projections of business savings for the period of growth rates in the GNP from 1950 to 1973. Using this historical
approach, they estimated that business will continue to be the primary source of savings for the private sector of the economy from 1974 to 1985, accounting for approximately $2.4 trillion from capital consumption allowances (i.e., depreciation charges) and another $550 billion from retained earnings. That comes to a total business savings of over $2.9 trillion for the period.

The NYSE expects annual personal savings to rise from $54.8 billion in 1973 to $135 billion by 1985, a cumulative total of more than $1.1 trillion. In sum, business and personal domestic savings would total just over $4 trillion. This is clearly not enough in the face of a projected capital need of $4.7 trillion. These projects suggest a capital shortage of $650 billion over the next 10 years.69

Projections for the same period by General Electric economists resulted in a much smaller gap.70 General Electric also used historical data to estimate the sources of gross private savings for the 12-year period. However, because of its higher projected rate of growth, General Electric estimated that gross private savings would total $4.3 trillion.71 This figure indicates a capital gap of only $200 billion as compared with the $650 billion gap projected by the NYSE.

However, from a policy viewpoint, the precise dimension of a capital shortage is not the issue. Whether the gap between savings and investment is $650 billion or $200 billion, the problem remains the same. As the NYSE analysts stated:

It is more important to know whether a different set of “reasonable” assumptions would develop projections that would eliminate the prospective gap, or reduce it to inconsequential or manageable proportions.72

Neither the NYSE alternative scenarios73 nor General Electric’s econometric model suggest that such a reasonable set of assumptions exist.74

The occurrence of a major capital shortfall would severely affect domestic business activity. Small and medium size businesses would find it increasingly difficult to obtain needed long-term debt. As credit availability declined, lenders would increasingly put their funds with larger “safer” borrowers. Even larger companies could experience difficulty obtaining funds due to a dwindling supply of willing investors. Commercial paper too might become unavailable to all but

69 It must be remembered that this is only the New York Stock Exchange’s “most likely” outcome, based on reasonable assumptions of future capital demands and savings availability. The smallest gap produced by any New York Stock Exchange scenario was $396 billion. New York Stock Exchange, supra note 54, at 19. Several economists argue that the New York Stock Exchange’s huge projected investment spending would generate a faster rate of growth in gross national product than the 3.6% the study assumes. Jones, Business Capital Requirements 1974-1985, Financial Executive, Nov. 1974, at 22-23; Growth Capital?, supra note 1.

70 Jones, supra note 69.

71 Econ. Growth Hearings, supra note 22, at 74.

72 Capital Needs, supra note 54, at 17.

73 Id. at 19-25.

74 It should be noted that the saving gap or capital shortage projected in the two studies represents a theoretical imbalance between investment capital demand and investment capital supply. The gap itself will never actually show up; rather, it will be apparent after the fact in the form of high interest rates brought about by intense competition for an insufficient supply of savings and by reduced credit availability. Id. at 26.
the major AAA credit-rated corporation. As lenders become increasingly wary, they will probably shy away from buying "high risk" paper unless the borrower has an unquestioned creditworthiness. And slower growth at home due to decreased investment spending might mean higher unemployment, placing greater strains on already overburdened social services, especially in central cities. In short, the entire nation's well-being could be threatened by a capital shortage.

3. A Critical Assessment

Various economists disagree with the NYSE and General Electric findings. Economists at the Brookings Institute state that America can finance its public and private capital needs in the next decade, but just barely. They concluded that the country's capital supply will be sufficient to meet requirements through the 1970's if (1) the Government and agencies run an average annual surplus of $11.5 billion, and (2) the Federal Reserve System promotes low interest rates with a relatively easy money policy.

At first blush, Government surpluses seem to be an effective way to stimulate investment. If the Government operates at a budgetary surplus and presumably retires some of its outstanding debt, it frees funds for investment in private securities. However, to the extent that taxes are used to finance federal surpluses, corporate and personal income would be reduced, and as a result private savings would be lowered. Further, projections of the aggregate deficit from 1974 to 1976 are in the vicinity of $150 billion. To reach the average surpluses suggested by the Brookings study, therefore, annual surpluses for 1977 to 1980 have to be roughly $70 billion per year—hardly a likely result.

There is an even more basic fallacy in the Brookings approach which is also common to the NYSE and General Electric studies. All of these studies consider aggregate capital needs. In fact, capital needs vary widely from industry to industry, even within single economic sectors. Some industries would have little problem even if capital were in short supply during the next decades. Others might be driven to the brink of ruin by the unavailability of financing. The NYSE, in its effort to predict capital needs sector by sector, lumped utilities and oil together under the single heading "energy." However, these two industries have different types of capital needs, and for different reasons. Any workable solution to capital shortage in either the utility or petroleum industry must take account of each sector's particular capital picture.

Historically, the utilities industry experienced little difficulty meeting its capital needs, despite being the most capital-hungry industry in the American
But substantial increases in fuel and production costs in recent years created a capital shortage in the industry. The inability of regulatory agencies to respond quickly to requests for rate increases resulted in the utilities increasingly committing capital to meeting costs, not to generating income in excess of costs. To keep utilities competitive in the money markets, most state regulatory agencies permit the companies to improve their capital picture through bookkeeping credits. However investors are not fooled by such ploys, and utilities face the unhappy plight of neither being able to borrow at reasonable rates nor to sell equity issues at prices in excess of book value. While analysts disagree with respect to the exact amount of the industry’s capital needs in the next decade most concur with the Edison Electric Institute that the utilities’ capital needs for plant expansion from 1974 to 1980 will be in the $277 billion range, and that the industry will be required to externally finance one half of this figure.

The capital requirements of the petroleum industry are even greater, particularly if this country wishes to achieve independence in this field. In order
to double America's output of oil by 1985, projections indicate that the annual capital requirements for the next decade must triple the industry's investment in 1975.\(^91\)

This enormous sum of money required by the petroleum industry may in part be obtained from external sources, but the major portion must be generated internally from depreciation and retained profits.\(^92\) The industry will attempt to generate additional funds by borrowing in the capital market, but firms face an uncertain availability of capital.\(^93\) High interest rates may also make these loans expensive.\(^94\) In the past, provisions for capital recovery such as depreciation, depletion, and other write-offs have constituted an important means of internally generating funds for the petroleum industry.\(^95\) By eliminating the depletion allowance for certain oil companies, Congress drastically curtailed the effectiveness of the petroleum industry's ability to internally generate funds for investment and exploration.\(^96\) According to the Chase Manhattan Bank, the action of other, it is quite apparent that spending will be extremely large and a burden on the economy. The Government's Project Independence Report estimated that more than \$450 billion in 1973 dollars would be required to meet the needs of our nation's energy sector during the period 1975-1985. \textit{See Hearings on Capital Requirements of Energy Independence Before the Subcomm. on Energy and the Subcomm. on Financial Matters of the Senate Comm. on Finance}, 94th Cong., 1st Sess. 48 (1975) (statement by Thomas O. Enders, Assistant Secretary of State for Economic and Business Affairs). Other studies are considerably higher. Chase Manhattan Bank estimates that in 1970 dollars, with a 5 percent inflation rate, the petroleum industry will require \$1.5 trillion worldwide between 1970 and 1985; with a 15 percent inflation rate, the need will be \$3 trillion. \textit{CHASE MANHATTAN BANK, supra} note 87, at 7. \textit{See also} N.Y. STOCK EXCHANGE, THE CAPITAL NEEDS AND SAVINGS POTENTIAL OF THE U.S. ECONOMY (1974), estimating \$884 billion in current dollars will be required to meet our energy needs between 1974-85. \textit{See also} Adams, \textit{Capital Expenditures Forecast}, PIPELINE & GAS J., July 15, 1974, at 17-21; \textit{Oil Firms to Hike U.S. Spending Over 50\%}, PIPELINE & GAS J., May 6, 1974, at 97. On May 7, 1975, Secretary of the Treasury William E. Simon estimated before the Senate Finance Committee that at current dollars approximately \$1 trillion was needed over the next decade. The study, conducted by the First National Bank of Chicago, estimated the minimum requirement to meet our energy needs in the decade ahead was \$750 billion. \textit{See also} Address by Gaylord Freeman, Chairman of the Board, The First Nat'l Bank of Chicago, Nat'l Conference on Capital Investment & Employment, May 19, 1975, at 10, 13.

