THE New York Stock Exchange

June 12, 1978

Dear Ralph:

It was good to meet you in Bob's office last week. For your information, I am enclosing two copies of a New York Stock Exchange Study on "Public Attitudes Toward Investing." This has just been released and is the most definitive study of its kind in ten years.

Hope our paths will continue to pass as we work on matters of mutual interest.

With best regards,

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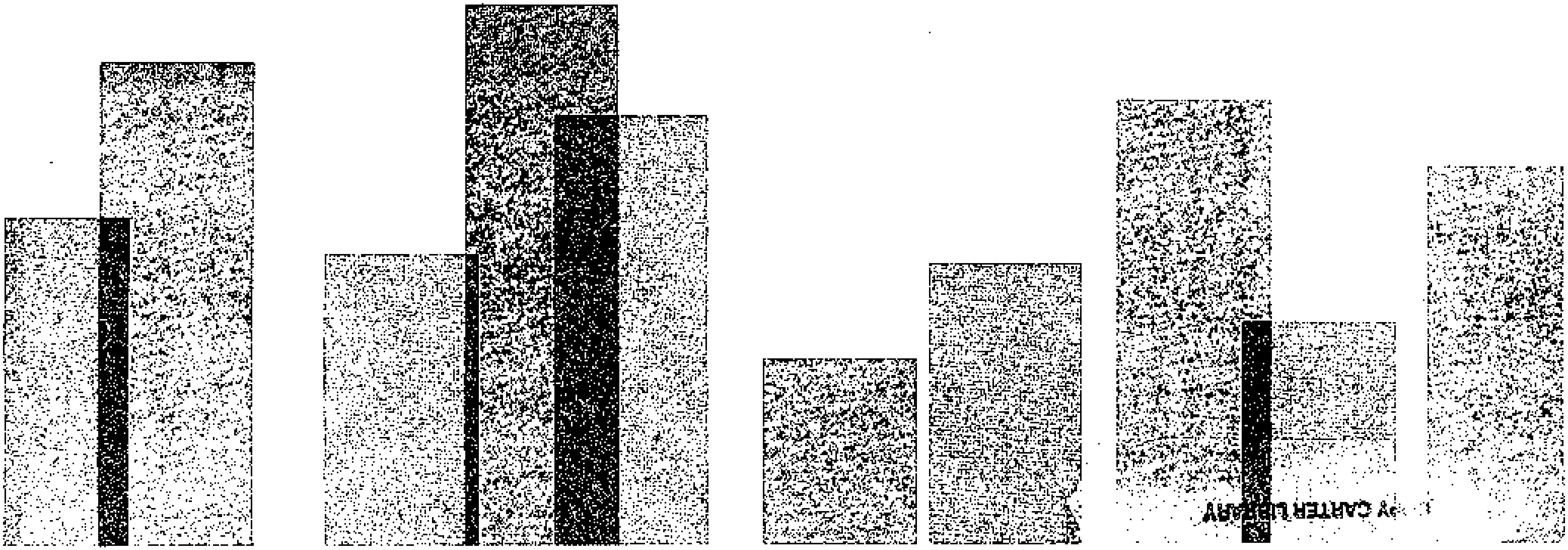
PUBLIC ATTITUDES TOWARD INVESTING

A Report by The New York Stock Exchange
Based on a Nationwide Survey



CAPITAL REQUIREMENTS AND FINANCIAL FLOWS FOR THE AMERICAN ECONOMY, 1978-1990

The Need for A Capital Markets Study

There has not been a comprehensive study in some thirteen years which provides a detailed review and analysis of the prospects for capital supply and demand in the medium term ahead, say the next ten years.

The Capital Markets Study, to be directed by Dr. Lawrence Klein, Benjamin Franklin Professor of Economics at the University of Pennsylvania, assisted by a distinguished Advisory Committee, would offer the opportunity for a comprehensive review and analysis of the future capital needs and the alternative ways of fulfilling those needs. All aspects of the issue would be examined and researched, in an integrated fashion. The data gathered and analyzed and the policy programs offered and discussed could be of significant value in assisting in providing solutions to the problems of financing the nation's future economic expansion.

