Investment Banking

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July 3, 1991

Governor John H. Sununu
The White House
Washington, DC 20500

Dear Governor Sununu,

I am terribly distressed at the petty, nitpicking, unfair beating you are taking from the media. I, along with most well informed people in these United States, feel you are doing a superb job and are in no small way responsible for the President's excellent performance and outstanding popularity rating. Keep up the fabulous job! I am certain that in due course you will be recognized as the great leader and statesman that you are.

In the meantime, I am enclosing for your review a copy of a paper I prepared that I believe offers, if implemented, immediate positive results in getting the American economy moving again and, even more, has the potential to launch the greatest new growth ever achieved, tantamount to a new Industrial Revolution.

Moreover, as you will quickly note, the "targeted" incentives proposed would cost very little in the way of revenues and produce what supply side economics was supposed to (but unfortunately never did)--a significant increase in the tax collections emanating from growth in productivity, capital investment, the explosion of entrepreneurialism, new jobs and the launching of new, profitable, permanently taxpaying businesses.

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I believe this is an idea whose time has come. Because you are one of the very few people with the wisdom and dynamism to help get such a proposal implemented, I hope you share in my belief in its validity and potential dramatic positive impact and in my optimistic enthusiasm for its outstanding success.

With kindest personal regards, I am

Sincerely,

Marty

J. Morton Davis
Chairman of the Board
Member "Team 100"

JMD:kac

P.S. I have also forwarded a copy of the enclosed paper to Vice President Quayle and Michael Boskin as well as to Larry Bathgate.

CAPITALISM WORKS!

"Incentives" Are What Makes It Work

"Targeted" Incentives Are Most Cost Efficient , And Rapidly Produce Desired Objectives

Sponsored By: American Public Priorities Institute

J. Morton Davis

April 1991

The euphoria of the domestic and international equity markets in the first quarter of 1991 masks a crucial weakness--indeed, what a growing number of economists and businesspeople have identified as *the* crucial weakness in the long-term health and competitiveness of the American economy. Despite a level of new equity issues that was the strongest in any quarter since 1986, the simple fact is that small and medium sized businesses are suffering an acute lack of access to financing in any form--debt or equity. America's poor performance in capital formation, particularly for small companies, strikes directly at job creation, innovation, and productivity. In addition to broad policies such as cutting the federal budget deficit, the country needs specific, targeted incentives to create and maintain the productive capital that can insure a sound economic heritage.

On both a broad and a specific level, the U.S. economy *appears* to be performing well. Excluding what now seems to be the brief recession of the past year, we are enjoying the longest peacetime economic expansion since World War II; between 1982 and 1989, the US GNP grew just over 30 percent (compared with 32.8 percent in Japan). The United States remains more productive, on average, than our two largest perceived competitors, Germany and Japan. The stock market has offered respectable real returns over the last five years.

However, the U.S. is falling behind in categories that have kept us the world's strongest and most innovative economy. During the 1980's the rate of increase of productivity of U.S. workers was about half that of Europe, and about a third of that in Japan; from 1980 to 1988 the number of patents issued to U.S. inventors barely increased, while it rose by more than 50 percent overseas. The United States is now the world's largest debtor, and *both* our savings and investment rates badly trail those of our major competitors. In the words of noted Stanford economist John B. Shoven, "we are having a good time, but we are not taking care of ourselves very well." In fact, ample research, including Mr. Shoven's, shows that America is already paying the price for failing to save and invest adequately.

Real weekly earnings in the private non-agricultural sector are the lowest they have been since *thirty years* ago; hourly real wages are below the levels of *twenty years* ago. While there is debate among economists about the length of time it takes for investment to have an effect on real wages, there is little doubt that the chief means for raising the return to work is providing the worker with more tools, physical and intellectual.

SEC Chairman Richard Breeden has identified the unfavorable cost of capital in the U.S. as perhaps the most important problem that we face in keeping America competitive. As support he has cited a Federal Reserve Bank of New York study estimating that the real, after-tax cost of capital during the 1980s in the U.S. was between two an four times as high as the cost of capital in Japan and Germany; in practical terms, this means that a $50 million investment that would increase a company's cash flow by $10 million a year for 10 years would actually *lose* a U.S. company about $9 million dollars, while a Japanese company would *make* a $15 million dollar profit. This helps to explain why U.S. investment in fixed assets, excluding residential housing, was lower as a percentage of Gross Domestic Product (GDP) than in West Germany, Italy, France, and Canada.