Through the initiative of the \textit{Oil & Gas J.}, Sept. 2, 1974, the results of a study undertaken for Project Independence have been made available. The study predicts the capital investment required to obtain U.S. crude oil at different rates of production over the next 10 years. Present domestic crude oil production is about 10.5 million barrels per day. To achieve this level of output, about \$408 million is spent in necessary capital investments per year. According to the report, even if the capital investment were to be tripled between 1974 and 1985, production will fall to 6.9 million barrels per day by 1985. In order to provide for an increase in oil production, a huge rise in capital investment is needed. For example, if production is to be doubled to 20.2 million barrels per day by 1985, annual capital expenditures would have to rise from \$408 million at present to \$13.535 million in 1985. \textit{Hearings on Capital Requirements of Energy Independence Before the Subcomm. on Energy and the Subcomm. on Financial Markets of the Senate Comm. on Finance}, 94th Cong., 1st Sess. 134-36 (1975) (testimony of Barry Commoner, Director of Center for Biology of Natural Systems, Washington U.). \textit{See also} id. at 10, 38 (testimony of Secretary of the Treasury William E. Simon, citing Chase Manhattan Bank estimates of a worldwide need for \$400 billion to find 600 barrels of oil between 1970 and 1985); \textit{Id.} at 146 (statement of Senators Bentsen and Gravel, citing National Academy of Engineering estimates of the need for coal by 1985, 1.2 billion tons annually).

It seems most likely that, at the maximum, \$240 billion will represent the money supplied by external sources to meet the petroleum industry's capital requirement. \textit{CHASE MANHATTAN BANK, supra} note 87, at 7.\(^93\)

\(^93\) \textit{Id.}\(^94\) \textit{Id.}\(^95\) \textit{Id.} These provisions were expected to furnish the petroleum industry with \$260 billion of the estimated requirement, provided they were not changed by governmental actions.

\(^96\) Limitations on percentage depletion in case of oil and gas wells. 26 U.S.C.A. § 613A (1975). A decreasing deduction still can be used by small independent companies. \textit{See} Hunt,
Congress in repealing the depletion allowance will cost the petroleum industry $2 billion in 1975 due to increased taxes, which in turn will reduce the petroleum companies' earnings and cash flow, forcing a cutback in capital outlays on oil and gas exploration. Profits will increasingly become the primary source for meeting the industry's financial needs. However the estimated $2 billion increase in taxes will adversely affect the industry's profitability, as will the worldwide recession and the rising costs of raw materials. Earnings reports in 1975 have indicated that petroleum profits entered a tailspin from the record breaking year in 1974.

From these descriptions, it is clear that the petroleum and utilities industries have different capital requirements which call for different solutions. Aggregate studies of capital needs and aggregate solutions to capital shortage are inappropriate in an economy as complex as ours.

Finally, critics of the capital scarcity theory note that in the aggregate, the manufacturing sector of the American economy is operating at approximately 75 percent of capacity. This underutilization of capacity thus obviates the need for extraordinary business investment in excess of the traditional 15 percent of GNP previously alluded to. Although other observers have disputed these statistics, once again careful disaggregation and industry-by-industry analyses are required. Furthermore, even if a firm or an industry has a surplus of plant capacity, its plant and equipment may be obsolete.

Before appropriate solutions can be chosen for even a single industry's capital problems, the alternatives must be examined.

II. Closing the Capital Gap Through Tax Subsidies—The So-Called Free Market Approach

In light of the predictions that capital needs of American industries will amount to over $4.5-trillion over the next decade, many economists agree that private investment must constitute more than its present 15 percent of the economy.
Even the Brookings Institute study suggests that some shift from consumption to investment may be needed. In fact, all of the major studies projecting capital requirements and supply for the next decade have concluded that in order to achieve full employment and a growth rate consistent with past patterns, capital investment must increase.

In response to these findings, the Treasury Department views the income tax system as providing the mechanism for stimulating increased private saving. Secretary of the Treasury William Simon points out that our tax system—like any which relies on the income tax—is biased against saving. In a recent statement before the House Ways and Means Committee he stated:

"In general, our tax system inhibits savings because it promises to take away a substantial part of the income from any amounts saved, thus reducing the incentive for saving."

The advisability of directing tax policy to favor investment remains a hotly debated topic. Commentators who believe that income tax should be progressive, with tax rates increasing as income rises, point to two main goals for tax reform: (1) narrowing the gap between rich and poor, and (2) keeping the federal tax base broad enough to pay for the needs of the growing public sector. They argue that tax reform should primarily seek to achieve greater fairness in the federal tax system and thereby restore public confidence in that system. "Tax loopholes," in the view of such commentators, constitute indirect, hidden subsidies which are distributed inequitably. As a result of tax loopholes, or subsidies, corporations, which are supposedly taxed on income at a rate of 48 percent, actually pay an average rate of only about 35 percent. Tax subsidies are also erratically distributed among companies in the same industry.

104 See Tax Reform Hearings, supra note 7, at 30 (statement of Secretary of the Treasury William E. Simon); id. at 6 (statement of Secretary of the Treasury William E. Simon).
105 Id. at 151 (statement of Joseph A. Pechman, Director of Economic Studies, Brookings Institute); The Drive to Revamp the Corporate Income Tax, Bus. Week, July 28, 1975, at 58 [hereinafter cited as Drive to Revamp].
106 Tax Reform Hearings, supra note 7, at 30.
107 Tax Reform Hearings, supra note 7; Drive to Revamp, supra note 105. See Kaufman, The Case for Business Tax Reductions, N. Y. Times, Aug. 3, 1975, at 33, col. 3.
108 Tax Reform Hearings, supra note 7, at 9.
109 Id.
110 Id. at 1 (statement of Stanley S. Surrey, Professor, Harvard Law School).
111 Id. at 15; see Surrey, The Sheltered Life, N.Y. Times, Apr. 3, 1975, § 7 (Magazine), at 22; Drive to Revamp, supra note 105, at 58; cf. Tax Reform Hearings, supra note 7, at 159. See generally S. Surrey, PATHWAYS OF TAX REFORM (1973).
112 Analysts who studied SEC figures for 1973 found that in the drug industry actual tax payments by Baxter were 13.31 percent of corporate earnings; G. D. Searle, 32.7 percent; Abbott, 32.7 percent; Johnson & Johnson, 46.7 percent; in automobiles, Chrysler, 19.1 percent; Ford, 32.7 percent; General Motors, 46.4 percent. (Until 1968, when the Treasury published the first tax expenditure budget, Congress and the agencies had no information on the amount being spent in the tax system through "subsidies"; not until the Budget Reform Act of 1974 was the item of tax expenditures included in the federal budget.) As to the effects of tax breaks for individuals, the following example is instructive. Assume that Congress passes a $1,000 tax deduction for expenses for home insulation as an energy-saving measure—a goal which is seemingly in the public interest. The law's effect is to give $700 to a homeowner in the 70 percent tax bracket, for that is the amount such a person saves in taxes when he deducts $1,000 from his income. Only $140 in savings goes to a homeowner in the 14 percent tax bracket, and zero goes to a homeowner whose income is so low that he does not pay taxes.
One of the leading opponents of tax subsidies, Professor Stanley Surrey, warns that proponents of tax breaks for business should not be permitted to chop more holes in a tax system which already overcompensates certain individuals and companies at the expense of other taxpayers. On the basis of this reasoning, Surrey and others agree that major tax reform could be accomplished simply by reviewing and eliminating most deductions, exclusions, and tax credits now on the books. Since tax breaks are in effect subsidies, they should be tested by the standards applicable to direct federal subsidies. That is, if a tax subsidy would not today be proposed by the President or passed by Congress, it should be eliminated. Any tax subsidy so justified should be converted to a direct subsidy. Thus the public will become aware of its cost.

Other antitax-cut commentators note that the 10 percent investment tax credit and the liberalization of depreciation have already given an $8 billion annual tax reduction to business which could be used for capital investment needs. No more special breaks are needed. They note that unemployment and underemployment will continue at a high rate even after business enters a full-fledged recovery from recession. Therefore, they suggest that pursuing a more expansive overall economic policy to reduce unemployment and to narrow the gap between what the economy is capable of producing and what it is presently turning out constitutes the best way to secure capital investment.

Tax cut proponents, however, argue that an immediate tax cut is necessary, and that fairness, while a prime objective of tax reform, should not be the only goal served by a tax structure. Private interests, concerned with capital shortage and falling rates of return on investment, want to use tax reform to provide more benefits to business than were received in the Tax Reduction Act of 1975, under which most benefits went to individual taxpayers. Most of our national savings occur in the business sector of the economy, and as business prospers—the argument runs—more jobs are created. It is asserted, therefore, that favoring the private sector, in particular the ability to generate more capital, comprises the best means to achieve economic growth in which all will share, albeit disproportionately, as greater gains will flow to capital interests.