Policy Options Available Now

The economy appears to be locked into an awkward position of stagflation and the contemporary debate focuses on "either-or" approaches to dealing with inflation as the number-one problem or unemployment/slow growth as the number-one problem. The two are treated as irreconcilable as far as policy is concerned. All too little attention is devoted to consideration of policies that promise to attack both problems together. The problems are difficult, to say the least, and no easy or quick solution is to be found; nevertheless, there are some basic policies that look promising, given enough time for full implementation, and it is in this spirit that the proposed capital market study is being presented. There are grounds for thinking that capital formation lies at the heart of the stagflation issue.

What are the policy options on which the present administration can draw?

1. The economy can be slowed down considerably, even to the point of bringing about increased unemployment. If carried to great enough extremes, this can restrain inflation, but it sacrifices the employment/growth objectives.

2. Repeated tax cuts, like the $25 billion reduction for 1978, can be proposed to keep the recovery alive. Eventually this policy is going to lead to inflationary finance and push the economy against a capacity ceiling without anything having been done to deal with accelerating inflation.

3. The tax system can be used for an incomes policy, by rewarding people and businesses for wage or price restraint. To a large extent, this approach gets more at the symptoms rather than the basic causes of inflation.

4. The same general level of fiscal stimulus being proposed now for 1978 and implied for 1979 can be accompanied by tax reform and other measures to enhance capital formation, leading eventually to rising output with increased productivity—a potent inflation fighter.

There are many reasons why all but the fourth option are not very satisfactory. The first two deal only with one or the other of the two components of stagflation. The administration have declared consistently that they would not fight inflation with unemployment. On the other hand, they have done very little thus far to face up to the inflation issue. The tax programs (TIPS) for wage and price restraint smack of gimickry; they are viewed skeptically or with hostility by large segments of the population, and they are very chancy as far as effectiveness is concerned. They create the suspicion, well founded or not, that they are forerunners of comprehensive direct controls.

The fourth line of approach, the line of this proposed investigation, looks to the stimulus of capital formation to keep the recovery alive in the near term and to raise productivity after capital has been put into place, in the intermediate term. Higher productivity is the key to an anti-inflation program. A shift in the economy towards more emphasis on capital formation is but one aspect, albeit an important one, of raising productivity; others will have to be used as well. It is also a time-consuming process, but the problems are so difficult that it is implausible to assume that they can be fully dealt with in a short period of time.

Captial Needs

It is generally assumed that the American Economy will have significant capital needs throughout the decade of the 1980's, particularly to equip the country to deal with energy, environmental protection, agricultural output, expansion and other issues—some not yet fully recognized. In the 1950's and 1960's, we tended to become a nation of affluent consumers, even wasteful consumers of energy, and now need to face up to a new range of problems by shifting to a higher savings-higher investment economy. It is not easy to achieve such a shift, and the consequences of not doing so are likely to generate continuing inflationary pressure because our capacity to produce economically has been allowed to slip. In the proposed study, it is intended to seek ways of using the tax and other policy instruments of government to realign the economy along a high investment path that has a better chance than our present sense of direction in achieving twin objectives of price stability with full employment.

Two kinds of policy issues must be faced: (1) In the short run (1-3 years), the economy must be under stimulus to complete the cyclic recovery from the April, 1975 low point to get back to full employment. (2) From the point of full cyclical recovery, we should seek to stay on a steady growth path appropriate to a high investment economy. The key to coping adequately with these policy issues is to increase capital formation and productivity. High level capital formation is needed in order to complete the cyclical recovery because investment activity has lagged in this particular cycle. But investment is also needed to keep the economy on a non-inflationary expansion path because, if we resort more to high consumer spending, we are likely to continue lagging in productivity. Investment is a principal means for restoring productivity growth. Without better productivity, we shall not be able to contain inflationary pressures. This is fundamental as an anti-inflationary force. By relying on the supply side of the economy to provide high productivity growth, we are getting at root causes of inflation; this is far better than more superficial approaches that would use tax policy to regulate the wage-price relationship. They deal with the manifestations of inflation more than with the underlying causes.