The high cost of capital is the result of many factors. The demand for funds, buoyed primarily by the federal budget deficit, is high, and the U.S. savings rate is, of course, low. The Savings and Loan crisis and ill-health of the banking industry is also taking its toll; Chairman Breeden cites the statistic that provisions for losses by FDIC-insured banks (hardly likely to be the source of future productivity) represent almost *40 percent* of total annual U.S. expenditures on non-defense research and development (the area that perhaps promises the greatest positive results for exciting new products and economic growth).

Aside from these economic factors, the public policy environment in the United States is positively hostile to long-term investment commitments. In South Korea, Taiwan, Hong Kong, Singapore, Germany, Italy, Belgium, and the Netherlands, long-term capital gains aren't taxed at all. In Japan, they are taxed at 5 percent. The United States is the only major industrial nation that provides no relief from the double taxation of corporate profits. The public policy preference for debt, given the deductibility of interest payments, is one of the simple and highly questionable facts of financing.

Because of the S & L crisis and the slowdown in bank lending, even this policy preference alone has of course been insufficient to provide financing to companies in the last year. There has been no doubt that a slowdown of credit demand slowed the growth of bank assets in 1990, but more serious than this has been the credit crunch that has most seriously affected small and medium-sized businesses. A Federal Reserve Bank survey conducted nearly every quarter has shown a consistently high percentage of banks reporting tighter credit standards, often highest for middle market and small firms; for the three-month period that ended in January 1991, the Fed reported that more than a third of the 58 banks surveyed had raised credit standards for routine business loans. The Fed found no improvement in this situation in the first quarter of this year. It doesn't take statistics, however, to know what so many involved with small and medium sized firms knows by anecdote and experience; bank lending to these companies has been sharply curtailed. If this is the situation for *existing* firms, there is almost a complete lack of funds for the start-up companies that can immediately add growth in jobs and innovation, to America's economy.

An MIT study has conclusively established that most new jobs and new products have been developed by small, emerging companies, far out of proportion to the dollar investment made, and furthermore, major companies have had a significant net decrease in job formation for a number of years. The importance of these emerging companies for the American economy can hardly be exaggerated; one estimate is that more than a third of America's workers are employed by businesses with fewer than 100 employees. It is not only in employment that small companies are important; they are the testing and proving grounds for new ideas and technologies that, aside from the sheer size of our market, has been America's greatest economic strength. These companies are not receiving the kind of investment they need to succeed.

In all of 1990, according to Securities Data Co., the number of new issues of equity

(211) was the lowest since the recession of 1982, while the dollar volume ($10.2 billion) was the lowest since 1985. Again, it was not young or emerging companies that received this capital--the vast majority of the funds went to either closed-end municipal bond funds, country funds (backing Europe's growth instead of America's), or the separation of large, usually energy and mineral, companies from their parents. The improved market in the first quarter of 1991 is also not doing as well for small or emerging growth companies as the figures would indicate; while the smaller-capitalization stocks on the Over-the-Counter (OTC) market have soared impressively, a fundamental factor behind the initial public offerings and the secondary common stock issues in the markets recently has been the substitution of equity for debt by such large companies as RJR Nabisco Holdings, Duracell International, and Safeway. This does little to encourage new investment in equipment or research, although, perhaps, the substitution of patient for impatient capital might slow the rate of layoffs and firings.

Venture capital provided some of this patient money for emerging company growth in the 1980's, but that, too, has virtually disappeared. By late 1989 the trend for venture capitalists to invest larger amounts in more mature, "second stage" companies, closer to going to the public equity markets, had been noted. A part of this trend has been a need for a larger amount of capital for new companies traditionally in the venture capital league. A study by Coopers and Lybrand, the American Electronics Association, and the National Venture Capital Association shows that the amount of risk capital needed to start a new technology firm is rising, and that technology companies are turning more and more to foreign investors. Publicly reported Japanese minority investments in small industrial U.S. companies (those with under $100 million in sales) rose 82% between 1988 and 1989, according to the consulting firm Venture Economics.

While the dollar level of that investment seems small, at $320 million, the trend is very important; many of these firms failed to raise money from U.S. investors, from whom the return would have to be much larger to compensate them for the risk and, more importantly, the capital cost.