Those who consider tax reform an effective means for stimulating capital
formation have put forth the following proposals: integration of corporate and personal income taxes, broadened capital gains treatment for investors, and other tax breaks to encourage investment.

A. Integrating the Corporate and Personal Income Taxes

To stimulate investment, the Ford administration has proposed an integration of the corporate and personal income taxes.\textsuperscript{123} Under the American tax system, income earned by corporations is taxed twice—first at corporate level and then again at the shareholder level, if and when earnings are distributed in the form of dividends. Advocates of an integration of the corporate and personal income taxes argue that double taxation tends to inhibit savings from flowing into corporate equity investments, because such investment must earn a higher level of income in order to produce the same return to an investor.\textsuperscript{124} As corporate tax rates have risen in other nations, such as Canada, Great Britain, France, Germany, Belgium, Italy, and Japan, these nations have integrated their tax systems so as to eliminate much of the impact of the corporate double tax.\textsuperscript{125} Each nation has used one of two basic mechanisms to replace corporate double taxation: a credit to stockholders for dividends received or a deduction by the corporation for dividends paid. A third possible mechanism would be full integration under which corporate tax would be eliminated and all earnings would be taxed initially and directly to the entity's stockholders, whether or not the earnings were actually distributed.\textsuperscript{126} This system, however, faces difficulties in implementation and, so far as can be determined, to date has not been adopted by any country.

Under the dividend deduction system, the corporation could deduct from its gross income as a business expense all or part of any dividend distribution to its shareholders. The deduction in effect reverses the tax which the corporation currently pays on such income.\textsuperscript{127} Under this system, the initial effect would

\textsuperscript{123} See Drive to Revamp, supra note 105. One alternative for avoiding double taxation is Congress' designating cash dividends on all stocks tax deductible as business expenses for the paying corporation, just as interest on bond indebtedness is deductible. Barnes, A Do-It-Yourself Way to Cut Taxes, Bus. Week, May 5, 1975, at 21; Barnes, One Way to End the Bear Market, Wall St. J., Oct. 9, 1974, at 42, col. 6.

The alternative suggested by Henry Wallich of the Federal Reserve Board is that dividends should be treated the same way as interest in the corporate income tax. Both should be deductible or both nondeductible, with changes in the corporate tax rate to keep revenues at present levels if that is deemed necessary. See Dale, Taxes and Building Corporate Capital, N. Y. Times, June 22, 1975, § 3, at 15, col. 1.


\textsuperscript{125} Tax Reform Hearings, supra note 7, at 16; Drive to Revamp, supra note 105, at 58. With regard to the Canadian plan, see Bittker, Income Tax Reform, 35 U. Gtr. L. Rev. 637 (1968).

\textsuperscript{126} Tax Reform Hearings, supra note 7, at 16; Drive to Revamp, supra note 105.

\textsuperscript{127} For example, assume that a corporation earns $100, is subject to a corporate tax of 48 percent, and pays a dividend of $100. If the corporation takes a full deduction, the stockholders will pay tax on the $100 distributed to them, but the corporation, having distributed all of its earnings, pays no tax. If the corporation distributes only $50, then the 50 percent deduction will mean that the corporation pays tax on $40, the amount left undistributed. Tax Reform Hearings, supra note 7, at 12.
be to place more money in a corporation's hands, since such entity receives a dividend deduction. Under either the deduction or credit system, however, a corporation's dividend policies will determine whether the additional dollars end up in the hands of shareholders or remain within the corporation.\(^{128}\)

Instead of giving a deduction to the corporation, the stockholder credit system (also called the "grossed up dividend credit") gives a credit to the shareholder as compensation for the tax paid by the corporation. In essence, it achieves integration for distributed earnings, but does it at the shareholder's end.\(^{129}\) Under this system, the cash tax savings are initially placed in the hands of the shareholders. But once again, by adjusting dividend patterns a corporation could keep the extra dollars from its shareholders.\(^{130}\)

In any of the integration schemes, the corporation has the final word on the size of tax benefits going to investors. The corporation can cut those benefits by withholding dividends. What difference does it make whether the stockholder or corporation is the initial recipient of the tax break? The shareholder credit method, which initially gives the tax break to the individual, may be more useful with respect to tax-exempt institutions.\(^{131}\) The dividend deduction method produces more immediate impact at the corporate level, which is probably the area of most immediate need. But again it achieves an indiscriminate, across the board approach, and may place funds in hands of firms and industries not desirous of increasing capital investment.

Secretary of the Treasury Simon took note of this conflict in his statement before the House Ways and Means Committee. He resolved it by recommending a combination of the two mechanisms, under which part of the double tax would be eliminated by one method, and part by the other.\(^{132}\) Simon also recognized, as have other analysts,\(^{133}\) that the nation could not afford to eliminate the double corporate tax completely in any short time period because of the enormous revenue losses. He therefore recommended a six-phase program, with the first phase effective January 1977.\(^{134}\)

Even if implemented in six phases, however, Simon's program suffers from defects common to any "tax breaks" aimed at stimulating investment. Tax cuts, though specifically intended to increase the flow of savings and investment, might actually be counterproductive. By reducing the Treasury's revenues, the tax cuts would increase the borrowing needs of the federal government, thereby increasing the federal deficit.\(^{135}\) Even Secretary Simon, in recommending integration of individual and corporate taxes, emphasized that we must avoid federal

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128 Tax Reform Hearings, supra note 7, at 16; Drive to Revamp, supra note 105, at 50.
129 Using a form much like current W-2 reports of wages, the stockholder would add his dividend receipt to the corporate tax paid on his share of the company's profits. He would then add this "grossed up" amount onto his other taxable income, calculate his full tax, and then subtract the withheld corporate tax as a credit. Drive to Revamp, supra note 105.
130 Id.
131 With respect to tax-exempt shareholders, the tax has already been eliminated at the shareholder level so under the dividend deduction method which eliminates tax at the corporate level, the result would be an elimination of all tax, not just an elimination of double taxation. Id.
132 Tax Reform Hearings, supra note 7.
133 See Silk, supra note 114, at 31; Drive to Revamp, supra note 105.
134 Tax Reform Hearings, supra note 7, at 19-20.
135 Silk, supra note 114. See also Wall St. J., Sept. 11, 1975, at 3, col. 1.
deficits. Yet tax cuts certainly could create them. Further, there is no guarantee that money saved through tax cuts will be invested. Neither the stockholder credit nor the dividend deduction plans contain controls on the use of additional tax cut funds. In fact, each would allow a corporation to determine whether the additional funds end up with its shareholders or with the corporation.

B. Increasing the Benefits on Capital Gains

Many analysts in the business community contend that a lessening of the tax on capital gains would increase the incentive for individuals to save and invest, and would help to unlock investments which people are hesitant to sell because of the substantial tax which is levied upon gains. This approach has also been touted as an especially good one for encouraging the small investor to return to the stock market. The following are alternative methods for reducing the capital gains tax:

1. Scaling Down the Capital Gains Tax According to the Time a Stock Has Been Held

A sliding scale of graduated capital gains taxes would be introduced, with the effect that the longer an investor held an asset, the lower the proportion of the gain such shareholder would be required to include in his taxable income. This approach is designed to recognize the inflationary facts of life—that $100 invested in 1947 has a real value of approximately $50 today. Because gains due to inflation are lumped for tax purposes in the one year in which the stock is sold, the tax bite on inflation has an even more dramatic effect on those investors who have held capital assets for many years.

2. Capital Gains Roll-Over Treatment

The tax on capital gains would be deferred so long as the proceeds from the sale of eligible assets were fully reinvested in specified assets. Theoretically,
this "roll-over" treatment would exert an incentive for investors to remain active in securities markets without exacting a penalty for capital asset transactions.

Both the scaling down and roll-over proposals, like most efforts to sweeten capital gains tax treatment, encounter the objection that only the affluent will benefit. In fact, capital gains rates, perhaps more than any other item, explain why many wealthy people pay income taxes at rates far lower than their actual income would seem to require. In addition, none of the appreciation in value of a capital asset is subject to income taxation if an individual dies holding the asset. Consequently, the tax rate for a wealthy individual is reduced to zero on the appreciation of capital assets if he holds them until his death and passes them on to his heirs. Therefore, any efforts to make tax treatment on capital gains even more advantageous is viewed by some as utterly inequitable—a boon to the rich.