It has been some time since we have had a thoroughgoing investigation of capital formation in this country; looking simultaneously at both the supply and demand for capital. In the 1950's, there were major studies by Simon Kuznets and Franco Modigliani on the history and contemporary analysis of capital formation. The Commission on Money and Credit in the 1960's looked at many aspects of the capital formation process. There is a need for a new investigation, at the present time, to target on the 1980's, and address the capital formation problem in the light of present circumstances. These circumstances are stagflation, energy shortages, the wider problem of shortages of renewable resources, environmental deterioration, international disequilibrium, and chronic food crises on a world scale.

The Meaning of Capital Formation

Capital formation in this setting means many things. It means attracting flows of savings to finance the necessary expansion; it means inducements to invest by creating the physical capital that will deal with these issues; it means invigoration of equity markets; it means facilitating international transfers of funds from capital surplus to deficit areas. All these aspects and more will be dealt with in the proposed study. The approach will be quantitative and draw upon the research resources of Wharton Econometric Forecasting Associates to carry out the analysis. An appropriate advisory board will be asked to advise, monitor, and criticize the investigation as the work unfolds.

The study design will be structured from two sides—the demand for capital and its supply. On the demand side, the first step will be to identify capital requirements, industry by industry or sector by sector. We shall examine energy requirements in oil, gas, coal, nuclear and other sources, drawing on the Wharton energy model that already has these sources laid out in a combined input-output and final demand model of the economy as a whole. Other industries, many of them heavy energy users, will be analyzed one-by-one to determine their capital requirements. Steel is a case in point. The capital expansion required to bring modernization and world competitive pricing to steel will be examined, and the same kind of analysis will systematically be done for each of the remaining two digit manufacturing industry groups. Several non-manufacturing industries will also be exaimined in the same way.

This first step will lay out capital requirements. Associated with the requirements, there will be capital demand, depending on equity prices, bond prices, interest rates, and the tax system. Tax incentives for capital formation will be particularly scrutinized.

Sources of Capital

To match capital requirements and demand, there will have to be an adequate flow of financial capital. This will come from the following sources:

Personal savings

Foreign investment funds

Internal funds: retained earnings, depreciation, and other capital consumption reserves.

Personal savings. In getting people to appreciate the virtues of thrift more in relation to their present spending plans, we shall look into the motivating factors behind saving. One area is private pension schemes. It can be presumed that people who are covered by good private schemes save more, on balance, than do their counterparts without such pension schemes, in the same income classes. Policy proposals for making private pension schemes more attractive and more widely held will be studied. One such proposal will be for vesting private schemes on a larger scale.

The social security system is in financial trouble and provides inadequate income for full support in retirement years for a large number of middle class income earners. Private pension systems are one source for supplementing their retirement incomes. Another is the use of ESOP's and like systems designed to broaden the base of equity holding to a larger number of households. Expansion of the ESOP system will be another area for study with respect to the flow of personal saving funds. Experiences with workers equity funds, of long standing in Europe, will also be studied.

Low and middle income savers will be the focus of attention in the analysis of retirement systems and ESOP schemes. Higher income groups have a greater stake in the tax treatment of capital gains, as far as their entrance into equity markets and savings patterns are concerned. Capital gains taxation deserves re-examination at this juncture. Re-examination refers to the fact that recent discussions about tax reform have generally aimed at weakening or doing away with preferential treatment of capital gains taxation as part of the personal income tax system. The present study will consider not only the retention of favorable treatment of capital gains, but also of the effects of giving them more favorable treatment.

The reasons for looking into capital gains taxation from the side of favorable treatment are twofold. In order to meet what are expected to be unusually large capital requirements, it will be important to have stimuli for private savings, especially in higher income groups where the marginal savings coefficient is known to be high. Secondly, lighter marginal tax burdens on capital gains income should encourage the provision of risk capital in equity markets. Risk capital will generally be associated with more innovative types of investment. They should all be more oriented towards the equity side of the market because that is where risk capital tends to be financed.

It is difficult to determine the relationship between savings and risk capital motivations to capital gains taxation, but underlying data collections for the proposed study will try to do this from several viewpoints.