To return to economist John Shoven's analogy, what must America do to take care of itself? Two of the main factors would be a reduction in the federal budget deficit and incentives for savings, and increasing incentives for investment. Many policies have been prescribed, and unfortunately some of them have been either too broad or misperceived. A capital gains tax cut is an easy issue for many businesspeople and financiers to support, because the clear effect of the cuts in 1978 and 1981 was a flood of capital in the securities and venture capital markets. But many people, spurred by Mr. Kevin Phillips' work, perceive wealthy individuals as receiving a hugely disproportionate slice of the benefits from that period, and there are many legitimate questions about the long run benefits of that period. The 1986 Tax Act, noted for its aim of treating all income equal, retained the biases toward debt financing, the double taxation of corporate profits, and even some preference for real estate investment by individual investors in the form of tax deductibility of mortgage payments for second homes. There have been a few steps taken to encourage small company capital formation; on a state level, the Small Corporate Offerings Registration (SCOR) has attempted to make it easier for companies to comply with state regulations, and, of course, on a national level, President Bush proposed an annual 25% tax deduction for up to $50,000 of investment per individual in small companies. This was a compromise that seemed to please few; venture capitalists called it inadequate, and others called it a move to "open the doors wide to extensive tax sheltering by wealthy investors."

Almost everyone can agree that capitalism's unparalleled success is due to incentives. The broad incentives supplied by the capital gains tax cuts across the board may not result in the specific goal of increasing capital formation in the most productive and forward-looking sector of our economy--emerging growth businesses. Targeted, effective incentives that would not be open to abuse or excess must be implemented for America's long term growth in investment and productivity--and for growth in real hourly and weekly wages for American workers.

While increasing the incentives for individuals to save is an important goal, this paper proposes to focus on specific incentives to invest in small companies in ways that might be politically feasible, or at least not perceived by Americans as benefitting wealthy investors. Many incentives have been proposed, including tax treatment of company investments in plant and equipment, research and development and so forth. While many of these are worthwhile, two *targeted* incentives that aid companies in forming strong balance sheets will provide them directly with the patient funds necessary to create new jobs, new technologies, new cures.

1. ***No Capital Gains Taxes For Investments In Small Companies when the Proceeds Are Reinvested in Small Companies Within Six Months.*** Investments in real estate (in the form of family homes) already receive a similar treatment. Investment in American entrepreneurial activities deserves at least as much consideration. The definition of small companies could be conventions such as number of employees (under 100), or level of equity (under $50 million) or sales (under $200 million); perhaps crafting definitions that would encompass initial public offerings or startups would be suitable. In order to insure the productive use of such investments, the companies could exclude those whose principal activity is managing real estate and investments, or financial businesses. This would mean that the incentives would apply directly

to investors in companies, whether by private placement or public offering. A further restriction that might be considered would be limiting this incentive to the initial public offering or placement of an emerging business, rather than to secondary market offerings.

As opposed to across-the-board capital gains tax cuts, which are certainly perceived by the public and some key members of Congress as benefitting the rich, targeting small businesses has good public relations value. More importantly, the benefits of rapid employment and investment begin almost the very next day! New jobs are created, new capital equipment is purchased, and new products are being researched and developed that might very well impact our lives and those of our children and grandchildren. This is true capitalism!

Also, because this proposal would be limited to only small companies, it would be far less costly to the federal budget than across-the-board cuts. The income taxes generated by job creation and capital equipment purchases, and ultimately tax paid by these emergent companies, combined with relief from federal and state unemployment costs, would far exceed any lost revenues.

2. ***The Ability to Deduct Actual Losses From Investments in Small Companies From Any Form Of Income, Earned Or Investment.*** The inherent risk in small company investment could be alleviated in the form of a deduction for loss years. The most practical way to monitor this and avoid any abuse would be to restrict it to publicly traded companies, perhaps again placing a limit on the time in which such a deduction would be available (for example, within ten years of a company's incorporation.) Again, the incentives would exclude real estate and purely financial businesses.

These proposals would without a doubt provide the kind of incentives for capital formation in the most effective sector of America's economy, immediately and in the future, giving the economy the means to have a splendid time while looking after its long-term interests and strengths as well. These proposals offer a clear, simple, and non-bureaucratic approach to an explosive growth in "new capitalism". They would launch new entrepreneurial ventures perhaps tantamount in its ultimate scope to that achieved during the phenomenal expansion of the American Industrial Revolution.