3. Other Capital Gains Tax Proposals

A tax-free lifetime accumulation of a given amount of capital gains could be allowed. Investors would be permitted a lifetime exemption of perhaps $50,000 or $100,000 of capital gains realized on corporate securities and perhaps other specified types of property.

An annual exemption of a given amount of capital gains realized as a result of securities transactions has also been proposed. A variation on the tax-free lifetime accumulation, this approach would exempt up to a certain amount of capital gains—e.g., $5,000—per year. This method, with its relatively low annual limit, would be far more significant to persons of modest incomes than to those with large portfolios.

A number of people have suggested increasing the amount of capital losses which may be offset against ordinary income. The limit on capital losses which might be offset against ordinary income would be increased from $1,000 to $10,000 or $20,000. Some would advocate full offset of losses against ordinary income.

The primary objection to these three suggestions aimed at middle-income Americans is that they will not achieve their desired effect. Internal Revenue Service data demonstrates that only 6.5 percent of tax returns at the $10,000 in-
come level and 12 percent at the $20,000 level contained capital gain income.\textsuperscript{151} Over 50 percent of returns at the $100,000 and above level contained capital gains. The average capital gain in 1971 did not reach $3,000 until the $20,000 income level. But the average capital gain for incomes between $50,000 and $100,000 was $20,000.\textsuperscript{152} Overall, more than half the capital gains are received by those with incomes of $30,000 or more, only two percent of the families paying income tax.\textsuperscript{153} It hardly seems, then, that reducing the percentage of includable income from capital gains would be the most efficient means of encouraging investment by those making less than $30,000 per year.

Another alternative is to scale down the capital gains tax on certain stocks bought and sold within a given time period.\textsuperscript{154} A category of companies would be selected to qualify as "small companies," perhaps using the price of the companies' shares or the size of a firm's gross revenues as a measure.\textsuperscript{155} Upon sale, stocks of these companies would be accorded more favorable tax treatment with respect to long-term capital gains, provided that the owner bought and sold the stock within five years. In the case of short-term gains, only a certain percentage—perhaps half—of the gains would be included in ordinary income. If there was a loss, it could be deducted from ordinary income, but limited to $25,000 for any single stock issue, and a maximum of $100,000 over the five-year period.

C. Other Tax Breaks Aimed at Encouraging Investment

Increasing the dividend exclusion\textsuperscript{156} has been suggested. The current $100 dividend exclusion from federal income taxes would be increased to $200,\textsuperscript{157} or $500.\textsuperscript{158}

Another suggested change is to permit commissions on securities transactions to be deducted against ordinary income.\textsuperscript{159} Commissions paid by investors would be treated in the same way as other investment expenses, and not as part of the purchase or sale price of a security, as they are presently.

Ending the withholding taxes on dividends paid to foreign investors could attract foreign long-term capital to U.S. business.\textsuperscript{160} This move would be particularly effective in attracting so-called petrodollars, since oil producers are not subject to income taxes at home against which they could get credits for U.S. taxes.\textsuperscript{161} To satisfy those concerned about foreign control of U.S. corporations, the withholding tax might be waived only for those investors who would own

\textsuperscript{151} Senate Finance Hearings, supra note 137, at 19.  
\textsuperscript{152} Id.  
\textsuperscript{153} Id.  
\textsuperscript{154} Financial Markets Hearings, supra note 138, at 237.  
\textsuperscript{155} This arrangement is similar to that under Int. Rev. Code of 1954, § 1244.  
\textsuperscript{156} Financial Markets Hearings, supra note 138, pt. 1, at 111 (testimony of Needham), pt. 1, at 143 (testimony of Kolton).  
\textsuperscript{157} Id., pt. 1, at 43 (testimony of Needham), pt. 1, at 143 (testimony of Kolton).  
\textsuperscript{158} Id., pt. 1, at 43 (testimony of Whitehead).  
\textsuperscript{159} Id., pt. 1, at 111 (testimony of Needham), pt. 2, at 121 (testimony of Ford).  
\textsuperscript{160} Id., pt. 1, at 8 (testimony of Regan).  
\textsuperscript{161} Hearings on Long-Term Economic Growth Before the Joint Economic Comm., 93d Cong., 2d Sess. 128-29 (1974) (testimony of Reginald H. Jones, Chairman, General Electric Corp.).
less than a specified percentage of a U.S. company. Despite this option, many seem to fear (a fear more ephemeral than real) a flood of foreign investment.\textsuperscript{162}

Totally eliminating federal corporate tax for certain industries which already avoid many tax obligations through tax loopholes\textsuperscript{163} has been proposed in a bill introduced by Senator Lee Metcalf. The bill states that the utilities industry receives enormous tax breaks through hidden loopholes, and that taxes on utilities should be formally eliminated so that the public is aware of the utilities’ preferred position.\textsuperscript{164}

These last several proposals suffer from the same defect as the items mentioned above, in that (1) the reduction in taxes increases the likelihood of federal deficits, and (2) there is no guarantee that money saved through the tax breaks would be used for capital formation.\textsuperscript{165}

One of the most significant aspects of the “tax subsidy” approach to capital shortage is its inherent assumption that after an initial capital infusion resulting from the tax breaks, the market should and will take over capital allocation. This assumption fuels the long-standing controversy between those who favor “market systems” and those who would prefer long-term national economic planning and more direct government involvement in the economy.

The argument in favor of market systems is bottomed on the concept that the individual should have the right to pursue his own interest in a relatively untrammelled manner, because that is the best way to promote the general good.\textsuperscript{166}

The market mechanism allegedly has the advantage of harnessing self-interest

\textsuperscript{162} Letter from Robert A. Gerard, Director, Office of Capitol Markets Policy, U.S. Dep’t of Treasury to authors, June 25, 1975. \textit{See also} Wall St. J., Mar. 5, 1975, at 8, col. 1; \textit{see} S. 425, 94th Cong., 1st Sess. (1975) introduced by Senator Harrison Williams; \textit{Hearings on the Foreign Investment Act of 1975 Before Subcomm. on Securities of the Senate Comm. on Banking, Housing & Urban Affairs}, 94th Cong., 1st Sess. (1975). This bill would require more information on the identity of domestic and foreign investors in U.S. corporations and would give the President the authority to screen and block foreign investment to avoid takeovers. Jones, \textit{U.S. Companies Oppose Restrictions on Investments by Foreigners}, N.Y. Times, Mar. 6, 1975, at 55, col. 3; Jones, \textit{Ford Aides Fight Senate Bill with Plan to Control Foreign Investment in U.S.}, N.Y. Times, Mar. 5, 1975, at 45, col. 2; Stabler, \textit{Infusion Confusion: Foreign Capital, A Key to Rise of Early U.S. Now Stirs Misgivings}, Wall St. J., Mar. 5, 1975, at 1, col. 1; Wall St. J., Mar. 7, 1975, at 4, col. 3; Wall St. J., Mar. 6, 1975, at 6, col. 4. \textit{But see} Rohatyn, \textit{Getting Foreign Cash}, N. Y. Times, Aprr. 6, 1975, at 19, col. 1, suggesting that a foreign investment review board could review all proposed foreign investments aggregating over 20 percent of any corporation with over $10 million in assets, but that we should continue to encourage benign foreign investment to bolster the economy. \textit{See also} Rose, \textit{The Misguided Furor About Investments from Abroad}, \textit{FORTUNE}, May 1975, at 170, suggesting that there is much less foreign investment in this country than it would seem from the publicity given to such investment, \textit{id.} at 172, and that foreign nations with investments in the U.S. are more likely to remain friendly to this country, \textit{id.} at 173; Snyder, \textit{Danger: OPEC Might Not Invest Here}, N. Y. Times, Mar. 30, 1975, § 3, at 10, col. 3; Katzenbach, \textit{International Markets as a Source of Capital}, \textit{FINANCIAL EXECUTIVE}, Nov. 1974, at 44.


\textsuperscript{165} \textit{Drive to Revamp, supra} note 105, at 50.

LOOKING AHEAD: CAPITAL SHORTAGES, ETC.

In a market system, government serves to compel competing groups to play by the rules of the game but does not intervene in the process of distributing national wealth. Indeed, advocates of the market system point out that government intervenes too much in the market place by overregulating business.