There have been significant international differences in the tax treatment of capital gains. These differences will be studied in relation to associated savings and investment flows to see if there is any connection to the motivations being examined in the present study. In addition to international differences, there may be some state/local differences within the United States. These, too, will be examined. Finally, the changes that have occurred in various revisions of the federal tax code in the United States in recent years will also be studied for evidence of underlying statistical relationships of the type being considered here.

Foreign investment. American enterprise has invested abroad on a large scale. For many years, we have been trying to attract foreign investment to the United States in order to relieve pressure on dollar exchange values. At the present time, the U.S. market does seem to be an attractive investment area to foreigners. This attractiveness has kept the dollar exchange rate from being worse than it otherwise would have been, under the pressure of our large ($27 billion) merchandise deficit in 1977. Also, the lower dollar rates have, in themselves, attracted a fair amount of foreign capital.

The large surplus countries or areas are natural sources for which to look for capital imports. These are Germany, Japan, and OPEC countries. This is not to exclude other large possibilities of foreign investment, but these three are very likely cases in present circumstances. The OPEC surplus, in particular, appears to be a permanent fixture on the economic horizon; therefore, it should receive special attention from the point of view of attracting investment funds. In this connection, it may be worthwhile to examine the potential involved in providing specially designed equity instruments for OPEC investors. Special classes of equity issues with voting safeguards with respect to corporate control are to be considered. Depository rights, like those set up for U.S. investors in Japanese companies are an investment medium that might be used for OPEC funds. Whatever the particular form of security that is used, it seems to be evident that there will have to be some pulling of OPEC funds into the U.S. capital market in order to finance our coming investment expansion. A large part of these funds should find their way into equities. This process deserves careful analysis.

Internal corporate funds. A large part of domestic capital formation is financed from corporate savings and additions to depreciation reserves. The sum of retained earnings and capital consumption allowances just about matches the size of nonresidential investment. Retained earnings are obviously affected by tax laws both at the corporate and personal level. Corporate income taxes are a direct charge against profits and, therefore, are not available for investment. As long as personal income taxes are based on favorable treatment for capital gains, companies will be urged by large shareholders to plow back earnings in capital expansion, putting individuals on a capital gains basis rather than a more punitive income basis. It appears, on the surface, that this situation is conducive to a high rate of corporate capital formation. This aspect of capital gains taxation in relation to the supply of internal funds warrants close examination.

In an inflationary economy, depreciation reserves are rarely adequate for purchases of replacement capital. Accelerated depreciation rates for tax accounting provide one means for meeting this situation, but other forms of tax treatment of depreciation need to be looked into as well. The issue is to devise a scheme of tax relief so that reserves are adequate for capital replacement in a rising price market.

The central focus of this study is to be on business fixed capital—needs and financial resources—but capital markets are highly inter-related and do not easily break off into isolated segments. Accordingly, attention will have to be paid to residential construction markets from the joint viewpoints of dwelling unit construction and supplies of mortgage funds. Mortgage money competes with other financial flows; therefore, careful analysis will have to be made of this market even though it may be of only indirect interest in the present context.

Methods of Analysis

The study is to be both quantitative and conceptual. Where possible, statistical measurement of capital flows—sources as well as uses—will be made and used to back up the analytical argument, but all the issues cannot be quantified. Unrealized capital gains, peoples' reactions to them, new tax incentives, and other aspects of the problem, will present new situations in many cases, for which data may not exist. Some of the arguments about taxes involve concepts of justice and equity. These are logical and ethical concepts that must be argued in the abstract. Nevertheless, the study will largely be based on statistical data, legal facts, institutional practices, and historical information. The first part of the investigation will involve preparation of a relevant data bank and classification of factual or institutional information, both domestic and foreign.

Much of the analytical work will, however, be done through the medium of the Wharton Model of the U.S. economy. That system has a detailed inter-industry sector that will be used, as described above, to estimate energy and other capital needs.

