

## 2 TRADITIONAL SYSTEM OF FINANCING NEW CAPITAL FORMATION

That the acquisition of privately owned capital in the United States and throughout the Western world has been financed almost entirely through savings is too well known to deserve documentation. From the early days of industrialization, when these savings were predominantly by individuals, slow changes have taken place in financing techniques in the direction of substituting corporate savings for personal savings in the capital-forming process. The rise of the corporation, the introduction of the personal and corporate income tax systems and the consequent growing importance of depreciation, depletion, and amortization procedures have had their influence in bringing about this shift. So has the growing severity of personal income tax rates, causing corporate shareholders to seek the benefits of accumulation through indirect capital gain (in the market value of stock or other assets) which is taxed at a lower rate, or in some countries not taxed at all. In the United States, the Federal corporate income tax, which is imposed solely

on the earnings due stockholders, has more than cut in half this potential source of personal savings of stockholders.

Perhaps of even greater significance in the trend toward the use of business savings rather than personal savings to finance new capital formation is the almost universal custom of corporation laws of the Western world to give management discretion to use corporate earnings to finance expansion rather than pay them out in dividends to shareholders. So long as personal savings, brought into the corporate system through the sale of newly issued common or preferred stocks, were an important source of funds for capital formation, the necessity of a satisfactory yield to shareholders to encourage them to make further investments acted as a restraining influence on management's tendency to withhold earnings from shareholders. However, the sale of newly issued corporate stock has all but ceased to be an important source of capital funds. Over the ten-year period, 1948-1957, the average annual capital formation by corporations in the United States was 31 billion dollars. Of this, the sale of equity securities for cash averaged 6.2 percent. Common stocks alone accounted on the average during the ten-year period for only 4.6 percent of the total sources of corporate funds.

Yet, it is clear that even this volume would be smaller today if it were not for the stocks of regulated public utility companies which are required by law to use a high proportion of equity financing.

In the year 1958, the sale of corporate stock accounted for 2 billion dollars or 7.2 percent of new capital formation, while 27.5 billion dollars of new capital formation came from internal corporate sources.<sup>4</sup> In the year 1959, the sale of common and preferred stocks together accounted for only 2.5 billion dollars out of aggre-

---

<sup>4</sup> First National City Bank *Newsletter*, August 1959, pp. 91-92.

gate new capital formation by corporations of 47 billion dollars, or 5.3 percent of corporate capital formation. During that year, internal corporate sources, consisting of withheld earnings, depletion allowances, depreciation allowances and amortization allowances, accounted for 30.5 billion dollars of the total, and *future* corporate earnings, necessarily obligated to repay some 13.5 billion dollars in debt incurred to finance new capital formation, provided the remaining sources of corporate funds.<sup>5</sup> In general today, about three-fourths of new capital formation is internally generated by corporations, and most of the remainder consists of borrowing against future internally generated funds.

While corporations account for the dominant portion of the production of wealth in the United States, 219.8 billion dollars out of a total of 402.8 billion dollars in 1959,<sup>6</sup> the dependence of new capital formation upon savings is quite the same for unincorporated businesses. Here, however, the savings are still personal, since individuals directly own such businesses.<sup>7</sup>

The change in the United States over the past forty years from the almost exclusive use of personal savings to finance capital formation to the predominant use of corporate funds for this purpose has its own separate significance quite apart from the fact that, *from the standpoint of individuals*, savings still remain the source of capital formation in our economic system. Disregarding the effect upon the concentration of nominal ownership of capital, all funds of corporations, whether withheld earnings, depreciation, depletion, or amortization allowances, are, *from the standpoint of individual members* of the economy, savings; they are funds invested in instruments of production rather than in goods used for consumption by

---

<sup>5</sup> Economic Report of the President, January 1960, pp. 224, 226.

<sup>6</sup> U.S. Department of Commerce, Office of Business Economics, *Survey of Current Business*, National Income Number, July 1960, p. 14, Table 12. The figures quoted are annual rates for the fourth quarter, seasonally adjusted.

<sup>7</sup> Associations *taxed* as corporations are a technical but unimportant exception.

individuals. Because the corporation is legally regarded as an entity, it is treated as the immediate (though not the ultimate) owner of such savings. But in the end, it is the impact upon the individual members of the economy that is important.

The mechanics of finance, both corporate and non-corporate, which connect the formation of capital to savings are familiar to all of us. The individual uses part of his income to buy corporate stocks, or bonds, or notes, and the corporation, using the funds thus acquired, purchases land, plant, equipment, or employs the funds as working capital. The individual proprietors or partners in small businesses use part of their income to invest in capital goods, or mortgage or pledge assets accumulated through previous savings to provide such funds. Corporations and non-corporate businesses, using their allowances against income taxation, and corporations, using earnings withheld from stockholders, purchase capital assets, etc.

The most spectacular uses of existing capital assets (themselves a product of the use of financial savings to effect capital formation) to bring about new capital formation are to be found in the long-term loans made to corporations. These may be secured by liens upon assets or may be made on the strength of the ownership and wealth-producing power of such assets even though the assets themselves are not technically mortgaged or pledged to secure the loan. These loans may or may not be represented by securities, such as corporate bonds, notes or debentures, and they may be made either by great numbers of individuals who purchase corporate debt securities, or by one or more financial intermediaries such as commercial banks, pension trusts, or insurance companies.

In the latter instances, each of the financial intermediaries (*except commercial banks*) will have served as a collector of the financial savings of individuals for the purpose of investment in capital formation. Our commercial banks, however, do not merely invest a portion of savings and deposits of individuals and businesses in

new capital formation, subject to the retention of necessary reserves. Through the system of central reserve banking, each dollar of time deposit funds and of bank capital funds may support several dollars—on the average about six dollars—of commercial loans. In this instance, pure credit is employed to finance new capital formation.<sup>8</sup>

To the extent that the credit exceeds the reserve required against the loan, and the loan is not secured by a lien on the corporation's assets, capital formation taking place through a bank term loan is not solely dependent upon current or past savings. Perhaps it would be more accurate to say that in the case of such commercial bank loans new capital formation is to a minor extent (*i.e.*, to the extent of the bank's reserve required to be held against such loans) dependent upon, but not limited to, savings. Such loans, however, will be repaid out of future corporate earnings or other internally generated funds, amounting to an involuntary commitment by stockholders of *future savings*. These involuntary future savings by stockholders take place as the wealth produced by the corporation is applied to repayment of the principal and interest on the bank loan.

---

<sup>8</sup> Harold G. Moulton in 1935 pointed out that increased capital formation could come about in spite of a decline in savings through the use of commercial bank credit. See *The Formation of Capital*, p. 107.