The "market" argument is criticized today by those who say that the United States never will have a pure market system, and that if we are going to have some government intervention, it should at least be planned, efficient intervention. During the industrialization process of the past century, efficiency and growth were given preference over redistribution of income and equality of result. It was hoped that society could best upgrade the lot of the underprivileged not by redistributing wealth but by expanding the pie through rising productivity and profits. This concept was, at least in part, abandoned in the New Deal era. Since that time the Government has attempted albeit in a disorganized manner to regulate business practices and to improve the lot of the have-nots vis-a-vis those who succeed in the market place. A problem is that to date the federal government merely reacts to crises rather than anticipating and avoiding them. The result is a complex of unconnected aid programs to various industries and companies, some of which no longer require such aid. Advocates of economic planning point to the existence of technology with which to plan and avoid governmental waste, as evidenced by the efficient planning mechanisms of large corporations. Indeed, some state that we must acknowledge that other large corporate bodies will plan and intervene, that their interests are explicitly not ours as citizens, and that planning as a mode of political power cannot be denied.

In an effort to mobilize the available expertise, Senators Humphrey and Javits introduced the Balanced Growth and Economic Planning Bill in May 1975. The bill calls for the gathering of economic information so that the President and Congress will have a total picture of the national economy and

[168] Id. at 3.
[170] Polanyi, supra note 169; Smith-Barney, supra note 166; at 3; Silk, Market vs. State, N.Y. Times, Feb. 19, 1975, at 43, col. 2.
[172] The market argument also fails to account for the existence of huge multinational corporate conglomerates, which are far from being regulated by the federal government. Indeed these transnational systems often control government decision-making. Professor John Kenneth Galbraith attributes the success of these huge "technostructures" to their ability to plan. Rather than merely responding to express consumer needs, these multilimbed creatures cajole consumers into new markets and infiltrate government agencies which are authorized to control such markets. In the face of this situation, perhaps planning is the key to more effective governmental intervention. J. Galbraith, Economics and the Public Purpose 92-99 (1973).
areas of crucial concern. Although it specifies no national economic plan, critics call it "a program designed to destroy the free market system and with it our personal liberty." These critics will perhaps be even more vociferous in the face of more specific plans for governmental economic intervention.

III. Government Assistance to Private Business—The So-Called Planning Approach

Financial difficulties encountered by floundering firms and the capital requirements of the dynamic sectors of the American economy have spurred various proposals for direct federal involvement: credit allocation, government financing of business, and loan guarantees. To date, all such suggestions have failed to define a suitable standard to govern the allocation of funds; such decisions have been relegated to ad hoc administrative determination.

A. Credit Allocation

In the absence of government policies to the contrary, the large corporate business sector of the economy has received preferred treatment from financial lending institutions. When credit is tight, funds are channeled into this sector to the exclusion of the sectors of America's dual economy which lack clout, such as housing, agriculture, and small business. These groups, as a rule, also bear the brunt of general monetary policies aimed at deflating the economy, such as the raising of interest rates and tightening of credit availability. In response to this situation, other industrialized nations, including Japan, Italy and Sweden, have established specific borrowing privileges for those sectors which are hardest hit by general credit squeezes.

In fact, rather than merely reestablishing the neutrality of general monetary policy, these nations designed policies which have created preferred sectors in the economy. For example, Sweden has expanded mortgage loans to boost the housing sector, while diverting loans from private business. Italy has encouraged plant construction in its southern regions, and Japan has allocated moneys within the private industrial sector to maximize economic growth. Since national goals vary so widely, it is difficult to predict whether policies adopted abroad would be effective in our national context. Further, some countries take their credit preferences more seriously and make more forceful efforts to dis-

175 Id. § 203; see Case for Planning, supra note 169; New Push, supra note 169, at 21.
176 Wriston, supra note 169, at 3; Schlesinger, supra note 169. See generally F. Hayek, The Road to Serfdom (1944).
177 Staff of the House Comm. on Banking and Currency, 92d Cong., 2d Sess., Report on Foreign Experience With Monetary Policies to Promote Economic and Social Priority Programs 4-6 (Comm. Print 1972) [hereinafter cited as Monetary Policies Report].
179 Id.
180 Monetary Policies Report, supra note 177, at 1-2.
181 Id. at Chs. III-V.
tribute loanable funds than others. Nevertheless, there is a surprising agreement among other Western nations that government should undertake credit preferences. A consensus also exists as to the order of announced preferences: exports, housing, state and local governments (where they exist), underdeveloped regions (where they exist), small business (including agriculture), and large corporate business. Three major techniques exist for achieving neutrality in monetary policies or for creating preferred sectors. These involve: (1) asset reserve requirements, (2) government borrowing in the capital markets and relending to preferred sectors, and (3) competition by government financial institutions for primary savings so that captured funds can be loaned to the preferred sectors.

Under the "asset reserve requirements" approach, governments and central banks place an asset reserve requirement on every financial intermediary such as banks and insurance companies unless a certain percentage is invested in the desired sector. For example, if the national goal were to channel 25 percent of total savings into housing, every financial intermediary might be forced to place in reserve 25 percent of its assets unless it invested that amount in housing. This system has achieved favorable results in Sweden, where a set share of funds goes to housing even in the midst of credit crunches. It is a straightforward form of assistance to specified sectors which does not require the complex regulations involved in U.S. aid to housing, and does not discriminate between smaller and larger savers. Each can receive the same interest returns, since the housing industry is assured of an investment flow. The drawbacks of this system center around value questions. Is it fair to force savers to invest in housing? Is it not fairer to tax everyone to support housing rather than to limit the options of only the savers?

The technique of "government borrowing and relending" was the one adopted in Italy to increase the industrial base in that country's southern region. Italy's version of this instrument includes a very large interest subsidy, as much as five percentage points below market rates to preferred sectors. In addition to lowering the cost of borrowing in the preferred sector, this system gives the government the power to determine exactly what projects are to be undertaken within the preferred sector. Since the government programs offer reduced interest rates, projects vie for government loans and are usually postponed until such loans are available. The result, as critics point out, is that the long-term lending market in Italy is now virtually nationalized. Private lenders cannot compete with the government sector. To date neither industry nor income in the south have caught up with the north in Italy. Such changes take time, however, and depend on more than credit distribution.

Japan created "government savings institutions" to distribute funds to

182 Id. at 178. See also Address by Donald R. Hodgman, Symposium on Credit Allocation, Federal Reserve Bank of Boston, Feb. 10, 1975.
183 MONETARY POLICIES REPORT, supra note 177, at 2.
184 Id. at 11.
185 Id. at 31.
186 Id. at 39.
187 Id.
188 Id. at 49.
preferred sectors. \(^{189}\) Savings in Japan flow into the treasury (of which the Bank of Japan is a part), which relends to financial intermediaries designed to aid various sectors. \(^{190}\) The public intermediaries lend to private intermediaries who relend to prescribed industries and companies. The result of this system is that both private financial intermediaries and private companies are deeply in debt to the government, making the entire economic system extremely sensitive to government directives. Rather than using this system to aid areas of social priority, Japan uses it to maximize economic growth. Considering that it has experienced the fastest growth rate in the industrialized world, Japan’s methods deserve some consideration.

To date, calls for credit allocation in this country have encountered vociferous opposition. \(^{191}\) Opponents of preferential treatment for economic sectors describe the horror of a situation in which the hand of the federal government would be at the jugular vein of our economy. A family’s decision to purchase a home or automobile would be at the mercy of the prevailing federal policy governing credit preferences. \(^{192}\) Perhaps a less emotional and more practical criticism of federal credit allocation is its technical, operational difficulties. \(^{183}\) In order to allocate credit effectively, the allocators’ information must be complete and accurate. There is some question as to whether any single person or committee could collect and master enough information to determine with any acceptable degree of accuracy where and when investment should be made. Further, some critics argue that market economic forces are so strong and human ingenuity so great that no government monetary regulation can be devised which could not be circumvented. \(^{194}\) A corollary to this view is that although monetary markets can be affected by special monetary policies, attempts to circumvent these policies will produce so many unintended and undesired consequences that the costs of such policies would outweigh the benefits. \(^{195}\)

Advocates of credit allocation emphasize that the absence of programs designed to create credit priorities does not mean that credit priorities will not be created. Commercial banks give first priority in their lending activities to the credit needs of their oldest and largest business and industrial customers.

\(^{189}\) Id.
\(^{190}\) Id.
\(^{191}\) Representative Reuss was forced to withdraw a national credit allocation bill which he introduced in early 1975, H.R. 212, 94th Cong., 1st Sess. (1975); see Hearings on H.R. 212 Before the Subcomm. on Domestic Monetary Policy of the House Comm. on Banking, Currency and Housing, 94th Cong., 1st Sess. (1975); N. Y. Times, Feb. 21, 1975, at 39, col. 6; Wall St. J., Feb. 5, 1975, at 20.