Different tax treatment of capital gains, depreciation, investment credits, personal retirement systems, and employee-equity funds will be introduced into the model to examine the economy with impact of the various capital-related issues that are being studied. In cases where personal or business reactions are not known—as with some tax treatments of capital gains—various alternative assumptions about such reactions will be run through the model.

The Wharton model is used in short term analysis for forecasting, but a special version for long term policy analysis is also available, with baseline projections to the end of the century. These long run baseline projections will be used as reference paths for different capital formation scenarios. Many aspects of capital formation require a long time for their effects to be fully worked out. That is why it is important to have a framework for a long view of the American economy in this investigation.

The research group responsible for this investigation will be Wharton Econometric Forecasting Associates centered around a team led by Lawrence R. Klein (Chairman of WEFA). An advisory committee consisting of scholars from academic institutions who are specialists in capital market research, representatives of financial institutions, legal specialists and public agencies, will meet with the WEFA team at regular intervals to monitor and help with the research effort.

The research budget for a year's project is given below.

ANNUAL BUDGET

Project Director (budgeted at one day/week, $400/day)	$20,800
Senior Research Economist, WEFA staff	35,000
Two Research Assistants, WEFA staff	24,000
Secretarial (1/3 time)	3,500
Computing, with programming	10,000
Travel, communication, documents, supplies	3,000
Advisory Committee Meetings (no honoraria)	3,000
Duplicating (including final report)	2,000
	$101,300
WEFA overhead 1.10	111,430
TOTAL	**$212,730**

The Second Phase

The first year of the project has been outlined in the preceding section. It is intended to produce some findings that will be of immediate use in shaping policy, but the previous large scale studies of capital formation have all been long term projects, spanning several years. Given that the initial year's research is satisfactorily concluded, a larger scale effort, building on the first year's achievements, is thus proposed.

The second and third year projects should take up tax reform in greater detail, the industry or sector composition of investment, and the statutory mechanics of such personal savings programs as the vesting of private pensions and the extension of ESOP schemes.

Tax reform has virtually been set aside, in the present debate, in favor of large scale tax reduction. It is proposed in the second phase to reconsider many of the issues that were being discussed in depth during early 1977. These are double taxation of dividends, integration of personal and corporate tax systems, treatment of inflation in a progressive tax system, and the tax treatment of capital gains. In many respects, the present investigation will consider radical departures from the 1977 discussions, e.g., the more favorable rather than less favorable treatment of capital gains. The second phase of the study will focus on legislative action and public attitudes. The latter issues will be approached through the use of sample surveys to ascertain public attitudes to the aspects of tax reform being considered in this study.

At the present time, Wharton Econometric Forecasting Associates are preparing a complete flow-of-funds model for capital markets, showing supply and demand, on a sector basis, for each of many credit market instruments. This system should be workable during 1978 or early 1979. In the second phase of the present study, the flow-of-funds system should have been installed and tested in the Wharton Model. It will then be ready for use in the capital market study, showing the sources of funds by credit market instrument and associated with an estimated market rate for each instrument. It will then be possible to identify more closely the type of financing that will be available for covering capital requirements. It will enable us to estimate, more carefully, equity and debt proportions of capital financing and will provide a medium through which policies to improve the flow of equity capital can be studied by means of simulation analysis.

There are many variations of pension schemes and employee stock ownership proposals. In the second phase, these alternatives will be separately investigated in the hopes of guiding legislation to find improved systems. These alternatives will also be simulated through the extended Wharton Model with the flow-of-funds system.

Staff requirements for the second phase will be larger than in the first. Additional needs will be for a field survey analysis (contracted out to a survey organization), for more detailed simulation studies, for statutory analysis of tax reform, and for use of the extended flow-of-funds model.

ANNUAL INCREMENTAL BUDGETARY REQUIREMENTS (ESTIMATED)

Senior Research Economist, WEFA staff	$35,000
Two Research Assistants, WEFA staff	24,000
Secretarial (2/3 time)	7,000
Computing	20,000
Field work, sample survey	100,000
Travel, communication, documents, supplies	5,000
Duplicating	4,000
	$195,000
WEFA overhead 1.10	214,500
	$409,500
Base annual budget	212,730
TOTAL	**$622,230**