Representative Reuss then introduced the Credit Uses Reporting Act of 1975, H.R. 6676, 94th Cong., 1st Sess. (1975), which would require disclosure of uses of commercial bank credit. However, this bill too has encountered staff opposition. See Staff of House Comm. on Banking and Currency, 94th Cong., 1st Sess., Report on Credit Uses Reporting Act of 1975 (Comm. Print 1975); Wall St. J., May 13, 1975, at 6, col. 2.


\(^{193}\) Bucher, supra note 192, at 28-29.

\(^{194}\) Monetary Policies Report, supra note 177, at 3.

\(^{195}\) Id.
Whatever loan funds remain are distributed among other borrowers, with long-term loans occupying the lowest priority in their lending activity. Proponents of credit allocation note that our present system simply has not provided adequate borrowing power to sectors such as housing. Countering the argument that government-allocated credit would impede personal freedom rests the fact that the federal government already attempts to influence borrowing through general monetary policies and specific pressures. The problem is that such policies and regulations are haphazard and fall more harshly on businesses, particularly within the market sector, lacking sufficient internal sources of funds. A general scheme of credit allocation might, under this view, make lending more equitable.

B. Government Financing of Private Business

In the winter of 1974-75, political and business leaders revived the idea of a federal agency to advance funds to business to curb spiraling unemployment. Such an agency could also meet capital shortages faced by American business. Before analyzing such proposals, the two previous federal instrumentalities, the War Finance Corporation and the Reconstruction Finance Corporation, will be discussed.

A great strain was placed upon the banking resources of the United States during World War I by wartime government financing and expanded private industrial activity. To assist banks in furnishing essential credit for private business and to bolster the financial system of the United States, the War Finance Corporation was created in 1918.

The War Finance Corporation (WFC) provided financial support and
credit for key industries essential to the war effort.\textsuperscript{200} The WFC obtained funds to finance its activities from two sources: the Treasury Department subscribed to $500 million in capital stock, and $200 million was raised through a public sale of WFC bonds to individuals and corporations.\textsuperscript{201} Funds advanced were repaid and operations of the WFC produced substantial earnings for the Government.\textsuperscript{202}

The WFC provided credit through three mechanisms:

(1) Making loans for up to five years to commercial banks which had previously extended credit, by loans or the purchase of obligations, to businesses with operations important to the war effort;\textsuperscript{203}

(2) Making advances for up to one year when fully secured to savings institutions (savings banks, savings and loan associations, banking institutions, or trust companies) when deemed necessary for or contributory to the war effort or important for the "public interest."\textsuperscript{204}

(3) Making loans, in exceptional cases, directly to essential businesses otherwise unable to obtain funds on reasonable terms through the usual commercial banking channels. Such advances required a positive recommendation from a federal department or agency directly concerned with an applicant’s operation and adequate collateral security.\textsuperscript{205} During the period from May 1918 to November 1918, applications for funding by the WFC came primarily from public utilities, coal mining companies, and enterprises engaged in the manufacturing of war materials.\textsuperscript{206} After the First World War, the WFC assisted in the financing of the exports of agricultural and other products.\textsuperscript{207}

The Great Depression brought into existence, in 1932, the Reconstruction Finance Corporation (RFC), the most significant involvement to date by the federal government in financing private industry. During the operation of the RFC from 1932 to 1953, the Corporation disbursed over $40 billion to financial institutions and other business entities.\textsuperscript{208} President Hoover, in creating the


\textsuperscript{201} Act of April 5, 1918, ch. 6, §§ 2, 12, 40 Stat. 506. See also Monetary Policies Report, supra note 177, at 2.

\textsuperscript{202} Final Report of the Secretary of the Treasury with Regard to the Liquidation of the War Finance Corporation 19-20 (1943) [hereinafter cited as WFC Liquidation Report]. The magnitude of earnings which exceeded $64 million must be discounted by the cost of the money to the Treasury which supplied the capital to the Corporation. The War Finance Corporation continued in existence until 1929, with final liquidation and abolishment of the Corporation taking place on July 1, 1939. Id. at 20-22.

\textsuperscript{203} Act of April 5, 1918, ch. 6, § 7, 40 Stat. 506.

\textsuperscript{204} Id. § 8.

\textsuperscript{205} Id. § 9.

\textsuperscript{206} With respect to public utility applicants, the directors of the WFC were to satisfy themselves that the facilities afforded by these companies were necessary or contributory to the operation of enterprises directly engaged in the manufacturing or transportation of war essentials. The Corporation, under its war powers, advanced public utilities nearly $39 million. With reference to war essential industrial applicants, the WFC often secured the required funds from other governmental agencies more directly concerned with an applicant’s output. WFC loans to these war essential industries amounted to over $23 million. WFC Liquidation Report, supra note 202, at 8-9.

\textsuperscript{207} Id. at 12-13.

RFC, viewed the agency as a defensive measure to protect the credit machinery of the United States from liquidation should the depression not subside. The RFC was empowered to make loans directly to banks, insurance companies, and other financial institutions. RFC could neither buy equities nor make loans in other business entities. Funds so lent were required to be fully and adequately secured with a maturity not to exceed three years. Although a limitation also existed on the RFC’s ability to make loans to any one institution, allegations of favoritism in the distribution of funds were made, especially after the discovery that a considerable portion of RFC loans to financial institutions had gone to three large banks.

President Roosevelt vastly expanded the powers and financial resources of the RFC. From an original authorization in 1932 to issue $500 million in equity to be purchased by the Department of the Treasury and to borrow $1.5 billion by publicly floating debentures, the RFC eventually borrowed over $54 billion, of which $51 billion came from the Government. In March 1933, the RFC was authorized to invest in preferred stock issued by commercial banks and trust companies. One year later, Congress, in response to complaints that the banking system could not adequately meet the demand for credit, permitted the RFC to make direct loans to business enterprises, apart from financial institutions. Such loans required adequate security and a showing that a banking institution could not provide credit to a firm. Limitations, subsequently modified and lengthened, were imposed on the amount and the maturity dates of loans.

209 See generally A. Schlesinger, Jr., The Coming of the New Deal 427 (1958); A. Schlesinger, Jr., The Crisis of the Old Order 236 (1957) [hereinafter cited as Old Order Crisis]. In February 1932, when the RFC commenced business, the unemployment figure reached 20 percent and total reserves of the member banks of the Federal Reserve System were within $50 million of the lowest amount legally permitted. See J. Jones & E. Angly, Fifty Billion Dollars, My Thirteen Years with the RFC (1951).

210 Act of June 20, 1932, ch. 8, § 5, 47 Stat. 1.
211 Id.; Old Order Crisis, supra note 209, at 238.
212 Act of June 20, 1932, ch. 8, § 2, 47 Stat. 1. See RFC Report, supra note 208, at 33-34; Memorandum, supra note 208, at 5.
213 J. Jones & Angly, supra note 209, at 20. The Emergency Bank Act of March 9, 1933, ch. 7, § 304, 48 Stat. 6, provided that if the Secretary of the Treasury believed a bank needed capital funds he could, upon the approval of the President, request the RFC to subscribe to preferred stock of such bank or make a loan secured by such stock. The Act of March 24, 1933, ch. 4, 48 Stat. 21, limited this power to cases where the preferred stock was nonassessable. See also Final Report on the Reconstruction Finance Corporation, Pursuant to § 6 (c) Reorganization Plan No. 1 of 1957 4 (1959) [hereinafter cited as Reorg. Plan Report]. Beginning in March 1933 and continuing until 1945, the RFC authorized subscriptions for nonassessable preferred stock of $4,202 bank and trust companies. The amount authorized was $859,592,768, of which $782,206,656 was actually disbursed. On December 31, 1945, there remained outstanding $118,317,931 in preferred stock, with $657,578,063 of the original disbursements having been liquidated and $6,310,642 charged off. RFC Report, supra note 208, at 55, 56, 222-23.
214 Act of June 19, 1934, ch. 7, § 5d, 48 Stat. 1108-13. This new section allowed the RFC to make direct loans to any industrial or commercial business established prior to January 1, 1944. Revision of RFC Act, January 31, 1935, significantly altered the 1934 amendment. By eliminating the restriction on loans to businesses established prior to January 1, 1934 and the previous limitation on the amount any corporation could borrow, the maturity deadline was extended to not later than January 31, 1945. Revision of RFC Act, April 13, 1938 expanded the authority under § 5d to include the purchase of securities and obligations of any business enterprise. The security standard was changed from “so secured as reasonably to assure repayment” to “of such sound value, or so secured, as reasonable to assure retirement or repayment.” An Act approved June 25, 1940 extended maturity deadline to January 31, 1955. See Reorg. Plan Report, supra note 213, at 10, 65-66.
The loan policy of the RFC was based on four factors: public benefit derived from a loan, the soundness of a prospective borrower, assistance to small businesses, and participation of other financial institutions. The RFC sought to allocate funds to firms to prevent business failures which would heighten unemployment rates. Stated differently, the RFC looked to whether the granting of a loan would have a favorable impact on the economic life of a community. The RFC, however, generally did not rescue businesses that were on the verge of bankruptcy.\footnote{215}

The RFC placed considerable emphasis on the financial soundness of a business and its future potential as a successful operation. The RFC assessed the inherent soundness of an enterprise and the probability that funds advanced would be repaid. Each loan applicant had to demonstrate that credit was unavailable at usual rates through customary banking channels and that funds sought would promote operating efficiency and financial viability. In making so-called nonbankable loans, the RFC looked at many of the same factors used by commercial banks in analyzing credit risks, including: (1) prospects of future earnings, (2) financial position, (3) collateral requirements, (4) management, (5) business of borrower, (6) purpose of loan, (7) customer relationship, (8) size of borrower, and (9) loan maturity. The RFC construed the concept of credit risk with a more "liberal" eye and made long term loans which commercial banks were unwilling to undertake.\footnote{216}

The RFC emphasized the development of small business enterprises. Almost nine out of 10 loans made by the RFC went to small businesses, as defined by the RFC, and were in an amount of $10,000 or less.\footnote{217}

The RFC also sought to make loans in cooperation with other lending institutions. Involvement of the RFC reassured other lenders, which in turn enabled business entities to tap other sources and reduce the amount of funds advanced by the RFC. Participation, therefore, served to reduce the potential loss exposure faced by the RFC.\footnote{218}

Despite the benefits flowing to businesses from the RFC, increasingly the RFC came under attack for alleged corruption.\footnote{219} Any future government finance operation must require insulation from political interference.

During the winter of 1974-75, a clamor arose in political and business

\footnote{215 RFC, INFORMATION REGARDING LOANS TO BUSINESS ENTERPRISES, CIRCULAR No. 13, at 1 (rev. 1946) [hereinafter cited as LOANS INFORMATION]; Stafford, How the RFC Chooses Borrowers, BANKING, Aug. 1949, at 46, 119.}

\footnote{216 Glover, Industrial Loan Policy of RFC, HARV. BUS. REV., June 1936, at 465-66. See also LOANS INFORMATION, supra note 215, at 2-4.}

\footnote{217 Stafford, supra note 215, at 46; RFC: Haven for Businessmen in Need, U.S. NEWS & WORLD REP., Oct. 21, 1949, at 22.}

\footnote{218 Immediate participation loans, those made in cooperation with financial institutions taking part of the loan disbursed by the RFC, functioned by several means. In most instances the RFC disbursed the entire amount of the loan and immediately sold the agreed-upon portion to the participating financial institution. Deferred participation loans were serviced by the financial institution with an agreement with the RFC under which the RFC agreed to purchase an agreed-upon portion of the outstanding loan upon the request by the lending institution. REORG. PLAN REPORT, supra note 213, at 66-67.}

circles to revive the Reconstruction Finance Corporation. Congressmen introduced bills to establish a federal agency empowered to make loans directly to business concerns unable to obtain funds. Senator Mike Mansfield, Senate Majority Leader, introduced a bill to authorize a new federal corporation to lend money and enter into loan guarantees to business enterprises for any of the following purposes:

(1) to enable a business to finance plant construction, conversion or expansion, or the acquisition of equipment, facilities, machinery, supplies, or materials;

(2) to supply a business with working capital; or to aid a business in the payment of current debts or obligations, if such aid is considered by the board of directors of the federal corporation to be in the public interest.\(^\text{x220}\)

Loans would be made for a period not to exceed 10 years with provision for a limited extension of maturity date, and would require full and adequate security. As a prerequisite for obtaining funds, a business concern would be required to demonstrate that funds were unavailable from other sources on reasonable terms. The Mansfield bill provided that the corporation would be financed by the issuance of $2 billion in stock in the United States Government. The corporation could also issue debt obligations in an amount not to exceed three times its government subscribed capital. The Ford administration has also proposed a $100 billion program for energy projects thought too risky or too vast for funding by private capital markets. This program would establish a new federal corporation which would, among other things, make direct loans to firms and also guarantee private loans.\(^\text{x221}\)


To assist faltering businesses in a time of deepening recession, we urge Congress to revive the Reconstruction Finance Corporation as a means of meeting legitimate credit needs in the private sector.


The new corporation would go out of business after 10 years and would focus on three areas: developing the application of new technologies for the production and transmission of energy, constructing nuclear power plants, and developing other power sources. But see Burnham, Greenspan Asserts Energy Loan Plan Could Have Potential for Corruption, N.Y. Times, Sept. 6, 1975, at 7, col. 1.

Senator Henry Jackson has proposed that the federal government guarantee $6 billion in loans to private companies for the construction and operation of synthetic fuel plants and the speedier development of oil from shale and the conversion of coal into oil and gas. Cowan, Congress Is Asked for Fuel Funding, N.Y. Times, Sept. 26, at 51, col. 1; Gapay, Financing New Energy, Wall St. J., Nov. 6, 1975, at 40, col. 1.
Outside Capitol Hill, businessmen led by Felix G. Rohatyn, a partner in Lazard Freres & Co., have also advocated the creation of a new Reconstruction Finance Corporation. Rohatyn’s proposal contemplated two functions for the agency: (1) lender (or guarantor) of last resort, (2) purchaser of equity instruments in the form of common or preferred stock to facilitate a resolution of financial problems, including ever mounting debt burdens. Rohatyn felt that equity investments would be on a temporary, two- or three-year basis. Henry Kaufman, a partner of Salomon Brothers, has advocated a Federal National Development and Investment Bank for the purpose of supplying new capital, not for bailing out ailing business. To aid the beleaguered utility industry, a Utility Finance Corporation, funded by the United States Government, has been suggested. Such an agency would make direct loans and purchase equity issues.

Proposals for federal financing instrumentalities have received a negative response from several quarters. Defenders of a market financing concept advance two arguments. First, as previously discussed, the present capital market constitutes the best mechanism for allocating funds, and a new agency could not apportion capital better. A public financing corporation, moreover, would reach staggering proportions and encourage inefficiency and poor management, as large numbers of firms would seek assistance. As Senator William Proxmire, Chairman of the Senate Banking Committee, put it, part of the free enterprise system is “the right to fail.” The Government should not be required to bail out mismanaged companies or keep unsound industries going. According to Senator Proxmire, “If a company can’t make it in the market place, my position is that it ought to be allowed to expire. Having something like the RFC is a formula for protecting buggy-whip manufacturers.” Secondly, current financial problems, it is believed, are of a different magnitude than those encountered in the Great Depression. A sufficient number of programs already exist to meet the difficulties experienced by firms. Such programs include the

222 Rohatyn, A New F.F.C. Is Proposed for Business, N.Y. Times, Dec. 1, 1974, § 3, at 12, col. 3. See also An Interview With Felix Rohatyn, FORBES, Feb. 15, 1975, at 46. Rohatyn recommended an initial capitalization of $5 billion in common stock subscribed to by the Treasury, and the authority to issue up to $10 billion in U.S. guaranteed obligations. This could be achieved by a levy of one percent of pretax profits of all enterprises earning over $1 million per annum. The Treasury should be reimbursed in less than five years following this plan. Legislation was also introduced in New York State to create a state-owned bank to fill unmet capital needs of private industry. The Bank of North Dakota, founded in 1919, currently is the only state-owned bank in the United States. Loans to farmers and farm-related industries and housing loans constitute the bulk of funds made available by the Bank of North Dakota. Fowler, State-Held North Dakota Bank Is Under Study As a Model Here, N.Y. Times, Apr. 26, 1975, § C, at 11, col. 5; Harvaez, State-Owned Bank Urged As A Way to Help Economy, N.Y. Times, Apr. 25, 1975, § M, at 35, col. 7; Karp, Hard-nosed Socialism? The Bank of North Dakota Knows How to Make a Buck, BARRON’S, June 2, 1975, at 5; Mathews, The Only Bank of Its Kind, N.Y. Times, Apr. 13, 1975, at 4, col. 4.


227 Kaufman, supra note 223, at 12, col. 2; Mooney, supra note 220.
Small Business Administration, the informal powers of the Federal Reserve Board to put pressure on member banks to keep open lines of credit or advance more funds, and various ad hoc federal loan guarantees. Senator Lloyd Bentsen has proposed an energy development bank to encourage the construction of plants for alternative energy sources. As part of the program the Government would guarantee up to 70 percent of the investment made by private business.

These piecemeal, ad hoc approaches suffer several deficiencies. Such approaches put Congress in the position of being a forum for corporations seeking a bailout. Loan guarantees and other emergency measures may only constitute a temporary palliative. Proponents of a program for credit allocation, use of loan guarantees, or a revival of the RFC must face the challenge of a need for a systematic approach by the federal government to the capital needs and difficulties facing American business. This dilemma and the gathering movement for national economic planning hopefully will produce a more searching scrutiny of the type of industry and firm the federal government should assist and, if help is deemed necessary, the most desirable type of aid. This avenue of inquiry may promote a more searching examination of the entire American economic and social system.

Whether the United States uses an ad hoc or systematic approach, a need exists for standards to determine what industries and firms will receive governmental funds or tax breaks. As preliminary criteria, the following are suggested. First, in a time of high unemployment and underemployment, a need exists to encourage labor-intensive firms and industries. Second, using a cost-benefit analysis, the federal government may discover that it may be cheaper to bail out firms than to allow them to go under, and then support or find jobs for such additional unemployed workers. Third, if the United States is to have con-
continued availability of cheap raw materials, particularly energy, assistance must be forthcoming to secure a strong energy base. Fourth, as the United States increasingly becomes a service economy, those service firms which may also serve sound ecological ends should be encouraged. Fifth, America's great strength in the world trading market lies in technological and other advanced-knowledge industries, such as computers. Assistance might be given to such industries, if necessary to further our world position. Finally, attention should be paid to encouraging innovation throughout the economy. This aim may include aiding small and large business.

Whether government financial assistance will in the end constitute a "back door" means to nationalize firms constitutes another problem. The example offered by the Labor Government in England might point in this direction. In 1975, Prime Minister Wilson led the way to the creation of a new agency, the National Enterprise Board, to implement a plan to promote greater national ownership of industry and to help modernize industry by the purchase of shares, through a variety of means, in unspecified corporations. To date, the Board's


Our economy and the American way of life depend on the existence and the encouragement of thousands of small independent enterprises that grow. That is the yeast of our economy. That provides the competition. That provides the infusion of new ideas and technology and that keeps us alive.

Id. at 169.

However, there are those for whom the nostalgia for a decentralized and competitive America is unrealistic, and for whom large, on-going firms with substantial market power hold the greatest potential for research and innovation. See, e.g., G. Mills, White Collar: The American Middle Class 30-33 (1951); Adams & Dirlan, Big Steel, Invention and Innovation, 80 Q.J. Econ. 167 (1966); Grabowski, The Determinants of Industrial Research and Development: A Study of the Chemical, Drug and Petroleum Industries, 76 J. Pol. Econ. 292 (1968); Scherer, Firm Size, Market Structure, Opportunity, and the Output of Patented Inventions, 55 Am. Econ. Rev. 1122 (1965); cf. B. Mansfield, Industrial Research and Technological Innovation 84 (1968). The latter view has often been attributed to Schumpeter. See E. Schumpeter, Capitalism, Socialism, Democracy, Part II (1942); but this is an area in which Schumpeter's view has been misunderstood. While Schumpeter admired the accomplishments of big business, he did not conclude that bigness is prerequisite to innovation. McNulty, On Firm Size and Innovation in the Schumpeterian System, 8 J. of Econ. Issues 627 (1974). In a recent analysis of the Schumpeterian hypothesis, Professor Paul McNulty suggested that the essential factor on producing innovation and economic growth was not firm size, which was in Schumpeter's words, "a secondary element," but rather the quality and especially the "newness" of the firm's entrepreneurship. So far as market structure is concerned, then, the relevant variable in Schumpeter's view was the condition of entry. According to McNulty, Schumpeter's position was as follows:

Where the entry of significant competitors (in an industry) appears to be impossible, innovation will be slow; when the entry of significant competitors is possible, innovation will be much faster.

Id. at 630.


British Prime Minister Harold Wilson has recently proposed that an analysis be under-
Looking Ahead: Capital Shortages, Etc.

The greatest endeavor is the takeover of British Leyland. Several grounds were proposed as a basis for nationalization of ailing industries, including the threat of investors from a foreign country acquiring control over a firm, or the need to infuse funds into a financially troubled entity that is a source of national prestige. It remains unclear whether the United States, even if it adopted a massive program of financial assistance to business, would use such a plan as a means to nationalize ownership.

IV. Conclusion

Assuming that a policy to encourage growth in the American economy will exist, that corporate capital needs will continue to increase, and that such needs in some industries will not be met through retained earnings, depreciation, or the private capital market, it is recommended that further tax breaks not be used to make available additional funds to business. Utilization of the tax mechanism, as an indirect subsidy to business, obscures knowledge of the cost from public purview.

The federal government possesses both the tools, based in part on the experience of other countries in economic planning and credit allocation, and the financial ability to aid certain industries and firms facing capital shortage or the threat of financial ruin. A rational ordering of priorities, however, must first take place at the executive and legislative levels so that allocation of funds is not left to the unfettered discretion of a federal administrative agency. If the federal government engages in additional borrowing to fund an agency, such action will itself probably squeeze the capital market further, thereby limiting the funds available to other enterprises.

The capital needs of certain crucial industries, like energy, which may be critical to America's future development, should not be left to the vagaries of retained earnings or the capital market. The latter mechanism lacks the ability to assess the social costs or the future consequences of a project; the need for a nonmarket decision should be faced. Implicit in this conclusion taken of key British industries over a 5-year period to identify those firms that are likely to be successful, as well as those that are critical for other industries and the economy in general. The plan is designed to more effectively use government financial assistance to business and to ensure that industry earns sufficient profits. Kilborn, Britain to Stress Industry in Shift of Economic Aim, N.Y. Times, Nov. 6, 1975, at 1, col. 1.

239 British Leyland, England's largest automaker, largest exporter, and biggest private employer (170,000 workers), first sought help from its pressing financial problems in December 1974. At that time then Secretary of Industry, Anthony Wedgewood Benn, announced a multimillion pound rescue operation for British Leyland in return for an unspecified shareholding in the company. In return for an initial 50-million pound lifeline, British Leyland effectively came under government control. The British Leyland board agreed that the Minister of Industry's consent was required for the following: any capital expenditures over one million pounds, any further major borrowings, or the sale of any part of the business. In addition, the Minister of Industry would be consulted concerning any major wage negotiations, dividend payments, and service contracts for directors. See Hillmore, Government Controls Leyland, Manchester Guardian, Mar. 29, 1975, at 4, col. 1; Robards, Britain Planning Leyland Control, N.Y. Times, Apr. 25, 1975, at 45, col. 1; Manchester Guardian, Dec. 14, 1974, at 9, col. 1; Wall St. J., Dec. 9, 1974, at 16, col. 2.
is the assumption that a federal agency making decisions as to allocation of funds can do so free from political influence.240

Finally, in the case of larger firms and more ambitious projects, consideration should be given to advancing funds in the form of equity investments, so that in an inflationary and hopefully expanding economy the Government might benefit from the success of firms so aided, and not receive repayment in depreciated dollars.

All that has been said to this point assumes that the American corporation and the general economy should and will continue to grow.241 Corporate growth, however, may be an addiction: the stronger it gets, the greater the need and dependency. In a few years, the incremental advantages of private capital investment might be exceeded by the disadvantages of environmental destruction, technological unemployment, and economic crises. Like other addictions, growth is at least in part a habit acquired in an attempt to avoid responsibilities and obligations.242

The current economic difficulties, which combine inflation, unemployment, and the specter of resource scarcities, may be viewed as placing a damper on fundamental inquiries. Yet this time of doubt, characterized by the prospect of capital shortages and the plight of failing business, may provide an unparalleled opportunity for a fundamental reexamination of American society, its institutions, and values. This should include further questioning of the mania for growth, the lack of concern for natural resources, and the organizational apparatus in which an increasingly skilled and educated work force must toil.


241 For an analysis of the reasons for continued corporate growth, see J. GALBRAITH, ECONOMICS & THE PUBLIC PURPOSE (1973).